

THE JUDICIAL ACCESS BARRIERS TO REMEDIES FOR SECURITIES FRAUD

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I

INTRODUCTION

Congress has created a mechanism through which victims of securities fraud may pursue remedies for their losses against perpetrators. That mechanism includes the substantive prohibitions of the federal securities laws as well as the procedural pathways established by the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Federal Rules of Civil Procedure and Evidence. Some federal courts have modified this mechanism by creating access barriers to remedies for securities fraud victims at the pleading, class-certification, and summary-judgment stages. In this article, we delineate those access barriers and question both their constitutionality and wisdom.

II

REWRITING RULES AND STATUTES TO CRAFT PRE-TRIAL ACCESS BARRIERS

In some federal jurisdictions, the requirements of the PSLRA and the Federal Rules of Civil Procedure and Evidence have been rewritten by the courts to erect merits barriers at three key pre-trial litigation stages that force plaintiffs to prove their case to a judge, often without the benefit of discovery, before they can reach a jury.

A. Pleading Scienter to Survive a Motion to Dismiss

Some federal courts have redesigned the pleading standard under the PSLRA and the federal rules to steeply discount allegations of scienter that are based on circumstantial evidence. Under the PSLRA, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with

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the required state of mind.”¹ The required state of mind is scienter—that is, “intent to deceive, manipulate, or defraud.”² Federal courts have also determined that recklessness is sufficient to establish scienter in actions for securities fraud.³ In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court interpreted “strong inference” to mean that a securities fraud complaint will survive dismissal only if “a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”⁴ The Court later reaffirmed that the scienter standard “requires courts to take into account plausible opposing inferences.”⁵ Although *Tellabs*’s weighing process may have reasonably interpreted the PSLRA, the Court’s standard leaves room for courts considering a motion to dismiss to discount the kind of circumstantial evidence of scienter that would otherwise be sufficient to meet the plaintiff’s burden of proof at trial.

Circumstantial evidence gives rise to two equally plausible inferences. In contrast, direct evidence is evidence from which there is only one plausible inference. Direct evidence of a defendant’s mental state is rare because it is usually limited to an actual admission by the defendant under oath or the testimony of a witness based upon personal knowledge. Thus, before *Tellabs*, circumstantial evidence of scienter was commonly pleaded and accepted by alleging that the defendant had a motive and an opportunity to engage in fraud, and had access to information that discussed the fraud or concerned the company’s core operations.⁶ *Tellabs* did not eliminate the use of circumstantial evidence in pleading, but rather held that when two inferences are equally plausible, the tie goes to the plaintiff.⁷ And circumstantial evidence is still accepted both explicitly and in application by several federal courts.⁸

Nonetheless, since *Tellabs*, some federal courts have erroneously steeply discounted circumstantial evidence of scienter.⁹ Even though the federal courts

1. 15 U.S.C.A. § 78u-4(b)(2) (Supp. 2011).

2. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The PSLRA heightened Rule 8(a) and Rule 9(b), which together make clear that plaintiffs do not have to plead a defendant’s mental state in a fraud claim with particularity. *See* FED R. CIV. P. 8(a), 9(b).

3. *See, e.g., Konkol v. Diebold, Inc.*, 590 F.3d 390, 396 (6th Cir. 2009).

4. 551 U.S. 308, 324 (2007). The Court set out to resolve whether and to what extent district judges should consider non-culpable inferences when ruling on a motion to dismiss. *Id.* at 309.

5. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1324–25 (2011) (internal quotation marks omitted).

6. *See* J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 1.05[4][e] (2010).

7. *Tellabs*, 551 U.S. at 324.

8. *See, e.g., Makor Issues & Rights, Ltd. v. Tellabs Inc. (Tellabs II)*, 513 F.3d 702, 709–12 (7th Cir. 2008) (determining that material misrepresentations by company’s top executives regarding flagship products with corroborating allegations based on twenty-seven confidential witnesses in positions likely to have access to pleaded information created strong inference of scienter).

9. At least one court has rejected circumstantial evidence entirely, requiring direct evidence of state of mind. In an unpublished, nonprecedential decision, the Eleventh Circuit made explicit what is implicit in many cases—a complaint that fails to allege direct evidence of scienter provides district courts room to steeply discount allegations of scienter based on circumstantial evidence and will be

have said that allegations of circumstantial evidence are sufficient to create a “strong inference” of scienter and even reiterated that mere recklessness is enough to satisfy the pleading standard, some courts in their application have found that the inference of scienter is *less* likely than virtually any other non-culpable mental state, even including negligence,¹⁰ ignorance,¹¹ motive to improve the business,¹² and belief that undisclosed information was not material.¹³ For example, in *Konkol v. Diebold, Inc.*, the Sixth Circuit said circumstantial evidence of recklessness was enough, but then found that circumstantial allegations, including that defendants had access to and used reports with non-disclosed information, engaged in insider sales, and that a confidential witness would testify to their knowledge, were not enough to make the inference of scienter at least as likely as an inference that the defendants engaged in honest activity.¹⁴ Instead, the court required “specific facts” that

dismissed. In *Durgin v. Mon*, 415 F. App'x 161 (11th Cir. 2011) (*per curiam*), the plaintiffs alleged that the defendants knew that representations regarding certain loans were with recourse (as opposed to nonrecourse) because the loans made up seventy percent of the company's net worth and because the defendants signed guarantees. *Id.* at 166. But the Eleventh Circuit held that the inference of scienter was not as compelling as an inference that the defendants acted with inexcusable neglect. *Id.* at 167. The court wanted the plaintiffs to allege direct evidence of fraud, for example, that the defendants had told someone that the loan was not “non-recourse.” *Id.* at 165. As we show, however, discounting circumstantial evidence (or prohibiting it entirely) is improper.

10. See *Dronsejko v. Grant Thornton*, 632 F.3d 658, 667, 670 (10th Cir. 2011) (determining it was more plausible that auditor was negligent than deliberately reckless when it certified as “probable collectability” a collection rate that was barely over fifty percent); *In re Ceridian Corp.*, Sec. Litig., 542 F.3d 240, 248–49 (8th Cir. 2008); *Local 295/Local 851 IBT Employer Grp. Pension Trust & Welfare Fund v. Fifth Third Bancorp.*, 731 F. Supp. 2d 689, 727–28 (S.D. Ohio 2010).

11. See *Glazer Capital Mgmt., LLP v. Magistri*, 549 F.3d 736, 746–47 (9th Cir. 2008) (deciding it was more plausible that CEO was unaware of bribes paid by the company's foreign sales agent even though the company was small and had limited foreign customers and products, because by its nature bribery is “surreptitious”).

12. See *Metzler Inv. GMBH v. Corinthian Coll., Inc.*, 540 F.3d 1049, 1069 (9th Cir. 2008) (concluding it was more plausible that CFO's statement that admission counselors were “gray area” was a general exhortation to improve business rather than a “winking” suggestion to admit unqualified students).

13. See *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp.*, 632 F.3d 751, 758–59 (1st Cir. 2011) (determining it was plausible that even if executives knew about a regulatory change in a foreign market, they may not have considered it significant, even though the regulatory change happened in a market that accounted for ten percent of total foreign sales). A related inference is that the defendants knew circumstances were bad, but did not think they were so bad that their concealment constituted fraud, as in *Slayton v. American Express Co.*, 604 F.3d 758, 775–76 (2d Cir. 2010), in which the court said that it was more plausible that defendants did not know of the *extent* of the deterioration in a high-yield portfolio. Whether this is a legitimate competing inference is in doubt after *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), in which the Court concluded that the inference that executives knew about adverse drug reports but did not think they were statistically significant was at least as likely as the inference of scienter. *Id.* at 1324–25.

14. 590 F.3d 390, 397–404 (6th Cir. 2009). The plaintiffs sued Diebold, Inc., a manufacturer of voting machines and ATMs, and its executives alleging that they (1) inflated revenue by booking revenue from sales of voting machines to municipalities that the company knew would not satisfy government regulations; (2) sent phony invoices to customers to inflate revenue; and (3) bundled service contracts with other products and prematurely recognized revenue from the service contracts. *Id.* at 395. To allege scienter, the plaintiffs alleged that the defendants had access to detailed financial reports and real-time accounting information that disclosed the fraud, attended high-level accounting

defendants had knowledge of the fraud, and steeply discounted the confidential witness statement of this knowledge.¹⁵ Similarly, in *Matrix Capital Management Fund, LP v. BearingPoint, Inc.*, the court of appeals began by stating that recklessness was sufficient to establish scienter, but then refused to allow a jury to infer it from circumstantial evidence including red flags and even an admission that the environment was conducive to fraud.¹⁶

The federal courts have compounded their erroneous discounting of circumstantial evidence in two ways. First, there is a growing trend of discounting allegations that are based on confidential witness statements.¹⁷ Plaintiffs often rely on confidential witnesses to try to satisfy the rigorous pleading demands of the PSLRA¹⁸—these witnesses can often provide accounts of what top executives knew. Yet, the federal courts have used *Tellabs* to undermine the availability of these witness accounts. For example, in *Zucco Partners, LLC v. Digimarc Corp.*, the court discounted six confidential witnesses and said the complaint lacked “specific admissions from top executives.”¹⁹ No substantive area of law requires plaintiffs to disclose their

meetings, that confidential witnesses said the executives knew what was going on, that five of these executives sold nearly 40,000 shares in the two weeks after the company inflated its earnings to an all-time high, that SEC and DOJ were investigating the company for accounting violations, and that a memorandum from outside counsel told executives that their voting machines would not comply with government regulations. *Id.* at 397–403. The Sixth Circuit said many of these allegations were too conclusory or not particularized enough to raise an inference of scienter. *Id.* at 404.

15. *Id.* at 398–99.

16. 576 F.3d 172, 181, 183, 187–90 (4th Cir. 2009). The plaintiffs sued BearingPoint (a management and technology consulting company), its former president, and its CFO, alleging that they misstated the company’s revenue, earnings per share, net income, and good will. *Id.* at 176–80. According to the plaintiffs, the company acquired foreign consulting businesses but lacked the internal controls needed to get these firms to adhere to accepted accounting practices. *Id.* at 177. Yet the company continued to express confidence in the reliability of its accounting and claimed in public reports that the company had resolved material accounting issues. *Id.* at 177–79. Eventually, the company announced that it had overstated its income by over \$90 million, was taking a good will write down of over \$150 million, and filed for Chapter 11 bankruptcy. *Id.* at 176, 178–80. To allege that the defendants knowingly and recklessly issued false financial statements, the plaintiffs alleged that (1) the company later admitted its management was incompetent and that it had an environment conducive to accounting fraud; (2) red flags alerted the executives to the accounting improprieties, including that an employee spoke with one of the defendants about the serious problems with internal controls; and (3) that an internal report from a consultant said that every contract he reviewed improperly recognized revenue in some way. *Id.* at 183–85. The court held that it was more plausible that the executives were overwhelmed, negligent, and had not intentionally created an environment conducive to accounting fraud. *Id.* at 183, 187–89.

17. See Michael J. Kaufman & John M. Wunderlich, *Congress, the Supreme Court and the Proper Role of Confidential Informants in Securities Fraud Litigation*, 36 SEC. REG. L.J. 345, 351–57 (2008); Gideon Mark, *Confidential Witnesses in Securities Litigation*, 36 J. CORP. L. 551, 566–67 (2011).

18. See Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, 1832 PLI/Corp. 413, 518 (2010); Harold S. Bloomenthal & Samuel Wolff, *Pleading Information and Belief After the PSLRA*, in SECURITIES & FEDERAL CORPORATE LAW § 16:101 (2d ed. 2010); Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 551, 556 (2007).

19. 552 F.3d 981, 996–1000 (9th Cir. 2009). The plaintiffs alleged that the defendants capitalized internal-software-development expenses (payroll and ordinary expenses) that should have been expensed, which caused the company to look more profitable than it really was. *Id.* at 987–88. To show that the company and its executives knowingly and recklessly overestimated earnings, the plaintiffs

sources in a complaint,²⁰ but when plaintiffs refuse to disclose their sources, federal courts believe this anonymity frustrates the weighing process demanded by *Tellabs*. The use of confidential witnesses is further undermined when courts also discount confidential witnesses as being incredible. One appellate court assumed that confidential witnesses are incredible,²¹ and another court even allowed defendants to depose confidential witnesses on a motion to dismiss to make sure the sources supported the allegations in the complaint.²²

The second way that the erroneous discounting of circumstantial evidence is compounded is that, in conducting the weighing process, the federal courts do not even analyze evidence. To the contrary, what is weighed at the pleading stage is a complaint's allegations, which are not taken as true, against arguments in a defendant's briefs or briefs filed by amici.

B. Proving Reliance and Loss Causation by a Preponderance of the Evidence at Class Certification

By aggregating small claims, the class action remedies the practical impediment posed by a widespread, de minimis harm. Securities fraud claims are uniquely suited to class actions because investors often suffer damages that are small relative to the expense of litigation. The courts have rewritten Federal Rule 23 to require plaintiffs to prove to a judge the merits of the elements of reliance and loss causation by a preponderance of the evidence to obtain class certification, a burden at least equal to their burden of proof at trial.

Class certification for a securities fraud claim is governed by Rule 23 and the PSLRA. To warrant class treatment, Rule 23 requires commonality of issues, adequacy of representation, numerosity of proposed class members, and

alleged that six confidential witnesses claimed that the CFO eliminated internal controls that prevented improperly capitalizing expenses, that the President instructed employees to capitalize payroll expenses, and that numerous employees complained about improper accounting. *Id.* at 992–95. The court said that these allegations were not particularized and were insufficient to overcome the inference that the defendants had not acted with scienter. *Id.* at 999–1000.

20. The PSLRA does not require plaintiffs to disclose anonymous sources. *See Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000) (“[E]ven if [confidential] personal sources must be identified, there is no requirement they be named, provided that they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.”).

21. *Higginbotham v. Baxter Int’l Inc.*, 495 F.3d 753, 757 (7th Cir. 2007).

