HURDLES OF DIFFERENT HEIGHTS FOR SECURITIES FRAUD LITIGANTS OF DIFFERENT TYPES

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Fraud claims filed by investors in the wake of the financial crisis of 2008 reveal a significant and unrecognized problem in securities law: the law treats claims of investors who purchase securities through private placements more favorably than it treats claims of investors who purchase shares on public exchanges or in public offerings. The disparity is a symptom of financial markets outpacing their legal and regulatory framework, and this Article proposes a remedy.

The different hurdles confronting investors who invest in different transactions but who make similar allegations and rely on the same law are, the Article contends, an unfair and apparently unintended result of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which sought to curb frivolous shareholder class