22. *Campo v. Sears Holding, Corp.*, 635 F. Supp. 2d 323, 330 (S.D.N.Y. 2009). The plaintiffs relied on confidential witnesses to allege scienter with particularity. *Id.* at 329. The district court ordered that the *defendants* depose the confidential witnesses, and then the court, when ruling on the motion to dismiss, considered only those allegations that were corroborated by later deposition. *Id.* at 330. The court ordered these depositions “for the limited purpose of determining whether the confidential witnesses acknowledged the statements attributable to them in the complaint,” and to ensure the plaintiff’s attorney’s compliance with Rule 11. *Campo v. Sears Holding, Corp.*, 371 F. App’x 212, 216 n.4 (2d Cir. 2010) (unpublished decision). The Second Circuit endorsed this approach on appeal because, according to the court, anonymity frustrates *Tellabs*’s weighing process. *Id.* This approach not only violates the PSLRA’s stay of discovery, 15 U.S.C.A. § 78u-4(b)(3)(B) (Supp. 2011), but also the federal rules’ requirement that courts refrain from considering material beyond the pleadings on a motion to dismiss, FED. R. CIV. P. 12(d).

typicality of the lead plaintiff's claim.²³ If the class is an "opt out" class, then common questions of law and fact must predominate over individualized questions and a class action must be superior to alternative methods of adjudication.²⁴ The PSLRA imposes additional procedural requirements regarding notice and the selection of a lead plaintiff, but otherwise does not require increased scrutiny at class certification.²⁵

The inquiry under Rule 23 is a procedural one: are the questions raised by the litigation more efficiently addressed on a class rather than on an individual basis? The Supreme Court understood that under Rule 23 the inquiry was procedural and judges should not conduct an inquiry into the merits, explaining in *Eisen v. Carlilse & Jacqueline* that neither the language nor the history of Rule 23 allowed a court "to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."²⁶ Addressing the merits before trial, the Court observed, would prejudice defendants: plaintiffs could get a ruling on the merits of their class claim before a decision on whether they were entitled to bring the claim as a class action at all, and defendants would have to litigate this merit decision without the traditional rules and protections afforded at trial.²⁷ At minimum, the Court said, a preliminary judgment on the merits would "color the subsequent proceedings."²⁸ The Court adhered to its prohibition on merits inquiries on a Rule 23 motion even in *General Telephone Co. of the Southwest v. Falcon*, where the Court held that courts should conduct a "rigorous analysis" into whether the Rule 23 requirements were met.²⁹ Notably, the Court did not require a searching inquiry in every case into the merits, but only if allegations

23. FED. R. CIV. P. 23(a).

24. *Id.* 23(b)(3). Class actions pursuing monetary damages are usually "opt-out" class actions in which a class member can leave the class. See David Betson & Jay Tidmarsh, *Optimal Class Size, Opt-Out Rights, and "Indivisible" Remedies*, 79 GEO. WASH. L. REV. 542, 542-43 (2011).

25. 15 U.S.C.A. § 78u-4(a)(2)-(3), (7) (Supp. 2011); see Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 348-50 (2010) (noting the absence of heightened certification standards while surveying the PSLRA's changes to class action procedure).

26. 417 U.S. 156, 177 (1974). *Eisen* questioned which party ought to bear the cost of notice. The district court held that defendants had to pay if the plaintiff could show a strong likelihood of success on the merits. To determine which party should bear the cost of notice, the court assumed that Rule 23 allowed it to make a preliminary judgments on the merits. The Court, however, said courts should refrain from an assessment of the merits on class certification.

27. *Id.* at 177-78.

28. *Id.*

29. 457 U.S. 147, 161 (1982). The "rigorous analysis" formulation says nothing at all about how much the plaintiffs must show or prove. When the *Falcon* Court referred to a 'rigorous analysis,' it was responding to a line of precedent that liberally allowed across-the-board class actions in employment discrimination cases without seriously attending to Rule 23's requirements. But as long as a judge applies Rule 23 carefully, it is not apparent why a 'rigorous analysis' necessarily requires [the judge] to look beyond the pleadings to assess 23(a)(2).

Robert G. Bone, *Sorting Through the Certification Muddle*, 63 VAND. L. REV. EN BANC 105, 111 (2010).

on the face of the complaint were insufficiently precise.³⁰

Recently, in *Wal-Mart Stores, Inc. v. Dukes*, the Supreme Court rejected this interpretation of *Eisen* and *Falcon*, saying that Rule 23 is not “a mere pleading standard” and that a rigorous analysis that overlaps with the merits of the claim cannot be helped.³¹ To interpret these cases any other way, the Court said, was a mistake.³² Ultimately, the Court held that plaintiffs must prove a common injury to satisfy Rule 23’s requirement of commonality and enable a judge to certify a common class.³³

Even though *Wal-Mart* requires plaintiffs to prove a common injury to enable class certification, the extent of this holding for securities class actions is unclear, particularly in light of the Court’s traditional appreciation for the important role of class actions in providing effective remedies for defrauded investors and in maintaining the integrity of the securities markets. The Court has interpreted substantive elements of securities fraud claims in ways that facilitate class actions. For example, the Court adopted an objective approach to materiality to make class-wide adjudication possible³⁴ and presumptions of reliance—the most important of which is the fraud-on-the-market theory—to facilitate a determination that common issues predominate.³⁵ Under *Basic, Inc.* and the fraud-on-the-market theory, district judges can infer that class members are not victims of separate wrongs because misrepresentations on an efficient market support a legal inference of a single wrong.³⁶ The *Basic, Inc.* presumption rests partly on the efficient market hypothesis, which posits that in an open and well-developed market, prices for a security incorporate public information, that is, public misstatements.³⁷ Under this theory, if the fraud is publicly disseminated and the stock trades on an efficient market, the fraud is impounded in the price and investors are presumed to rely upon it. *Basic, Inc.* further clarified the effect of this presumption on class certification, specifying in a footnote that the presumption was rebuttable *at trial*.³⁸

30. *Falcon*, 457 U.S. at 160.

31. 131 S. Ct. 2541, 2551 (2011).

32. *Id.* at 2552 n.6.

33. *Id.* at 2551–52.

34. *See TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 445–46 (1976) (adopting objective test for materiality).

35. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (presuming reliance in an efficient secondary market); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1972) (presuming reliance when fraud by omission is alleged); *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 384–85 (1970) (presuming reliance for claims under Rule 14a-98).

36. *See Basic, Inc.*, 485 U.S. at 247.

37. JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION: CASES & MATERIALS* 213–14 (10th ed. 2007). The fraud-on-the-market theory rests only partly on the efficient market hypothesis because to suggest that all investors rely on just the price would be absurd as it would ignore the significant number of other investors who rely on brokers or advisers. Donald C. Langevoort, *Basic At Twenty: Rethinking Fraud On the Market*, 2009 WIS. L. REV. 151, 158–59 (2009). The presumption is rather a matter of “juristic grace,” presuming reliance because investors *should* be able to rely on the integrity of the stock price. *Id.* at 160–61.

38. *Basic, Inc.*, 485 U.S. at 249 n.29; *see also In re Micron Techs., Inc. Sec. Litig.*, 247 F.R.D. 627,

Despite the judiciary's earlier commitment to facilitating class-wide resolution of securities fraud claims, some courts have rewritten Rule 23 to require plaintiffs to prove reliance and loss causation.

1. Proving Reliance

Some federal courts require plaintiffs to prove reliance on a motion for class certification, the same burden they have at trial. The Second and Third Circuits have held that for fraud-on-the-market cases, defendants must have an opportunity to rebut the presumption of reliance at class certification and left open the possibility that defendants could do so by showing a lack of market-price impact at the time the fraud was revealed.³⁹ The Supreme Court clarified in *Erica P. John Fund v. Halliburton Co.* that price impact at the time the fraud is revealed has no bearing on the fraud-on-the-market presumption of reliance, but left open the possibility that defendants might still contest a market's efficiency by arguing a lack of price impact at the time of the alleged misstatements.⁴⁰ And *Wal-Mart's* language about proving a common injury on class certification lends support to this interpretation as well.⁴¹

Even though the burden is on the defendant to rebut the presumption of reliance at trial, allowing rebuttal at class certification requires both sides to address reliance in detail then.⁴² This is the same burden plaintiffs are faced with at trial.⁴³ To prove a market is efficient, plaintiffs can rely on a number of objective factors, including a security's average weekly trading volume, the number of analysts covering a security, the presence of market makers or arbitrageurs, the issuer's eligibility to file Form S-3 with the Securities and Exchange Commission (SEC), and the stock price's reaction to unexpected information in the past.⁴⁴ This last factor is often proved with an event study that measures a particular stock's reaction to new information.⁴⁵ Defendants often try to rebut the showing of market efficiency by offering an expert and event study that shows the market is inefficient.⁴⁶

634 (D. Idaho 2007).

39. *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 637–38 (3d Cir. 2011); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484–86 (2d Cir. 2008).

40. 131 S. Ct. 2178, 2186–87 (2011).

41. *See Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551–52 (2011).

42. Kaufman & Wunderlich, *supra* note 25, at 342–43.

43. *Wal-Mart Stores, Inc.*, 131 S. Ct. at 2552 n.6; *Basic, Inc.*, 485 U.S. at 245–47; *see, e.g.*, Model Civ. Jury Instr. 9th Cir. 18.5 (2007).

44. *See Cammer v. Bloom*, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989).

45. Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 380 (2002) (“[E]vent studies provide a metric for measurement of the impact upon stock prices of policy decisions.”); Esther Bruegger & Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coefficients*, 35 J. CORP. L. 11, 16 (2009) (“Event studies are widely used in litigation to measure the effect of alleged misconduct by examining the share price impact of relevant disclosures. The event study method is commonly used in securities litigation for estimating the share price impact of events because it meets scientific standards.”).

46. *See generally* MICHAEL J. KAUFMAN, EXPERT WITNESSES: SECURITIES CASES § 2.16–2.23 (2011).

To resolve the efficient-market inquiry, plaintiffs have to undertake extensive (though not full) discovery, both parties submit competing expert reports on the market's efficiency, and the district court has to resolve the debate between the two experts.⁴⁷ This transforms Rule 23 into a battle of the experts when the proper time for this is at trial, where the experts' testimonies and theories can be subject to the rigors of cross-examination; the judge, by assigning each opinion weight and deciding between the two, takes on a role traditionally reserved to a fact-finding jury.⁴⁸

2. Proving Loss Causation

The Fifth Circuit went even further than the Second and Third Circuits, requiring plaintiffs to also establish loss causation on a motion for class certification. The Fifth Circuit held in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.* (and in a few other cases) that before plaintiffs can invoke the fraud-on-the-market presumption of reliance, plaintiffs must establish loss causation by a preponderance of the evidence on a Rule 23 motion.⁴⁹ The Supreme Court recognized in *Erica* that this requirement was far afield from its decision in *Basic, Inc.* and held that plaintiffs do not have to prove loss causation before invoking the fraud-on-the-market presumption of reliance at class certification.⁵⁰

To best understand loss causation and its role at class certification, we must turn to the PSLRA and *Dura Pharmaceuticals, Inc. v. Broudo*.⁵¹ The PSLRA requires plaintiffs to plead that the defendant's act caused "the loss for which the plaintiff seeks to recover damages," colloquially known as loss causation.⁵² Generally, the PSLRA allows investors to recover for inflationary loss so long as investors define their precise losses and establish the causal link.⁵³ Thus, plaintiffs could state a claim under Rule 10b-5 by alleging inflationary loss—first, stating that they seek to recover inflationary damages, and then alleging that the inflation was caused by the defendant's fraud.⁵⁴ In *Dura*, the Supreme Court held that plaintiffs could not state a claim for securities fraud by alleging inflationary loss alone; rather, plaintiffs had to allege "economic loss."⁵⁵ The

47. Steig D. Olson, "Chipping Away": *The Misguided Trend Toward Resolving Merits Disputes as Part of the Class Certification Calculus*, 43 U.S.F. L. REV. 935, 964 (2009).

48. See, e.g., *Tennant v. Peoria & P.U. Ry. Co.*, 321 U.S. 29, 35 (1944) (stating that the jury, not the court, "weighs contradictory evidence and inferences, judges the credibility of witnesses").

49. 487 F.3d 261, 266 (5th Cir. 2007); see also *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton, Co.*, 597 F.3d 330 (5th Cir. 2010); *Fener v. Operating Eng'rs Constr. Indus. & Misc. Pension Fund (LOCAL 66)*, 579 F.3d 401, 407 (5th Cir. 2009); *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 227-28 (5th Cir. 2009) (per curiam).

50. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011).

51. 544 U.S. 336 (2005).

52. 15 U.S.C.A. § 78u-4(b)(4) (Supp. 2011).

53. Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation Under the Federal Securities Laws*, 2 N.Y.U. J.L. & BUS. 1, 6-7 (2005).

54. *Id.*

55. *Dura*, 544 U.S. at 338, 342-43, 345.

Court's decision was, as one author of this article put it, "inconsistent . . . , incoherent . . . , [and] incomplete."⁵⁶ The novel concept of economic loss lent itself to two different interpretations: (1) to plead and show loss causation, plaintiffs have to allege a specific loss and then a causal link connecting the loss to the defendant's fraud; or (2) to plead and show loss causation, plaintiffs have to establish a "lie-truth-drop" scenario, which required defendants to publicly lie, publicly correct the lie (a "corrective disclosure"), and then show the stock price dropped as a result of the correction (a "post-transaction decline").⁵⁷ Some federal courts have narrowly interpreted *Dura* to mean that plaintiffs must plead the "lie-truth-drop"; others have focused on only the identification of a corrective disclosure and an expert tying that corrective disclosure to a drop in stock price in their analysis of loss causation.⁵⁸ This has resulted in a noticeable decline in cases being filed that lack the "lie-truth-drop" formula.⁵⁹

The federal courts further compounded the problematic, narrow reading of *Dura* by requiring plaintiffs to prove on a Rule 23 motion without full discovery that other factors did not cause the loss for which plaintiffs seek to recover. In *Oscar Private Equity Investments v. Allegiance Telecome, Inc.*, the court was confronted with whether the plaintiffs had adequately shown loss causation and reliance when the correction of the fraud on the market was commingled with the revelation of other bad news that moved the stock price downward.⁶⁰ The plaintiffs offered an expert who opined that with an event study, the expert could later (after merits discovery) quantify the portion of the price drop proximately caused by the company's fraud.⁶¹ But, the Fifth Circuit said, the plaintiffs had to show loss causation at class certification, not trial, and to show loss causation the plaintiffs had to *isolate* the effect of the fraud on the stock price from other effects with an event study.⁶²

Using loss causation as a precondition to class certification is problematic in

56. Kaufman, *supra* note 53, at 1.

57. Madge S. Thorsen et al., *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93, 117–19 (2006).

58. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 825 (2009) (stating that "[a]lthough *Dura* did not explicitly require a corrective disclosure, the loss causation analysis in most cases has focused on both the identification of an adequate corrective disclosure and expert testimony tying that corrective disclosure to a drop in stock price"); James C. Spindler, *Why Shareholders Want Their CEOs To Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653, 666, 671 n.111 (2007) (collecting cases and finding that courts require plaintiffs to show a market decline (ex post loss)).

59. Scotland M. Duncan, *Dura's Effect on Securities Class Actions*, 27 J.L. & COM. 137, 167 (2008) (empirical study that *Dura* has resulted in the avoidance of cases lacking market corroboration in the form of a price decline).

60. *Oscar Private Equity Invs. v. Allegiance Telecom., Inc.*, 487 F.3d 261, 263, 266, 270 (5th Cir. 2007). The company corrected misstatements about the amount of installed telecommunications lines at the same time the firm released bad news about business prospects, including that it missed analysts' earnings expectations, had greater than expected earnings losses, and had a thin margin of error for meeting revenue covenants. *Id.* at 263.

61. *Id.* at 270.

62. *Id.*

two respects. First, it denies plaintiffs the presumption of reliance in fraud-on-the-market cases. Before plaintiffs can show loss causation (that fraud caused a cognizable loss to investors), they must show that the fraud was impounded in the stock price. Yet whether the fraud is impounded in the stock price is precisely what is *presumed* under *Basic, Inc.* Ergo, requiring loss causation as a precondition to the fraud-on-the-market theory muddies two distinct inquiries: (1) whether the defendant's fraud inflated the purchase price; and (2) whether that inflation dissipated in some way such that investors could not recover the inflationary loss. Only the former is required for class certification, and this is what the Supreme Court recognized in *Erica*.⁶³ Second, loss causation—whether the inflation dissipated in a way that investors could not recover it—is a question common to all class members; there can be no individual issues of loss causation.⁶⁴ Moreover, that *all* investors may not be able to establish loss causation is not justification for denying class treatment as plaintiffs need not prevail on the merits to receive class treatment.⁶⁵ A fatal similarity to all class members is best dealt with on summary judgment,⁶⁶ which would end the litigation, whereas denying a Rule 23 motion would just result in individual lawsuits.

Oscar also illustrates the dispositive role that event studies now play in securities fraud pre-trial litigation. The federal courts require plaintiffs to offer event studies that isolate the effect of the defendant's fraud from other factors that may have affected the company's stock price.⁶⁷ An event study is an empirical technique that is used to measure a specific event's impact on stock price, and in this regard has been used to show market efficiency (and thus reliance), materiality, damages, and causation.⁶⁸ Event studies are so useful, that without one, a plaintiff often never reaches a jury.⁶⁹ But requiring event studies to isolate fraud from other factors puts too much faith in these methods of evidence. To illustrate: in *Fener v. Belo Corp.*,⁷⁰ the plaintiffs sued a media company, alleging that it had inflated the circulation numbers of one of its newspapers.⁷¹ When, in a press release, the company revealed its fraud along

63. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011).

64. See John C. Coffee, Jr., *Securities Litigation: The Year Ahead*, N.Y. L.J., Jan. 20, 2011.

65. *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010).

66. See Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. REV. 97, 107 (2009).

67. Fisch, *supra* note 58, at 825.

68. William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 874–79 (2005).

69. See, e.g., *Oscar Private Equity Invs. v. Allegiance Telecom., Inc.*, 487 F.3d at 271; *Freeland v. Iridium World Commc'ns, Ltd.*, 545 F. Supp. 2d 59, 81 (D.D.C. 2008); *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1274 (N.D. Okla. 2007). Courts have coyly tempered the event-study requirement, recognizing that expert testimony, though not required, is undoubtedly "helpful." See, e.g., *Wortley v. Camplin*, 333 F.3d 284, 296–97 (1st Cir. 2003); *In re Netbank, Inc. Sec. Litig.*, 259 F.R.D. 656, 673 n.9 (N.D. Ga. 2009).

70. 560 F. Supp. 2d 502 (N.D. Tex. 2008).

71. *Fener v. Operating Eng'rs Constr. Indus. & Misc. Pension Fund (LOCAL 66)*, 579 F.3d 401, 404–05 (5th Cir. 2009).

with other “methodological” business problems, the stock price dropped.⁷² According to the facts as stated by the court, the plaintiffs did not come armed with an expert or event study to show that the stock price dropped because of the fraud.⁷³ The defendants did offer an expert, however, who separated the press release into disclosures about the fraud and revelations of other bad news and concluded that the drop in price was not attributable to disclosure of the fraud. The plaintiffs responded with an expert of their own who, according to the court, argued that the press release should be treated as one corrective disclosure.⁷⁴ Because the plaintiffs’ expert did not separate the revelation of the fraud from the other bad news, the Fifth Circuit rejected the testimony out of hand, saying that without positive proof in the form of an event study, the plaintiffs had not shown reliance.⁷⁵

The courts that require plaintiffs to establish (or rebut) loss causation on a Rule 23 motion accord talismanic significance to expert testimony and an event study’s ability to isolate the effect of the fraud. Expert testimony and event studies have long been a hallmark of securities fraud litigation, a trend that is unlikely to change so long as financial markets and investment vehicles grow in number and complexity. An additional byproduct of pushing the merits resolution up to the class certification decision and requiring a reliable event study, federal courts conduct at least a limited *Daubert* analysis of experts at the Rule 23 stage.⁷⁶

The Seventh Circuit has recognized the trouble with altering the inquiry under Rule 23 to that of a merits-based analysis on reliance and loss causation (the Supreme Court recognized this only implicitly and to a limited extent in *Erica*⁷⁷). In *Schleicher v. Wendt*, the defendants argued that before certifying a class and using the fraud-on-the-market theory, the district judge had to determine that the contested statements actually caused material changes in stock prices.⁷⁸ The Seventh Circuit rejected the argument on several grounds.⁷⁹

72. *Id.* at 405.

73. *Id.* at 408.

74. *Id.* at 408–09. Contrary to the representations by the court, it appears that the plaintiffs *did* allege that the purportedly unrelated methodological business problems *were* part of the fraud. Complaint at ¶¶ 50–53, *Fener v. Belo*, 560 F. Supp. 2d 502 (N.D. Tex. 2008) (No. 3:04-CV-1836-D), 2004 WL 2657127. What’s more, the plaintiff’s expert *did* isolate the other bad news from the fraud, opining that the unrelated bad news had already been disclosed to the public and already incorporated into the stock price before the company released news of the fraud. Declaration of Scott D. Hakala, PH.D., CFA Regarding Market Efficiency and Loss Causation, at ¶ 30; *Fener*, 560 F. Supp. 2d at 502, 2007 WL 4470898. The plaintiffs’ expert continued that even assuming the unrelated information was news to the public, it accounted for only half of the stock price decline. *Id.*

75. *Fener*, 579 F.3d at 410–11.

76. *See, e.g.*, *Am. Honda Motor Co. v. Allen*, 600 F.3d 813, 815–16, (7th Cir. 2010). The Supreme Court left this question open in *Wal-Mart*, but the Court’s discussion suggests that it would favor a full *Daubert* inquiry on Rule 23. 131 S. Ct. 2541, 2553–54 (2011).

77. *See Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011).

78. 618 F.3d 679, 683 (7th Cir. 2010).

79. The Second and Third Circuits have rejected *Oscar*’s loss-causation requirement as well. *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 637–38 (3d Cir. 2011); *In re Salomon Analyst Metromedia Litig.*, 544

First, the court rejected the notion that the district judge had to determine whether the fraud caused a “material” change in stock price on a Rule 23 motion.⁸⁰ Whether the fraud was material was a merits question common to all plaintiffs.⁸¹ Further, the court continued, plaintiffs did not have to show that they would *prevail* on the merits to obtain class treatment, and thus the court could certify the class even if the fraud had only a trivial effect on the stock price.⁸² Second, the Seventh Circuit (and the Supreme Court later in *Erica*) rejected *Oscar* because it required plaintiffs to establish their case at class certification contrary to *Basic, Inc.*⁸³ According to the Seventh Circuit, neither Rule 23, *Eisen*, nor *Basic, Inc.* allows for a full-blown merits inquiry, but only a “peek at the merits” to determine if class certification is proper.⁸⁴ Notably, the Seventh Circuit refused to rewrite Rule 23 to make success on the merits a prerequisite to class certification in securities fraud claims, even despite defendants’ concerns that class certification creates pressure to settle.⁸⁵

C. Proving Loss Causation Again on a Motion for Summary Judgment

The federal courts have converted summary judgment into a factual determination of not just the reliability, but also the credibility of the plaintiffs’ expert on issues of damages and loss causation.⁸⁶ Loss causation mirrors proximate cause at common law.⁸⁷ Thus, like proximate cause, loss causation is a quintessential fact question in part because it necessarily involves some inferential reasoning.⁸⁸ Whether the defendant’s conduct caused anything is a hypothetical question: what would have happened if the defendant had told the truth? If a jury determines by a preponderance of the evidence that the plaintiffs would not have suffered their economic losses had the defendant told the truth, then the jury may not find loss causation. At trial, plaintiffs must prove that the defendant’s fraud caused their losses (loss causation) by a preponderance of the evidence.⁸⁹ But whether some other factor caused a decline in the stock price or broke the causal chain is in the nature of a *defense*

F.3d 474, 483–84 (2d Cir. 2008).

80. *Schleicher v. Wendt*, 618 F.3d 685, 687 (7th Cir. 2010).

81. *Id.* at 685.

82. *Id.*

83. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186–86 (2011); *Schleicher*, 618 F.3d at 687.

84. *Schleicher*, 618 F.3d at 685–86.

85. *Id.* at 686.

86. Professor Arthur Miller made a similar point years earlier using *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489 (N.D. Cal. 1992), to show that judges use summary judgment to decide securities fraud cases that should go to a jury. Arthur R. Miller, *The Pretrial Rush to Judgment: Are the “Litigation Explosion,” “Liability Crisis,” and Efficiency Cliches Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U. L. REV. 982, 1095–1126 (2003).

87. *E.g.*, *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683–84 (7th Cir. 1990).

88. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 328C; *BCS Servs., Inc. v. Heartwood 88, LLC*, 637 F.3d 750, 754 (7th Cir. 2011).

89. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 345–46 (2005).

to the plaintiffs' claim.⁹⁰ Defendants may present evidence of intervening causes, and if at trial the defendants do present an intervening-cause defense, then the plaintiffs are permitted to try to rebut that defense. And even though plaintiffs always have the burden of persuasion at trial, they need not rebut any evidence of intervening cause until the defendant first presents that evidence.

Loss causation is also often the subject of expert testimony. To admit expert testimony, district judges must ensure expert testimony is reliable, but this should not be confused with whether the evidence is ultimately believable. Under Federal Rule of Evidence 702, which codified the Supreme Court's decision in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,⁹¹ an expert witness can offer testimony if: (1) the expert is qualified; (2) the expert's testimony will assist the trier of fact; and (3) the expert's testimony is based on reliable principles and methods.⁹² As a result of *Daubert*, parties challenge the admissibility of evidence more frequently, and judges scrutinize evidence more carefully and exclude a greater proportion of it.⁹³ The danger, according to Professor Paul Carrington, is that *Daubert* rewrote the Federal Rules of Evidence "to weaken and perhaps nullify federal laws dependent on their enforcement on the use of expert opinion," such as the private right of action for securities fraud, by allowing district judges "to exclude expert testimony that, on the basis of their personal scientific expertise, they deem unreliable."⁹⁴

In securities litigation, where motions *in limine* to exclude expert testimony and motions for summary judgment go hand in hand, a district judge can easily march through the merits of the case under the guise of a credibility analysis.⁹⁵ Plaintiffs must not only present a qualified and reliable expert to provide opinion evidence on loss causation, they must also convince the judge that their

90. See, e.g., 65 C.J.S. *Negligence* § 223 (2011); *BCS Servs., Inc.*, 637 F.3d at 757 ("The plaintiff doesn't have to . . . offer evidence which positively excludes every other possible cause of the accident. . . . [T]he burden of proving an 'intervening cause'—something which snaps the 'causal chain' (that is, operates as a 'superseding cause,' wiping out the defendant's liability, . . . that connects the wrongful act to the defendant's injury—is on the defendant.") (internal citations omitted); *Freeland v. Iridium World Commc'ns, Ltd.*, 545 F. Supp. 2d 59, 80 (D.D.C. 2008) ("Loss causation is an affirmative defense and the risk of nonpersuasion is on [the defendant], not Plaintiffs."); *In re Micron Techs., Inc. Sec. Litig.*, 247 F.R.D. 627, 634–35 (D. Idaho 2007) (stating that defendant bears the burden to sever the link in the causal chain after plaintiffs show loss causation).

91. *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589–95 (1993); FED. R. EVID. 702, advisory committee note; CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, FEDERAL EVIDENCE § 7:7 (3d ed. 2010).

92. FED. R. EVID. 702.

93. A. Leah Vickers, *Daubert, Critique and Interpretation: What Empirical Studies Tell Us About the Application of Daubert*, 40 U.S.F. L. REV. 109, 109–10 (2005) (summarizing empirical studies on *Daubert*).

94. Paul D. Carrington, *Politics and Civil Procedure Rulemaking: Reflections on Experience*, 60 DUKE L.J. 597, 662–63 (2010). *Daubert's* discretion afforded to district judges is compounded by deferential abuse-of-discretion review by appellate courts. See *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 138–39 (1997).

95. See Carrington, *supra* note 94, at 662–63 (observing that the discretion entrusted to district judges to determine reliability "has contributed measurably to the rise in summary judgments dismissing plaintiffs' cases").

expert is more believable than the defendant's on a motion for summary judgment.

*In re Williams Securities Litigation*⁹⁶ illustrates this point. In *Williams*, investors sued claiming that the company had committed fraud when it painted a rosy picture of the prospects of a subsidiary spin-off, when in fact, the subsidiary was spun-off because its future was in doubt.⁹⁷ To show loss causation, the plaintiffs' expert developed two scenarios: (1) no single disclosure resulted in the market learning about the fraud, but disclosure of the truth occurred gradually (leaking out); or (2) four different disclosures revealed the misstated information.⁹⁸

The Tenth Circuit rejected both of the expert's theories, but as Professor J. Robert Brown, Jr. observes, its analysis shows that plaintiffs will find maintaining a merited suit almost impossible.⁹⁹ First, the court rejected the expert's leakage theory (a theory apart from the "lie-truth-drop" formula). The court dismissed the entire "1300 page compendium of news articles, reports, and SEC filings" the expert pointed to as evidence of a gradual revelation of the fraud as news, concluding that it was "generally applicable to the . . . industry as a whole, or was an upbeat rather than negative statement."¹⁰⁰ Yet the court did not offer any examples to support its analysis. Then the court incoherently claimed that although a leakage theory was permissible to show loss causation, plaintiffs and their expert had to identify a specific event and a specific drop in share prices—the "lie-truth-drop" formula.¹⁰¹ The problem, as Professor Brown notes, is that

the notion of leakage is built around gradual disclosure, gradual revelation. The market may know at some point that the earlier, optimistic statements were not entirely true, but for the truth to be fully reflected in share prices, the market must know the extent to which the false statements misrepresented the company's capital position.¹⁰²

The Tenth Circuit also rejected the expert's reliance on four different corrective disclosures.¹⁰³ The court's reason: the truth already *leaked* to the market.¹⁰⁴ The

96. 558 F.3d 1130 (10th Cir. 2009).

97. *Id.* at 1133–34.

98. *Id.* at 1134–36.

99. J. Robert Brown, Jr., *Using Loss Causation to Repeal Rule 10b-5: In re Williams Securities Litigation (Part 5)*, www.theracetothetobottom.org (Mar. 24, 2009, 6:00 AM), <http://www.theracetothetobottom.org/securities-issues/using-loss-causation-to-repeal-rule-10b-5-in-re-williams-sec-3.html>.

100. *Williams*, 558 F.3d at 1138 (emphasis added).

101. *See id.* ("While the truth could be revealed by the actual materialization of the concealed risk rather than by a public disclosure that the risk exists, any theory of loss causation would still have to identify when the materialization occurred and link it to a corresponding loss.") (internal citation omitted).

102. J. Robert Brown, Jr., *Using Loss Causation to Repeal Rule 10b-5: In re Williams Securities Litigation (Part 4)*, www.theracetothetobottom.org (Mar. 23, 2009, 6:07 AM), <http://www.theracetothetobottom.org/securities-issues/using-loss-causation-to-repeal-rule-10b-5-in-re-williams-sec-4.html>.

103. *Williams*, 558 F.3d at 1143.

court dismissed the plaintiff's claim that the disclosures corrected the fraud because the market already *knew* of the fraud.¹⁰⁵

Why then did the court reject the leakage theory? The crux of the court's problem was that, in the court's opinion, the event study by the plaintiffs' expert was unreliable because the expert did not rule out other factors' effect on the stock price.¹⁰⁶ Yet event studies are notoriously ineffective at separating out the amount of a decline in stock price where multiple disclosures or multiple misrepresentations are made.¹⁰⁷ And to the extent "other factors" explain the drop in the company's stock price, this is a matter for cross-examination at trial.¹⁰⁸ In cases with dueling experts, such as *Williams*, the jury should determine which expert, *if any*, to believe.

III

JUDICIAL ACCESS BARRIERS AND CONSTITUTIONAL QUESTIONS

The access barriers erected at the pleading, class certification, and summary judgment stages of securities litigation pose both constitutional and practical concerns. First, by rewriting¹⁰⁹ rules of procedure rather than deferring to traditional rulemaking bodies like Congress and the Advisory Committee on Civil Rules of the Judicial Conference, the judiciary has usurped the rulemaking function of the legislature. By rewriting Rule 23 and Rule 56, the judiciary has shown a disregard for the congressional rulemaking process and bucked the historical trend away from unilateral judicial decision-making toward a process that includes multiple gatekeepers. The dangers of shying away from the formal rulemaking process have been well catalogued.¹¹⁰ We only highlight that neglecting the rulemaking process sacrifices balanced and transparent, informed, and cohesive rulemaking.

Second, the pre-trial barriers encroach on the province of the jury by requiring plaintiffs to meet, or at times even exceed, the burden of proof they will have at trial and leaving district courts with considerable fact-finding power. Requiring plaintiffs to satisfy pre-trial burdens of proof usually greater than their ultimate burden at trial may also infringe on the Seventh Amendment right to a trial by jury. The Seventh Amendment "preserves" our

104. *Id.*

105. *Id.*

106. *Id.* at 1138–39.

107. *See, e.g.,* Bruegger & Dunbar, *supra* note 45, at 25–26; Fisher, *supra* note 68, at 874–79; Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STAN. J.L. BUS. & FIN. 183, 231–33 (2009).

108. *See supra* note 90.

109. Although the difference between interpreting and "rewriting" a Rule is one of degree, Professor Stephen Burbank pointed out that "here the degrees of separation approach one hundred and eighty." Mark Herrmann et al., *Plausible Denial: Should Congress Overrule Twombly and Iqbal?* 158 U. PA. L. REV. PENNUMBRA 141, 161 (2009).

110. *See, e.g.,* Robert G. Bone, *Plausibility Pleading Revisited and Revised: A Comment on Ashcroft v. Iqbal*, 85 NOTRE DAME L. REV. 849 (2010); Arthur R. Miller, *From Conley to Twombly to Iqbal: A Double Play on the Federal Rules of Civil Procedure*, 60 DUKE L.J. 1 (2010).

right to a trial by jury in civil cases as that right existed in the common law in 1791,¹¹¹ ensuring the jury's status as a constitutional actor.¹¹² In the context of pre-trial screening, the Supreme Court suggested in *Tellabs* that so long as the plaintiffs' burden is not greater than the burden of proof at trial, then the Seventh Amendment is not violated.¹¹³ The Court also implicitly endorsed this interpretation in *Wal-Mart*, when it recognized that the burden on Rule 23 was the same as the burden at trial.¹¹⁴ However, the new pleading, class certification, and summary judgment standards significantly infringe on plaintiffs' right to a trial by jury.

A. Pleading Securities Fraud and the Seventh Amendment

Tellabs provides room for district courts to apply a burden of proof greater than the burden at trial. In *Tellabs*, the Court was forced to confront the Seventh Amendment implications of merit-based pre-trial screening.¹¹⁵ In a remarkably sweeping statement, the Court dismissed the Seventh Amendment argument and said that when the judiciary exercises a screening function—when considering a motion to dismiss, admitting expert testimony, making a judgment as a matter of law, or entering summary judgment—the Seventh Amendment is not implicated.¹¹⁶ According to the Court, Congress, as creator of federal claims,

111. U.S. CONST. amend. VII; *Colgrove v. Battin*, 413 U.S. 149, 155–56 (1973).

112. The jury's status as a constitutional actor is different from that of the three branches of government or of the states in that its status and strength is wholly dependent on the judiciary. Suja A. Thomas, *Judicial Modesty and the Jury*, 76 U. COLO. L. REV. 767, 791 (2005). Thus, at a minimum, judicial modesty in questions concerning the scope of the jury's power is warranted. *Id.* at 792–93.

113. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 328 (2007) (“We emphasize, as well, that under our construction of the ‘strong inference’ standard, a plaintiff is not forced to plead more than she would be required to prove at trial.”). Professor Suja A. Thomas has argued persuasively that the core principle of the substance of the common-law jury trial is that a court never decides issues without a determination of the facts by the parties (as through an admission) or by the jury, however improbable the evidence might be; rather, a jury decides a case with any evidence, however improbable, unless the moving party admitted the facts or conclusions of the nonmoving party. Suja A. Thomas, *Why Summary Judgment Is Unconstitutional*, 93 VA. L. REV. 139, 147–48 (2007). Under this formulation, she and other scholars have argued that many judicial access barriers infringe on the Seventh Amendment right to a trial by jury. See Allan Horwich & Sean Siekkinen, *Pleading Reform or Unconstitutional Encroachment? An Analysis of the Seventh Amendment Implications of the Private Securities Litigation Reform Act*, 35 SEC. REG. L.J. 4, 9–10 (2007); Kenneth S. Klein, *Ashcroft v. Iqbal Crashes Rule 8 Pleading Standards to Unconstitutional Shores*, 88 NEB. L. REV. 261, 287 (2009); Miller, *supra* note 86, at 1064; Suja A. Thomas, *Why the Motion to Dismiss is Now Unconstitutional*, 92 MINN. L. REV. 1851, 1873 (2008). But the Supreme Court's decision in *Tellabs* makes clear that the Court does not agree with Thomas's approach. See *Tellabs*, 551 U.S. at 328. Yet even under *Tellabs*, the access barriers in securities litigation pose Seventh Amendment questions.

114. *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2252 n.6 (2011) (“To invoke [the fraud-on-the-market presumption], the plaintiffs seeking 23(b)(3) certification must prove that their shares were traded on an efficient market, an issue they will surely have to prove *again* at trial in order to make out their case.”) (internal citation omitted).

115. See *Tellabs*, 551 U.S. at 317. In *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986), one of the Court's seminal summary-judgment cases, the Court recognized that weighing inferences is the jury's domain. *Id.* at 255. However, this is exactly what *Tellabs* demands of district judges. See *Tellabs*, 551 U.S. at 323–24.

116. *Tellabs*, 551 U.S. at 326–27, 327 n.8.

may set barriers to the courts, and the judiciary simply exercises its constitutionally permissible gate-keeping function by weighing inferences.¹¹⁷ The problem with this reasoning, as best put by Professor Joshua Davis and Eric Cramer, is that although the legislature has “the power to change a substantive legal right, the Seventh Amendment restricts how those rights may be adjudicated in federal court; in other words, Congress’s power to eliminate a right is not tantamount to power to control the jury’s role in assessing those rights.”¹¹⁸ Indeed, the Seventh Amendment explicitly limits Congress’s power by mandating a jury trial right for any claim of damages, which, absent a Constitutional amendment, Congress cannot change.¹¹⁹ Thus, contrary to what the Supreme Court said in *Tellabs*, Congress cannot use the subterfuge of pleading to allow a judge to make factual determinations that would otherwise be constitutionally required to be resolved by a jury.

And in *Tellabs*, the Court itself seemed to recognize how sweeping its statement regarding judicial gatekeeping and the Seventh Amendment was when, to mitigate any Seventh Amendment concern, the Court “emphasized” that the burden of pleading was not greater than the burden of proof at trial.¹²⁰ According to the Court, its new pleading standard survived a Seventh Amendment challenge because the standard did not require plaintiffs to exceed the preponderance-of-evidence burden of proof at trial. Yet, *Tellabs* (without so stating) provides room for district judges to require plaintiffs to plead direct evidence of scienter to survive a motion to dismiss. By steeply discounting circumstantial evidence of scienter as implausible in light of nearly any other non-culpable explanation, courts require plaintiffs to allege direct evidence of the defendant’s state of mind in order to adequately allege scienter. But this burden is greater than plaintiffs’ burden of proof at trial.

B. Certifying a Securities Fraud Class Action and the Seventh Amendment

Merits-based class certification is also in tension with the Seventh Amendment. In *Alaska Electrical Pension Fund v. Flowserve Corp.*,¹²¹ the Fifth Circuit was forced to confront the Seventh Amendment problem that merits-based class certification poses.¹²² The Fifth Circuit’s reasoning supporting its rejection of any Seventh Amendment problem leaves much to be desired, however. The court dismissed any resolution of the merits on class certification as a “coincidental” overlap with the fact-finder’s ultimate decision,¹²³ even

117. *Id.*

118. Joshua P. Davis & Eric L. Cramer, *Antitrust, Class Certification, and the Politics of Procedure*, 17 GEO. MASON L. REV. 969, 1018 (2010).

119. Suja A. Thomas, *A Limitation on Congress: “In Suits at Common Law”*, 71 OHIO ST. L.J. 1071, 1071 (2010).

120. *See Tellabs*, 551 U.S. at 328.

121. 572 F.3d 221 (5th Cir. 2009) (per curiam with former Justice O’Connor sitting by special designation).

122. *Id.* at 228.

123. *Id.* at 229.

though the court acknowledged that the issue on class certification and the merits inquiry are “practically identical.”¹²⁴ The court pointed to the fact that a district court could revisit the decision whether to certify a class to support its conclusion that a judge’s determination would not interfere with a jury’s.¹²⁵

The court’s reasoning is problematic in two respects: First, requiring a showing of loss causation on class certification turns the *presumption* of reliance on its head, refusing to infer reliance until plaintiffs show reliance. This is inconsistent with *Basic, Inc.*, as the Court explained in *Erica*.¹²⁶ Second, there is, in fact, a risk of preclusive effect being given to the district judge’s decision on class certification, which can be dangerous for plaintiffs and defendants. As a general matter, non-final judicial findings, such as a ruling on class certification, *are* entitled to preclusive effect.¹²⁷ There is no doubt that at class certification, district judges are finding facts, including whether plaintiffs have shown reliance and loss causation. But the jury is supposed to determine facts and which reliable expert (if any) to believe. And more precisely, Supreme Court precedent demands that the jury determines facts for class certification *before* the district judge. A class action is essentially an equitable tool.¹²⁸ The Court, in *Beacon Theatres, Inc. v. Westover*, and *Dairy Queen, Inc. v. Wood*, long ago settled who was entitled to decide merits questions first when the same facts were relevant to rights at law (jury) and rights at equity (judge): the jury.¹²⁹ In those cases, the Court held that in cases that combine legal and equitable issues the jury makes its findings first, and the judge is then bound by the jury’s factual findings.¹³⁰ The Court explicitly considered the inverse—having the judge first render his factual determinations and then binding the jury with the judge’s assessment—but the Court rejected that approach as inconsistent with the Seventh Amendment’s guarantee to trial by jury.¹³¹

The Fifth Circuit in *Flowsolve* tried to remedy the res-judicata conundrum, stating that a decision on class certification does not bind the jury.¹³² Yet why the district judge’s decision on the merits does not act as issue preclusion or law of the case is unclear. In *In re Bridgestone*, the Seventh Circuit correctly noted that issue preclusion does not depend on a final judgment, and thus a district

124. *Id.* at 233.

125. *Id.* at 228–29.

126. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011).

127. *In re Bridgestone/Firestone, Inc., Tires Prods. Liability Litig.*, 333 F.3d 763, 767 (7th Cir. 2003) (citing RESTATEMENT (SECOND) OF JUDGMENTS § 13).

128. *Phillips Petrol. Co. v. Shutts*, 472 U.S. 797, 808 (1985) (citing *Hansberry v. Lee*, 311 U.S. 32 (1940)).

129. *Kaufman & Wunderlich*, *supra* note 25, at 357–60; *see also* *Davis & Cramer*, *supra* note 118, at 1010–11.

130. *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 479 (1962); *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 510–11 (1959).

131. *Beacon Theatres, Inc.*, 359 U.S. at 510–11.

132. *Alaska Elec. Pension Fund v. Flowsolve Corp.*, 572 F.3d 221, 228–29 (5th Cir. 2009) (per curiam); *see also* Kevin M. Clermont, *Sequencing the Issues for Judicial Decisionmaking: Limitations From Jurisdictional Primacy and Intrasuit Preclusion*, 63 FLA. L. REV. 301, 340 (2011).

court's finding on class certification could be used to prevent a party from relitigating whether certification was appropriate.¹³³ Thus, the district judge's merit-based decision can preclude at least later class-certification inquiries. More problematic is whether the district judge's decision will act as law of the case.¹³⁴ If a district judge concludes that plaintiffs have not shown by a preponderance of the evidence that the defendant's fraud caused an actionable loss and thus denies class certification, then there is no reason why this finding would not bind individual plaintiffs in their individual suits against the defendant—the case has not changed. The law-of-the-case doctrine might also preclude defendants from relitigating an issue. If the district judge concludes, for example, that the plaintiffs have shown loss causation on class certification, then this finding might serve to bind the trier of fact. It makes no sense to try a case twice. This commonsense principle is embodied in the Seventh Amendment's Reexamination Clause, which allocates authority to review verdicts so that litigants will not be forced to succeed on the same issues again and again.¹³⁵

In *Beacon*, the Supreme Court did leave a small loophole in the rule that a jury must decide facts common to legal and equitable issues, by stating that judges may find facts in deciding equitable relief before a jury “under the most imperative circumstances.”¹³⁶ The Court has never defined this phrase though, and the most reputable treatise on federal procedure says that whether “any circumstances” would qualify is “highly doubtful.”¹³⁷ As Part IV shows, not only are these access barriers unconstitutional, but no “imperative circumstances” warrant an intrusion on the Seventh Amendment.

C. Expert Testimony and the Seventh Amendment

Judicial scrutiny of expert testimony at class certification and summary judgment also creates Seventh Amendment problems. First, it delegates the assessment of an expert's credibility to the district judge, requiring plaintiffs to convince a judge of the credibility of their expert and weight of their evidence to get to trial. Although federal judges may perform a gatekeeping role in

133. *In re Bridgestone/Firestone, Inc., Tires Prods. Liab. Litig.*, 333 F.3d 763, 767 (7th Cir. 2003); *see also Sawyer v. Atlas Heating & Sheet Metal Works, Inc.*, 642 F.3d 560, 564 (7th Cir. 2011); *Thorogood v. Sears, Roebuck & Co.*, 624 F.3d 842, 853 (7th Cir. 2010).

134. This has not been the subject of much study. The Chief Justice raised this concern at oral argument in *Halliburton*. Transcript of Oral Argument at 40–41, *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (No. 09-1403). Professor Kevin M. Clermont undertakes the first serious attempt at crafting a framework for intra-suit preclusion. Clermont, *supra* note 132, at 332–40. Based on a court's ability to resolve factual questions to determine subject-matter jurisdiction, he concludes there is no problem with law of the case. *Id.* at 342–43. Yet when a court decides whether there is subject-matter jurisdiction, the court does not decide whether the plaintiff should win on the merits of the claim. Davis & Cramer, *supra* note 118, at 1013.

135. Davis & Cramer, *supra* note 118, at 1012.

136. *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 510–11 (1959).

137. 9 CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 2338 (3d ed. 2008).

screening unqualified and unreliable experts, they may not assess the credibility of witnesses, weigh competing evidence, or draw legitimate inferences—the Court made these limits clear in *Daubert* and its summary judgment trilogy.¹³⁸ Those are core jury functions, particularly on factual questions such as causation and damages.¹³⁹ But decisions like *Williams* appear to allow judges to exercise these functions.¹⁴⁰

Second, although the plaintiff bears the burden of proof at trial, the plaintiff can meet that burden of proving causation and damages with evidence in forms other than scientific evidence or an event study. Courts implicitly have adopted the view that event studies present an objective method of establishing that, in all cases, reasonable minds cannot differ on the issue of causation. Causation, however, asks whether an act was the cause of an outcome, which requires asking the hypothetical question whether an outcome would have occurred without an act's having taken place—an inference drawn from experience and understanding.¹⁴¹ Expert testimony and event studies provide experience and understanding that help a fact-finder assess the causal question, but cannot be considered completely objective evidence of causation precisely because causation requires answering a hypothetical question. Experts are subject to their own value judgments and preexisting biases that may affect their view of a body of evidence and, as we explain below, there are many opportunities for experts to massage an “objective” study. Cross-examination and counter-proof are used to determine which expert's testimony, if any, is ultimately correct.¹⁴²

IV

THE ACCESS BARRIERS ARE UNWISE, UNFOUNDED, AND INJURIOUS

The judicial access barriers rest on three premises that are incomplete, unsupported, or false, including the contentions that defendants settle claims *in terrorem*, that Congress is incapable of fashioning rules responsive to litigation concerns and the jury is incapable of merited fact-finding, and that merits-based screening precludes only “frivolous” litigation.

138. See *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 596–97 (1993); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986); *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986); *Matsushita Elec. Indus., Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

139. See RESTATEMENT (SECOND) OF TORTS § 328C (1965).

140. *In re Williams Sec. Litig.*, 558 F.3d 1130 (10th Cir. 2009).

141. See RESTATEMENT (THIRD) OF TORTS: PHYS. & EMOT. HARM § 28 cmt. on subsection a, (c) (2005); RESTATEMENT (SECOND) OF TORTS § 433B cmt. (b) (1965) (“[C]ausation is incapable of mathematical proof, since no man can say with absolute certainty what would have occurred if the defendant had acted otherwise.”); Paul F. Kirgis, *The Right to a Jury Decision on Questions of Fact Under the Seventh Amendment*, 64 OHIO ST. L.J. 1125, 1156–57 (2003) (stating that causation and proximate cause require probabilistic inferences about hypothetical conditions); Glanville Williams, *Causation in the Law*, 1961 CAMBRIDGE L.J. 62, 70 n.22 (“[H]ypothesis and speculation are essential for determining causal connection, since every statement of causal connection asserts what would have happened if the facts had been different.”).

142. *Daubert*, 509 U.S. at 596; CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, FEDERAL EVIDENCE § 7:10 (3d ed. 2010).

A. The Incomplete and Unsupported Contention that Defendants Settle Claims *In Terrorem*

Many of the judicial access barriers to remedies for securities fraud are premised on the following “*in terrorem* settlement” rationale: Heightened access barriers are necessary to reduce the threat of litigation costs, which forces defendants to settle claims based on the *in terrorem* effect of these expenses rather than the merits.¹⁴³ These costs are arguably incurred by an exceptionally high rate of frivolous securities fraud claims, abusive discovery, the hydraulic pressure of class certification, and the prospect of an irrational jury rendering a catastrophic verdict. We show, however, that this multi-layered assumption is unsupported and incomplete and that judicial access barriers may actually increase litigation costs.

1. The Unsupported and Incomplete Multi-Layered Assumption

The argument that securities litigation is particularly frivolous is unsupported.¹⁴⁴ As a starting point, to state that a claim is “frivolous” when no merits have been disclosed via discovery is an untestable (and thus un rebuttable) assertion.¹⁴⁵ Absent an argument that contravenes black-letter law, how do we know a claim is frivolous without discovery? Some point to small settlements as evidence that plaintiffs’ attorneys file claims that are simply too expensive to defend. But just as small settlements may suggest that the case was too costly to defend against, so too may it suggest that the small damages in the case did not justify much effort on the plaintiff’s side.¹⁴⁶ That neither side wanted to invest much effort in the case does not make it inherently frivolous or meritless.

Further, to the extent some attorneys knowingly file meritless claims for the purpose of extorting a settlement, safeguards already exist in the Federal Rules of Civil Procedure, the Model Rules of Professional Conduct, and the PSLRA. These rules require in some form a reasonable inquiry and factual support for

143. See, e.g., *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 347–48 (2005); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 267 (5th Cir. 2007).

144. See, e.g., Lance P. McMillian, *The Nuisance Settlement “Problem”: The Elusive Truth and a Clarifying Proposal*, 31 AM. J. TRIAL ADVOC. 221, 227 (2007) (“Is nuisance litigation really the problem it is made out to be? Does the rhetoric match the reality? From an empirical standpoint, the consensus among scholars is that the answer to these questions is clearly no. The proof is simply not there.”).

145. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1536 n.5 (2006) (stating that a “strike suit” is a myth “like the unicorn, more discussed than directly observed”); Brian D. Hufford, *Deterring Fraud vs. Avoiding the “Strike Suit”: Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 633 (1995) (finding evidence that the merit of a securities fraud claims has substantial bearing on settlement); Suja A. Thomas, *Frivolous Cases*, 59 DEPAUL L. REV. 633, 634 (2010) (stating there is no working definition for “frivolous”).

146. Coffee, Jr., *supra* note 145, at 1536 n.5. Similarly, professors James Cox, Randall Thomas, and Lynn Bai find that cases involving smaller settlements have significantly smaller provable losses. James Cox et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 383–84 (2008).

all allegations in a complaint.¹⁴⁷ The prospect of sanctions and costs to reputation make fabrication by attorneys not only unethical, but also costly.¹⁴⁸ And, at the very least, filing a meritless case leaves plaintiffs with no credible leverage when negotiating settlement.¹⁴⁹

We now turn to the claim that abusive litigation costs—namely abusive discovery—force defendants to settle. Similar to the contention that securities litigation is “frivolous,” the contention that discovery is “abusive” is problematic because the judiciary lacks a working definition of “abusive discovery,” without which we cannot differentiate abusive discovery from appropriate discovery.¹⁵⁰ Yet even assuming the judiciary can define and measure “abuse,” there is reason to doubt that plaintiffs alone engage in abusive discovery. The judiciary’s assumption that only plaintiffs abuse discovery and impose asymmetric costs neglects abuse by defendants. Plaintiffs can assert that defendants withhold evidence, file frivolous objections, and use “dump truck” and warehouse discovery responses, just as easily as defendants can assert that plaintiffs use discovery to impose costs.¹⁵¹ Moreover, although abuse can come from both sides, some anecdotal evidence actually suggests that defendants are more prone to abuse. In an anecdotal survey, more plaintiffs (58%) reported problems with discovery than defendants (42%),¹⁵² the inference being that defendants are creating more problems for plaintiffs with discovery. Another anecdotal study reports that large corporate clients generate *demand* for “aggressiveness” or “unreasonableness” in litigation,¹⁵³ which could be construed as abuse. That defendants might engage in abusive or protracted-litigation tactics makes sense because their pay structure encourages protracted and involved litigation.¹⁵⁴ Defendants are paid hourly. Conversely, plaintiffs’ attorneys, who are paid on a contingency basis, have motive to refrain from driving up litigation costs: by imposing higher costs on defendants, plaintiffs

147. See 15 U.S.C.A. § 78u-4(c)(1), (2) (Supp. 2011); FED. R. CIV. P. 11(b), (c); MODEL RULES OF PROF'L CONDUCT R. 3.1, 3.3.

148. See Michael J. Kaufman & John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation*, 19 CORNELL J.L. & PUB. POL'Y 637, 682–86 (2010); Geoffrey P. Miller, *A Modest Proposal for Securities Fraud Pleading After Tellabs*, 75 LAW & CONTEMP. PROBS., no. 1, 2012 at 93, 99.

149. McMillian, *supra* note 144, at 249 n.85.

150. See, e.g., Frank H. Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 638–39 (1989) (“We cannot prevent what we cannot detect; we cannot detect what we cannot define; we cannot define ‘abusive’ discovery except in theory, because in practice we lack essential information.”).

151. Hufford, *supra* note 145, at 639; Richard L. Marcus, *Reassessing the Magnetic Pull of Megacases on Procedure*, 51 DEPAUL L. REV. 457, 470 (2001).

152. Thomas E. Willging et al., *An Empirical Study of Discovery and Disclosure Practice under the 1993 Federal Rule Amendments*, 39 B.C. L. REV. 525, 553 (1998).

153. Robert L. Nelson, *The Discovery Process as a Circle of Blame: Institutional, Professional, and Socio-Economic Factors that Contribute to Unreasonable, Inefficient, and Amoral Behavior in Corporate Litigation*, 67 FORDHAM L. REV. 773, 778–79 (1999).

154. Davis & Cramer, *supra* note 118, at 980; McMillian, *supra* note 144, at 250 (observing that filing nuisance class actions is incongruous with the amount of work required by plaintiffs and counsel who seek to represent the class).

lessen available insurance proceeds to pay their claim.¹⁵⁵ Insurance policies are often wasting policies that deplete as defense fees mount. Indeed, studies find that for plaintiffs, increased time spent on discovery is correlated with a decreased prospect of recovery.¹⁵⁶

Apart from the difficulties in quantifying “abuse,” much is unknown about the actual costs of litigation, including how much it costs to litigate a securities fraud claim, whether all claims are alike, and whether litigation costs are overstated or self-inflicted.¹⁵⁷ Without answers to these questions, however, courts presume that defendants settle because it must be cheaper. But what about other long-term and intangible savings the company might achieve from litigation? For instance, if defendants litigate a case to a successful judgment, the defendant might obtain long-term monetary savings in the form of reputational capital, signaling its unwillingness to settle “frivolous” suits and thus staving off future similar suits.¹⁵⁸

Even if we have an accurate picture of litigation costs and can isolate costs attributable to abuse, nevertheless we still do not know how much, if at all, concerns about litigation costs matter in a settlement decision. Some empirical evidence available suggests that discovery costs do not drive a settlement decision at all. In a survey conducted by the Federal Judicial Center, the majority of defense attorneys reported that discovery costs had no effect on the likelihood of settlement.¹⁵⁹ A majority of respondents also said that costs of litigation were the “right amount” in proportion to the stakes of the case and disagreed with the idea that “discovery is abused in almost every case in federal court.”¹⁶⁰ In contrast, in another survey by the American Bar Association, almost ninety-eight percent of respondents said discovery had some influence over the settlement decision.¹⁶¹

Scholars that have studied discovery costs and the perception of abuse have concluded that what appears to be rampant, is not abusive discovery, but the *perception* that discovery is abused.¹⁶² Studies by the Federal Judicial Center, the National Center for State Courts, and the Columbia Field Project all find that in most cases no discovery is ever requested, and when it is, it usually

155. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 778–89 (2009).

156. Judith A. McKenna & Elizabeth C. Wiggins, *Empirical Research on Civil Discovery*, 39 B.C. L. REV. 785, 795–96 (1998).

157. See Miller, *supra* note 110, at 61–63.

158. See, e.g., Audra Annette Arndt, Comment, *The Evolution of Michigan's Open and Obvious Doctrine in Premises Liability and Recreational Activities Cases and the Lessening of Liability for Defendants*, 81 U. DET. MERCY L. REV. 191, 214 (2004) (“No defendant wants to have the reputation that it will pay out money, particularly where there is no merit to the plaintiff's case.”).

159. Miller, *supra* note 110, at 63 n.254.

160. *Id.* at 64–65 (internal quotation marks omitted).

161. *Id.* at 63 n.254.

162. See McKenna & Wiggins, *supra* note 156, at 787; Linda S. Mullenix, *Discovery in Disarray: The Pervasive Myth of Pervasive Discovery Abuse and the Consequences for Unfounded Rulemaking*, 46 STAN. L. REV. 1393, 1396 (1994).

involves no more than two requests.¹⁶³ Even the studies that find an increased incidence of problems with discovery in complex litigation—like securities litigation—attribute the increase in problems reported to the increased amount of discovery in those cases.¹⁶⁴ Further, to the extent discovery is more expensive in complex litigation, this too is rationally attributed to increased monetary stakes; the monetary stakes in the case have a strong relationship to the total litigation costs, and thus as the stakes rise, so too does the cost of discovery.¹⁶⁵

We now focus attention on the claim that class certification imposes hydraulic pressure on defendants to settle. Whether any pressure actually exists is debatable. Some scholars have found no evidence that class actions push companies into bankruptcy, but rather the opposite, that class actions save companies from bankruptcy.¹⁶⁶ Moreover, class actions do not appear to pressure settlement any more than a traditional lawsuit. The Federal Judicial Center has found that the settlement rate for class actions is (73%), which is slightly less than the settlement rate for all other cases filed in federal court (77%).¹⁶⁷ Moreover, the authors of the Federal Judicial Center study concluded that the merits, not class certification, drive settlement.¹⁶⁸

That the merits matter in settling a securities fraud claim also suggests that any pressure to settle is not untoward. There is pressure to settle in all litigation¹⁶⁹ because the prospect of discovery and an adverse verdict is always present. And the law favors settling merited claims, particularly in the class action context.¹⁷⁰ The concern over hydraulic pressure as a result of class certification justifies heightened procedural barriers only if defendants feel pressure to settle *meritless* claims.¹⁷¹ But there is considerable evidence that the

163. Peggy E. Bruggman, *Reducing the Costs of Civil Litigation: Discovery Reform*, U. CAL. HASTINGS, 12–13 (Fall 1995), <http://www.uchastings.edu/public-law/plri/fal95tex/discov.html>; Judith A. McKenna & Elizabeth C. Wiggins, *supra* note 156, at 786–87 (1998); Willging et al., *supra* note 152, at 578.

164. McKenna & Wiggins, *supra* note 156, at 801; Linda S. Mullenix, *The Pervasive Myth of Pervasive Discovery Abuse: The Sequel*, 39 B.C. L. REV. 683, 685–86 (1998).

165. David M. Trubek et al., *The Costs of Ordinary Litigation*, 31 U.C.L.A. L. REV. 72, 76–77 (1983).

166. Charles Silver, “We’re Scared to Death”: *Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1405–06 (2003).

167. Allan Kanner & Tibor Nagy, *Exploding the Blackmail Myth: A New Perspective on Class Action Settlements*, 57 BAYLOR L. REV. 681, 697 (2005).

168. THOMAS E. WILLGING ET AL., *EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 61* (1996), available at <http://ftp.resource.org/courts.gov/fjc/rule23.pdf>.

169. See Kanner & Nagy, *supra* note 167, at 690; Silver, *supra* note 166, at 1401–02.

170. See, e.g., *In re Luxottica Grp. S.p.A. Sec. Litig.*, 223 F.R.D. 306, 310 (E.D.N.Y. 2006) (“Class action suits readily lend themselves to compromise because of the difficulties of proof, the uncertainties of the outcome, and the typical length of the litigation. There is a strong public interest in quieting any litigation; this is particularly true in class actions.”) (internal quotation marks omitted); see also *Klay v. Humana, Inc.*, 382 F.3d 1241, 1274 (11th Cir. 2004) (stating that nothing is wrong with a defendant feeling pressure to settle a non-frivolous lawsuit).

171. Kaufman & Wunderlich, *supra* note 25, at 362–64; see Thomas, *supra* note 145, at 635–41 (summarizing how procedural barriers, such as certain restrictions under the PSLRA, are justified

merits *do* matter when settling a securities fraud claim.¹⁷²

We now examine the contention that rigorous screening is necessary for complex litigation, such as securities fraud claims, because juries are incompetent and irrational decision-makers who will be moved by emotion to render a “Robin Hood” type verdict against corporate defendants rather than a merits-based verdict.¹⁷³ As it turns out however, juries are quite competent gatekeepers, and the contention that they do not understand a case is belied by empirical findings. Empirical data reveal no correlation between the complexity of the case and the likelihood of disagreement between a judge and jury on the outcome.¹⁷⁴ In fact, empirical study reveals that the most important determinant of jury verdicts are the case facts, and if a judge and jury disagree in outcome, the disagreement is generally attributed to differences in the consideration of the evidence, not competency.¹⁷⁵ Also, to the extent that jurors exhibit any kind of bias, this bias actually works in *favor* of corporate defendants. Several studies have confirmed that jurors exhibit an anti-plaintiff bias, not an anti-business bias.¹⁷⁶ Thus, out of the securities fraud claims that have resulted in a jury trial since the PSLRA, defendants have won their share (four to seven, according to some statistics).¹⁷⁷ Moreover, the prospect of a runaway jury award is tempered

because they purport to eliminate frivolous cases).

172. See Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's “Disimplifying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority”*, 108 HARV. L. REV. 438, 444–49 (1994); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2080–84 (1995).

173. One example of the distrust of the jury's competency in securities fraud is the suggestion that loss causation as measured by “lie-truth-drop” is necessary because juries cannot be trusted to sort out a misstatement's real financial effect. See John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo*, 60 BUS. LAW. 533, 533–34 (2005).

174. ROBERT P. BURNS, *THE DEATH OF THE AMERICAN TRIAL* 20 (2009); cf. Judge Royal Ferguson, *Civil Jury R.I.P.? Can it Actually Happen in America?*, 40 ST. MARY'S L.J. 795, 804 (2009). Even if juries do not understand complex cases, proposals for reform should focus on *empowering* the jury, for example, by encouraging juror note-taking and question asking, rather than abandoning the jury-system altogether. See *Development in the Law—The Civil Jury*, 110 HARV. L. REV. 1408, 1511–12 (1997).

175. BURNS, *supra* note 174, at 20–21; Valerie P. Hans, *The Jury's Response to Business and Corporate Wrongdoing*, 52 LAW & CONTEMP. PROBS. 177, 194 (1989). Judge Jed Rakoff recently responded to press coverage suggesting that the subject matter of a trial was too complex for jurors by stating that a jury is “supremely gifted” at discerning the truth of a matter. Peter Lattman, *At Citigroup Trial, the Wit and Wisdom of Judge Rakoff*, N.Y. TIMES (Oct. 19, 2010), <http://dealbook.nytimes.com/2010/10/19/at-citi-trial-the-wit-and-wisdom-of-judge-rakoff/>.

176. See, e.g., Shari Seidman Diamond, *Beyond Fantasy and Nightmare: A Portrait of the Jury*, 54 BUFF. L. REV. 717, 730–33 (2006); Valerie P. Hans & William S. Lofquist, *Jurors' Judgments of Business Liability in Tort Cases: Implications for the Litigations Explosion Debate*, 26 LAW & SOC'Y REV. 85, 97–98 (1992).

177. Eleven securities class actions have been tried to a verdict since 1996 where the conduct at issue was alleged to have occurred after Congress enacted the PSLRA, with seven verdicts for plaintiffs, and four verdicts for defendants. Kevin LaCroix, *CalSTRS Wins Rare Securities Suit Jury Verdict Against Homestore CEO*, THE D&O DIARY (Feb. 28, 2011), <http://www.dandodiary.com/2011/02/articles/securities-litigation/calstrs-wins-rare-securities-suit-jury-verdict-against-homestore-ceo/>; Adam T. Savett, *Securities Class Action Trials in the Post-PSLRA Era*, 2–3 (Nov. 2010), <http://www.box.net/shared/xxav75dzpf>. Another eleven securities class action cases

by the PSLRA, which caps damages at

the difference between the purchase or sale price paid or received . . . by the plaintiff . . . and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.¹⁷⁸

2. The Potential Costs to Access Barriers

That the *in terrorem* rationale is incomplete and unsupported might matter little if the procedural barriers that rest upon it proved innocuous. Whether an enhanced procedural regime is likely to reduce litigation costs, as opposed to simply displacing them is unclear.¹⁷⁹ Although the heightened standards for procedure save defendants expenses through early termination, these costs may be offset by increased appeals and more intense pre-trial litigation.¹⁸⁰ The heightened risks of premature dismissal also force plaintiffs to spend more time and money to develop a case.¹⁸¹ Increasing the initial investment required in the case has three deleterious consequences to injured investors. First, it narrows the pool of attorneys available to pursue securities fraud claims on behalf of investors because few firms can surmount the financial burden of prosecuting a securities fraud case.¹⁸² Second, heightened procedural rules skew plaintiffs' valuation of their claims downward, making them less than the actual value of the claim.¹⁸³ Plaintiffs must account for the increased probability of dismissal (and the blunted effect of threatening discovery or a jury verdict) during settlement negotiations.¹⁸⁴ Third, not only will plaintiffs have to undervalue their claims, but they also must pursue cases with greater damages to justify

have been tried to verdict since 1996 where the conduct at issue was alleged to have occurred before the PSLRA was enacted, with three verdicts for plaintiffs, six verdicts for defendants, one mixed verdict, and one hung jury. Savett, *supra*, at 5–6. *See also* Dr. Jordan Milev et al., *Trends 2010 Year-End Update: Securities Class Action Filings Accelerate in Second Half of 2010; Median Settlement Value at an All-Time High*, NERA ECON. CONSULTING 15 (2010), http://www.nera.com/nera-files/PUB_Year_End_Trends_1210.pdf.

178. 15 U.S.C.A. § 78u-4(e)(1) (Supp. 2011).

179. Scholars have raised this question before with respect to summary judgment. *See* D. Brock Hornby, *Summary Judgment Without Illusions*, 13 GREEN BAG 2D 273 (2009); Samuel Issacharoff & George Loewenstein, *Second Thoughts About Summary Judgment*, 100 YALE L.J. 73 (1990); Miller, *supra* note 86.

180. *See* Miller, *supra* note 110, at 54–57.

181. *Id.* at 66–67. Professor Geoffrey Miller finds that the significant premium on pre-filing private investigation has costs: (1) the cost of private investigation will be greater than the cost of discovery because defendants are not required to comply with requests by private investigators; (2) the cost of private investigation becomes duplicative if the case survives a motion to dismiss and the parties engage in discovery; and (3) private investigation is intrusive on privacy and potentially disruptive to the company. Miller, *supra* note 148.

182. Miller, *supra* note 110, at 67. Financial ability to litigate a class action is one of the factors that courts use to determine whether a plaintiff is an adequate class representative and whether a firm can effectively serve as class counsel. *See, e.g.,* McGowan v. Faulkner Concrete Pipe Co., 659 F.2d 554, 559–60 (5th Cir. 1981); *Pender v. Bank of Am. Corp.*, 269 F.R.D. 589, 599–600 (W.D.N.C. 2010).

183. *See* Miller, *supra* note 110, at 68.

184. *Id.* at 68–69.

litigation, and this actually may raise litigation costs.¹⁸⁵

B. The Myth that Congress is Incapable of Fashioning Rules that Respond to Litigation Concerns and that the Jury is Incapable of Merited Fact-Finding

The judicial access barriers that substitute the district judge for the jury are premised on the idea that federal judges are more nimble at rulemaking than Congress and more capable of fact finding than the jury. But neither of these judicial assumptions are necessarily true.

First, Congress and the drafters of the Federal Rules have a long history of enacting statutes, rules, and amendments responsive to perceived litigation costs and abuses. For example, the worry about “fishing expeditions” and costly and lengthy depositions even predates the liberal discovery rules in notice pleading, and the initial drafting committee of the Federal Rules was attuned to these concerns relating to liberal discovery, even placing special emphasis on the need for input on the new discovery provisions when the committee solicited comment from the bar at large.¹⁸⁶ Still, the drafters thought liberal notice pleading and discovery would strike the optimum balance between screening cases with no merit and affording merited claims their due. Since 1970, to keep pace with changing realities in litigation—namely, the development of aggregate litigation—the Federal Rules and the Manual for Complex Litigation have been revised to contain the scope of discovery by, for example, providing a discovery conference to narrow disputes, allowing district judges to limit the scope of discovery, encouraging judges to impose sanctions for discovery violations, and mandating that parties engage in automatic disclosure to facilitate discovery.¹⁸⁷ Congress has also modified procedural rules and statutes to take settlement pressure resulting from class certification into account: in 1966, it enacted Rule 23(f), which allows for interlocutory appeal of

185. There are some additional costs neglected by the access barriers, including (1) the social cost of underenforcement of the securities laws; (2) the constitutional cost incurred by an impaired Seventh Amendment right; (3) the increase in the tendency of young, inexperienced lawyers to eschew trial, caused by the feedback effect of resolving cases procedurally; and (4) the decrease in our ability to assess the efficacy of private enforcement, caused by the loss of discovery procedures through which the merits of a claim would come to light.

To say jury trials in securities litigation are rare is an understatement. Over 3,400 securities fraud cases have been filed since 1995, but only 28 have gone to trial and only 22 have resulted in a verdict. Milev et al., *supra* note 177, at 15. Without trials and jury verdicts, legal doctrines develop in a vacuum and settlement negotiations become unmoored from legal doctrine. Thorsen et al., *supra* note 57, at 113 (“[S]o few of these cases have gone to trial that no well-developed case law regarding the proof of law exists. Indeed, nearly all of the case law regarding loss has arisen in the context of motions to dismiss, summary judgment, class certification, evidentiary battles (admissibility of expert reports, for example), or settlement (where additional considerations may be in play) This means that concepts of loss have developed somewhat in a vacuum, uninformed by what evidence would actually be required and adduced at the proof stage.”); see also BURNS, *supra* note 174, at 89, 120.

186. Stephen N. Subrin, *Fishing Expeditions Allowed: The Historical Background of the 1938 Federal Discovery Rules*, 39 B.C. L. Rev. 691, 691, 695–96, 720–26, 730 (1998); see also Seymour Moskowitz, *Rediscovering Discovery: State Procedural Rules and the Level Playing Field*, 54 RUTGERS L. REV. 595, 607 (2002).

187. FED. R. CIV. P. 26(a), (d), (f), (g); Miller, *supra* note 110, at 55–57.

orders granting and denying class certification;¹⁸⁸ in 1990, it enacted the Civil Justice Reform Act, which required district courts to develop and implement litigation-management plans to reduce litigation expenses;¹⁸⁹ and in 1995, it enacted the PSLRA, which heightened pleading, stayed discovery pending a motion to dismiss, abolished joint and several liability, and ensured more client control over class actions.¹⁹⁰

Second, district judges are not better fact-finders than the jury, particularly where judges must find facts on pleadings alone. Access barriers that ask judges to resolve cases without a complete record on a motion to dismiss, at class certification, or on a motion for summary judgment force judges to rely on their “experience and common sense” to drive decision-making. The problem with asking judges to rely on their “experience and common sense” is that experience *shapes* our common sense: persons of different backgrounds see things—literally—very differently.¹⁹¹ And judges do not always recognize this and are prone to “cognitive illiberalism,” in which they neglect to account for the ways that their experience shapes their common sense.¹⁹² Thus, judges are unknowingly influenced by bias.

188. FED. R. CIV. P. 23(f). The rule drafters explicitly considered settlement pressure in enacting Rule 23. FED. R. CIV. P. 23 advisory committee note to subdivision (f). The drafters of the rules and Congress did not use the rules to remedy the pressure from class certification with merit-based screening by district judges. Rather, they specifically rejected a merits screening requirement for class certification. *See* Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010).

189. 28 U.S.C.A. §§ 471–482 (Supp. 2011).

190. 15 U.S.C.A. §§ 78u-4(a), (b)(1)–(3), (f) (Supp. 2011). The PSLRA’s damages cap also protects defendants by limiting damages to the difference between the purchase or sale price paid and the mean trading price of that security during the ninety days from the corrective disclosure. *Id.* § 78u-4(e)(1).

191. RICHARD A. POSNER, *HOW JUDGES THINK* 68 (2008).

When deliberating about what course of action is just, individuals will rarely have direct access to the answers themselves. Instead, they must judge whether the stories in which the information is embedded are plausible and are consistent with one another. And when interpreting a legal standard, they must consider which of the norms implicit in the standard are relevant, given the facts as they know them. All the empirical evidence we have suggests that individuals will do this through interlocking social and cognitive mechanisms that cause them to rely on a culturally contingent situation sense; an implicit knowledge of how the material and social world works.

Donald Braman, *Cultural Cognition and the Reasonable Person*, 14 LEWIS & CLARK L. REV. 1455, 1468 (2010).

192. Dan M. Kahan et al., *Whose Eyes Are You Going to Believe? Scott v. Harris and the Perils of Cognitive Illiberalism*, 122 HARV. L. REV. 837, 842–43 (2009). Kahan, Hoffman, and Braman use *Scott v. Harris*, 550 U.S. 372 (2007), the Supreme Court’s first-ever multi-media decision, as an example of cognitive illiberalism. *Id.* at 838. In *Scott*, the Court addressed whether a car chase that the plaintiff initiated posed a substantial and serious risk to the safety of others such that police were justified in ramming his car to stop him. *Scott*, 550 U.S. at 374. The Court said that the video-tape of the incident was clear: the plaintiff was driving like a madman. *Id.* at 378–80. Justice Stevens thought the tape evidenced something different. *Id.* at 390–93 (Stevens, J., dissenting). Rather than take on this dissenting view, the Court posted the tape to the internet and said it spoke for itself. *Id.* at 379 n.5. However, a survey of over 1300 people revealed that the tape was not speaking clearly. *Id.* at 841. Although “[a] fairly substantial majority did interpret the facts the way the Court did,” the “members of various subcommunities did not. African Americans, low-income workers, and residents of the Northeast, for example, tended to form more pro-plaintiff views of the facts than did the Court. So did individuals who characterized themselves as liberals and Democrats.” *Id.* at 841–42.

There is evidence that judicial resolution by implicit bias occurs in civil rights cases, which serve as a useful proxy for securities fraud cases in that both are likely to be thinly pleaded, that is, they rest on circumstantial as opposed to direct evidence, which is in the hands of defendant.¹⁹³ A recent study of civil rights cases has made three findings regarding *Bell Atlantic Corp. v. Twombly*,¹⁹⁴ and *Ashcroft v. Iqbal*'s¹⁹⁵ call to district judges to rely on "common sense and experience" when deciding motions to dismiss.¹⁹⁶ First, African-American plaintiffs are 2.66 times more likely to have their claims dismissed under *Bell Atlantic* and *Iqbal* than they were under *Conley v. Gibson*'s¹⁹⁷ pleading standard.¹⁹⁸ Second, African-American pro se plaintiffs' claims are 2.10 times more likely to have their claims dismissed.¹⁹⁹ And finally and most significantly, after *Iqbal* and *Bell Atlantic*, Caucasian judges dismiss African-American plaintiffs' claims of race discrimination at a higher rate (57.5%) than African-American judges (33.3%).²⁰⁰ These findings, the study concludes, suggest that district judges, without merits-discovery, rely on automatic stereotypes and implicit associations about race and discrimination that often turn out to be wrong when deciding claims.²⁰¹

If the premise of that article is correct, then injecting a judge's experience and common sense when weighing inferences, for example, makes room for judges to rely on stereotypes (likely implicit) or other heuristics to decide cases. In securities litigation, this may already be a problem; professors Stephen M. Bainbridge and G. Mitu Gulati have catalogued some of the flawed decision-making heuristics or shortcuts that judges already employ (consciously or subconsciously) as a substitute for analyzing the complexity of cases when deciding securities fraud suits.²⁰² If heuristics further permeate motions to

193. See Alexander A. Reinert, *The Costs of Heightened Pleading*, 86 IND. L.J. 119, 125–26, 159 (2011) ("[C]ases that are most vulnerable to dismissal for having thin pleadings are ones that rely on state of mind allegations, which are the heart of most civil rights and private discrimination claims.").

194. 550 U.S. 544 (2007).

195. 566 U.S. 662 (2009).

196. Victor D. Quintanilla, *Beyond Common Sense: A Social-Psychological Study of Iqbal's Effect on Claims of Race Discrimination*, MICH. J. RACE & L. (forthcoming 2011), available at <http://ssrn.com/abstract=1783065>.

197. 355 U.S. 41 (1957).

198. Quintanilla, *supra* note 196, at 33.

199. *Id.* at 34. Another study likewise found that the percentage of 12(b)(6) motions granted in all cases brought by pro se plaintiffs grew from *Conley* (67%) to *Bell Atlantic* (69%) to *Iqbal* (85%). Patricia W. Hatamyar, *The Tao of Pleading: Do Twombly and Iqbal Matter Empirically?*, 59 AM. U. L. REV. 553, 615 (2010). These findings suggest that the form complaints appended to the Rules (commonly relied upon by pro se litigants) are insufficient, which might lull litigants into filing a suit that would be dismissed.

200. Quintanilla, *supra* note 196, at 207.

201. *Id.* at 23–24.

202. 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, 118–36 (2002) (explaining that heuristics that substitute for analysis of materiality include puffery, bespeaks caution, zero price change, and trivial matters; heuristics that substitute for analysis of whether the defendant likely acted with a culpable state of mind include fraud by hindsight, internal

dismiss, motions for class certification, or decisions on the admissibility of experts, plaintiffs will have to overcome these misguided assumptions usually without any discovery to back them up.

In addition, the outgrowth of *Tellabs* that steeply discounts circumstantial evidence of a fraudulent intent does not account for the rationality of fraudulent behavior. Perpetrating a fraud, particularly where the potential pecuniary gains are great, can be rational, wealth-maximizing behavior.²⁰³ Taken most generally, economic theory assumes corporate executives are more likely to commit fraud when it is in their pecuniary interest to do so than when it is not.²⁰⁴ The premise of this assumption is what allows plaintiffs to allege scienter by alleging “motive and opportunity” alone. In some federal circuits (more before *Tellabs* than after²⁰⁵) plaintiffs could show that defendants acted with a culpable mental state by alleging only that the defendant (1) had an opportunity to commit fraud by misrepresentation, omission, manipulation or otherwise; and (2) would personally benefit by committing the fraud.²⁰⁶

Moreover, the idea that fraud may be rational, wealth-maximizing behavior is what causes Professors Jonathan R. Macey and Geoffrey P. Miller to argue that, at times, fraud is even consistent with executives’ fiduciary duties.²⁰⁷ For example, after *Dura* it may be *optimal* for companies subject to the federal securities laws to obscure or delay negative information in order to maximize investor welfare. Interpreting *Dura* to require a “lie-truth-drop” and requiring plaintiffs to isolate fraud as the only cause of moving the company’s stock price encourages companies to structure disclosures to minimize the effect on stock price.²⁰⁸ Companies can control the timing of their disclosures to enable them to manipulate the extent to which the company’s stock price reacts to new information, and thus, for companies with multiple projects, *Dura* enables companies to over-represent its value and minimize the consequences of fraud

forecasts, whether something sounds in fraud, and unusual insider stock sales; and heuristics that substitute for analysis of whether the defendant had a duty to disclose information include routine forecasts and extreme departures).

203. See, e.g., Daniel T. Ostas, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 AM. BUS. L.J. 571, 574, 601 (2007) (stating “[t]raditional economic analysis assumes that people, including corporate executives, are motivated by pecuniary, or material, self-interest” and finding that fraud can be rational, wealth-maximizing behavior when the expected payout of the fraud is greater than the deterrent force of the law).

204. *Id.* at 574.

205. See, e.g., *Institutional Invs. Grp. v. Avaya, Inc.*, 564 F.3d 242, 276–79 (3d Cir. 2009) (saying plaintiffs can no longer allege scienter by alleging motive and opportunity alone after *Tellabs*). After *Tellabs*, the Second Circuit has, however, reaffirmed that plaintiffs can plead scienter with motive and opportunity alone. See, e.g., *ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 198–99 (2d Cir. 2009).

206. See Alan R. Bromberg & Lewis D. Lowenfels, *Rule 9(b)*, in 5 BROMBERG & LOWENFELS ON SECURITIES FRAUD § 10:115 (2d ed. 2010) (discussing the motive-and-opportunity test for pleading scienter).

207. Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1060 (1990).

208. Spindler, *supra* note 58, at 656–57.

by offsetting fraud in one project with success in another.²⁰⁹ And for single-project companies, requiring plaintiffs to pinpoint a post-transaction decline and to attribute that decline to only the fraud encourages companies to create intervening causes and commingle revelation of the fraud with other bad news or even fabricate other news to mask the effect of the revelation of the fraud.²¹⁰

Another one of the shortcuts judges rely upon when forced to engage in pre-trial fact-finding without any facts is to put talismanic significance on event studies that purport to measure the effect of the fraud on the stock price and presumably provide objective evidence of loss causation.²¹¹ By emphasizing event studies, however, some courts refuse to recognize the full range of inflationary loss as cognizable economic loss. Rather, courts insist on a “lie-truth-drop” formula for securities fraud, and want an event study to show that the drop is attributable to the truth (or a “corrective disclosure” or a “revelation of the fraud”) and the truth alone. Judicial acceptance of this approach is not completely unfounded—indeed, it represents a simple and logical way of defining loss and causation. But it has no support in the text of the procedural rules governing securities fraud, takes too narrow a view of economic loss, and puts too much faith in event studies.

Economic loss and loss causation exist whenever (1) fraud inflates a stock price, and (2) the investor cannot recover that overpayment.²¹² Courts must first wrestle with how inflation can occur and how it can be measured. With respect to this first question, Frank Torchio of Forensic Economics, Inc., has found that event studies are sometimes improperly used by defendants to give the illusion that the stock price was never inflated.²¹³ He observes that by focusing event-study analysis on the day the alleged fraud was made as opposed to the dates of the corrective disclosure, event-study analysis can be misused to negate any showing of inflation.²¹⁴ But, as Torchio notes, the proper measure for price impact is from the date of disclosure because at the time of the fraud there may be absolutely no price impact.²¹⁵ Only when the case involves what Torchio

209. Patrick J. Coughlin et al., *What's Brewing in Dura v. Broudo? The Plaintiffs' Attorneys Review the Supreme Court's Opinion and its Import for Securities Fraud Litigation*, 37 LOY. U. CHI. L.J. 1, 26 (2005); Fisch, *supra* note 58, at 852; Spindler, *supra* note 58, at 677–80.

210. See Spindler, *supra* note 58, at 680–85.

211. According to the *Restatement (Third) of Torts*, viewing “science” as an objective method of establishing factual causation in all cases is incorrect because “[f]irst, scientific standards for the sufficiency of evidence to establish a proposition may be inappropriate for the law, which itself must decide the minimum amount of evidence permitting a reasonable (and therefore, permissible) inference, as opposed to speculation that is not permitted,” and “[s]econd, scientists report that an evaluation of data and scientific evidence to determine whether an inference of causation is appropriate requires judgment and interpretation. Scientists are subject to their own value judgments and preexisting biases that may affect their view of a body of evidence.” RESTATEMENT (THIRD) OF TORTS: PHYS. & EMOT. HARM § 28 cmt. on subsection a, (c) (2005).

212. Thorsen et al., *supra* note 57, at 95.

213. Frank Torchio, *Proper Event Study Analysis in Securities Litigation*, 35 J. CORP. L. 159, 159–60 (2009).

214. *Id.* at 163.

215. *Id.* Professor Langevoort explains that if the market had been anticipating earnings of \$3 per

terms an affirmative misstatement, a statement containing misleading information such that the information was not already in the total mix of information in the marketplace before the statement, will an event study focused on the date of the fraud accurately measure market impact.²¹⁶

Once a court determines that stock prices have been inflated, courts must then wrestle with how the loss occurred, that is, how inflation dissipated in a way that investors could not recover that loss. Inflation can dissipate in any number of ways, including by (1) a corrective disclosure, in which the full truth is disclosed; (2) a revelation of general improprieties; (3) raising questions or concerns without revealing the fraud; (4) a revelation of the company's true financial condition without revealing the fraud; (5) leaking the information with recurrent, partial revelations; (6) general market forces driving the stock down; or (7) the company going bankrupt.²¹⁷ This list illustrates that the loss need not dissipate by a corrective disclosure; and in some cases inflation can even dissipate before the truth is revealed.²¹⁸

Generally, event studies provide good evidence that new information has affected a stock price, but they suffer from several shortcomings that relegate the mode of analysis to good rather than conclusory evidence.

First, by making alterations within generally accepted parameters of operating an event study, experts can alter results and call reliability into question. For example, an expert can alter the length of an event window, or even skew the probability of detecting an abnormal return by altering the sample size.²¹⁹ Second, event-study analysis without merits discovery functions poorly when a corrective disclosure is commingled with other bad news.²²⁰ Decisions like *Oscar*, however, require an event study to isolate the effect of the fraud from the tangle of other factors, and thus encourage companies to commingle a corrective disclosure with other bad news to obscure the effect the corrective disclosure has on the fraud. Without merits discovery though it is difficult to tell whether the other news is truly unrelated to the fraud.²²¹ Third,

share, then lying by reporting earnings of \$3 would probably have little if any impact on the price of the stock. Yet if the true earnings were \$2.50, the \$3 lie would be harmful in the sense that telling the truth would have moved the price downward. Courts that simply assume that the lack of a price impact at the time of the alleged misrepresentation necessarily undermines plaintiffs' case are wrong—an example of expert testimony put forth by the defense lawyers getting in the way of common sense. Donald C. Langevoort, *Compared to What? Econometric Evidence and the Counterfactual Difficulty*, 35 J. CORP. L. 183, 185 (2009); see Spindler, *supra* note 58, at 663–64 (stating that analyzing market impact will be difficult when a company conceals bad news to avoid a negative market reaction).

216. Torchio, *supra* note 213, at 166.

217. Thorsen et al., *supra* note 57, at 101–07.

218. *Id.*

219. For example, by varying the sample size of studied companies from 25 to 100, the probability of detecting an abnormal return of 0.5% increases from 24% to 71%, the probability of detecting an abnormal return of 1% increases from 71% to 94%, and the probability of detecting an abnormal return of 2% increases from 71% to 100%. See Kaufman & Wunderlich, *supra* note 107, at 230–32.

220. See Bruegger & Dunbar, *supra* note 45, at 25–26; Fisher, *supra* note 68, at 880.

221. See Fisch, *supra* note 58, at 851–52 (expressing concern about a judge's ability to determine how much of a drop in price could be attributed to fraud).

for an event study to adequately account for other factors and isolate the effect of the fraud on the company's stock price, the event study must use a multi-factor model to control for the confounding information.²²² Identifying these factors for the model without merits discovery, however, proves difficult. Fourth, event studies are less reliable when the defendant has made recurring misrepresentations.²²³ For recurring misrepresentations, the inflation per share changes throughout the class period, but when the company issues a corrective disclosure, it does not correct each distinct misrepresentation in an isolated announcement. In this situation, an event study can overestimate or underestimate the inflation per share as the corrective disclosure may contain more or less information than was known during the class period.²²⁴

Focus on event-study analysis and the "lie-truth-drop" formula works against defendants as well. Professor Langevoort points out that the emphasis on an event study that measures a corrective disclosure implicitly uses as a causation counterfactual (the benchmark from which we measure the historical state of the world) a world of "truth telling," where the company told the truth, investors knew about the fraud, and did not purchase stock.²²⁵ Yet, as Professor Langevoort notes, mandatory disclosure is not always the correct counterfactual; the correct counterfactual may, in some cases, be a world in which the defendant said nothing (a "silence" counterfactual) rather than one in which the defendant disclosed information.²²⁶ The emphasis on an event study and corrective disclosure neglects this counterfactual. Moreover, deciding the counterfactual question on pleadings and without a record robs the defendant of an opportunity to present counterfactual arguments to a jury that might cancel out (or produce some other result).²²⁷ Emphasis on a corrective disclosure and a later drop in stock price may also artificially inflate the measure of the plaintiffs' damages. "[C]orrective disclosures are often prompted by the materialization of an undisclosed risk," and thus "the stock price drop in response to such a disclosure is likely to reflect that materialization rather than simply nondisclosure of the risk itself."²²⁸ The stock price drop then may be greater than the initial price inflation even if the drop in stock price is entirely responsive to the corrective disclosure.²²⁹

222. See Bruegger & Dunbar, *supra* note 45, at 25.

223. *Id.* at 26.

224. *Id.* at 26–29; see also Langevoort, *supra* note 215, at 184.

225. Langevoort, *supra* note 215, at 184–85.

226. Defendants do not have a general duty to speak. See Chiarella v. United States, 445 U.S. 222, 230 (1980); Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87, 101 (1999).

227. See Barbara Spellman & Alexandra Kincannon, *The Relation Between Counterfactual "But for" and Causal Reasoning: Experimental Findings and Implications for Jurors' Decisions*, 64 LAW & CONTEMP. PROBS. 241, 261 (2001).

228. Fisch, *supra* note 58, at 849.

229. *Id.* at 851–52. Professor Fisch also notes that corrective disclosures reveal the bad news itself along with the fact that bad news was fraudulently concealed, which may reflect concerns about poor management integrity and the anticipated likelihood of future litigation, further driving the stock price

Event studies mark a starting point, but remaining questions must be ferreted out with additional merits discovery and cross examination. Causation is an elusive concept in the law (and thus a classic fact question for the jury²³⁰), and loss causation in particular is “ungainly, exotic, [and] confusing.”²³¹ This was the gist of the Ninth Circuit’s decision in *Dura*: plaintiffs had to plead only that inflation occurred, and then at the evidentiary stage of litigation plaintiffs would show how that inflation dissipated.²³² But despite the challenges the issue of loss causation presents, the Supreme Court required at a minimum that plaintiffs also allege how the inflation dissipated.²³³ Some courts have recognized the nuances of economic analysis and inflationary loss apart from the “lie-truth-drop” scenario, which bodes well for injured investors.²³⁴ But the simplicity of the “lie-truth-drop” formula and the comfort of a purportedly objective analysis for causation is luring for judges considering the issue of loss causation before discovery and trial.

C. The Flawed Assumption that Merits-Based Screening Precludes Only Frivolous Claims

The judiciary assumes its access barriers separate out only frivolous claims. But as a result of the new pleading rules, merited claims face a greater prospect of dismissal where state of mind is involved. Studies that address the impact of heightened pleading for civil rights claims have found an increased rate of dismissal for *merited* claims. *Bell Atlantic* and *Iqbal* have increased the dismissal rate for civil rights cases from 50% under *Conley*, to 60% under *Iqbal*.²³⁵ Professor Alexander A. Reinert finds that for civil rights cases, plausibility pleading (or, heightened pleading) is no better than traditional, liberal notice

down. *Id.* at 849.

230. 75A AM. JUR. 2D *Trial* § 657 (2008).

231. Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 357 (1991) (internal quotation marks omitted); see also William Prosser, *Proximate Cause in California*, 38 CAL. L. REV. 369, 369 (1950) (stating that “[p]roximate cause remains a tangle and a jungle, a palace of mirrors and a maze”).

232. Thorsen et al., *supra* note 57, at 115.

233. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 345–46 (2005).

234. See Thorsen et al., *supra* note 57, at 120 n.103, 121 n.104–06 (collecting decisions). More decisions that correctly apply principles of economic loss likely exist, as rulings on expert issues can be disposed of with bench rulings or unpublished minute orders, and the parties may settle before a published opinion is released.

235. Hatamyar, *supra* note 199, at 556; see also Kendall W. Hannon, Note, *Much Ado About Twombly? A Study on the Impact of Bell Atlantic Corp. v. Twombly on 12(b)(6) Motions*, 83 NOTRE DAME L. REV. 1811, 1835–38 (2008) (finding spike in dismissal of civil rights claims after *Bell Atlantic Corp. v. Twombly*); Joseph Seiner, *The Trouble with Twombly: A Proposed Pleading Standard for Employment Discrimination Cases*, 2009 U. ILL. L. REV. 1011, 1029–30, 1035–38 (2009) (finding that district courts relying on *Bell Atlantic* dismissed a higher percentage of Title VII claims than courts that had previously relied on *Conley*, and an review of the decisions showed that some courts were using plausibility to reject Title VII claims). Studies that find an increased rate of dismissal after *Bell Atlantic* and *Iqbal* may underreport the true effect of the new heightened pleading standard because these studies do not quantify those plaintiffs who forgo filing suit at all in light of the new standards. Scott Dodson, *New Pleading, New Discovery*, 109 MICH. L. REV. 53, 65 (2009).

pleading at filtering out meritless claims, yet the rate of dismissal has risen.²³⁶ The lesson here is that merited cases that are dependent on circumstantial evidence, like civil rights claims or securities fraud claims, which require a particularized allegation of the defendant's state of mind, face an increased rate of dismissal.²³⁷

The heightened procedural barriers of the PSLRA *already* have caused merited claims to be tossed by district judges at a greater rate. Stephen Choi has found that a significant portion of merited claims without pre-filing "hard evidence" (an accounting restatement or an accompanying SEC action) or claims against companies engaged in smaller offerings face a higher dismissal rate after the heightened procedural bars were set in place by the PSLRA.²³⁸ A study on the effect of *Dura* has likewise found that less class actions were filed after *Dura* and the number of smaller settlements has declined as well.²³⁹

The increased dismissal of merited claims results in under-enforcement of the securities laws, which undermines the integrity of American markets. As an example of just one consequence of declining merited litigation, two studies have found that the reduction in securities litigation has reduced audit quality and manager incentives to report truthfully.²⁴⁰ By using the cost of equity capital

236. Reinert, *supra* note 193, at 125–26.

237. A recent study has found that *Tellabs* correlates with a significantly lower dismissal rate on scienter grounds in circuits previously applying a higher preponderance standard, like the Ninth Circuit. Stephen J. Choi & Adam C. Pritchard, *The Supreme Court's Impact on Securities Class Actions: An Empirical Assessment of Tellabs* (Dec. 4, 2009) U. of Mich. Law & Econ., Olin Working Paper No. 09-016; NYU Law & Econ. Research Paper No. 09-34, available at <http://ssrn.com/abstract=1457085>. The Ninth Circuit's scienter standard was considered extremely harsh before *Tellabs*. See 26 Michael J. Kaufman, *Pleading State of Mind*, in SECURITIES LITIGATION: DAMAGES § 3:10 (2007). That the dismissal rate in the Ninth Circuit went down says little about what the dismissal rate actually should be. If the dismissal rates have risen in other circuits, then the saved merited claims in the Ninth Circuit may be offset by the increased dismissal of merited claims in other circuits. This would exacerbate the increased dismissal rate as a result of the PSLRA, which doubled the dismissal rate for securities fraud claims. Compare Ronald I. Miller et al., *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead?*, at 4 (Apr. 2006), available at http://www.nera.com/extimage/bro_recenttrends2006_sec979_ppb-final.pdf (dismissal rate of 40.3% for securities class actions filed from 1998 to 2003), with Elaine Buckberg et al., *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?*, at 3 (July 2005), available at http://www.nera.com/extImage/Recent_Trends_07.2005.pdf (dismissal rate of 20.3% for securities class actions filed from 1991 to 1995).

238. See generally Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?* [hereinafter, Choi, *Do the Merits Matter?*], 23 J.L. ECON. & ORG. 598 (2007); see also Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 37 (2009). Professor Choi finds that nonnuisance claims without pre-filing hard evidence are less likely to be filed (a pre-PSLRA filing rate of 3.5% compared to a post-PSLRA filing rate of 1.7%). Choi, *Do the Merits Matter?*, *supra*, at 615.

239. Duncan, *supra* note 59. The author concludes that because filings declined after *Dura* and the average settlement value rose that *Dura* was the cause of this filing decline and rise in settlement value. The relationship may be correlative, but it is not necessarily causal. That cases are no longer settling for small amounts tells us little about its merit. There are big and small frauds, and a small settlement may just signal that the case did not require much effort by either side. Also, the lack of smaller settlements may just suggest that plaintiffs are bringing cases with higher damages to offset their increased pre-filing investigation costs.

240. Ho-Young Lee et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the*

as a proxy for the quality of financial information, one of these studies found that the quality of financial information decreased after the enactment of the PSLRA.²⁴¹ The other study found that after the PSLRA diminished the prospect of a lawsuit, there was an increase in income-increasing discretionary accruals for auditor companies, which the authors posit means a decreased incentive for auditors to curtail earnings management (or cooking the books) by clients.²⁴²

V

CONCLUSION

As a result of access barriers that largely substitute the district judge as the fact-finder on a motion to dismiss, class certification, and summary judgment, injured investors face significant obstacles to recovery under Rule 10b-5. The barriers that rewrite rules of procedure for securities fraud to achieve the goals of preventing discovery and sparing defendants the burden of frivolous litigation pose both significant constitutional and practical concerns. Eschewing the formal rulemaking process resembles a usurpation of the legislative's rulemaking function. And replacing the jury with a pre-trial fact-finding judge and requiring plaintiffs to meet a burden of proof equal to or greater than the burden at trial raises serious Seventh Amendment questions. The constitutional concerns aside, the wisdom of these access barriers is doubtful. The premise that defendants are forced *in terrorem* to settle is incomplete and unsupported. Moreover, merits-based screening requires judges to engage in fact-finding without facts, and thus, when deciding cases judges rely on extrajudicial information, inferences, and assumptions—even about human behavior and motives—that often turn out to be wrong.

Cost of Equity Capital, Q. J. FIN. & ACCT., Mar. 22, 2009, at 85; Ho-Young Lee & Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors*, AUDITING: J. PRAC. & THEORY, Mar. 1, 2003, at 93.

241. Lee & Mande, *supra* note 240, at 103.

242. *Id.* at 94, 105.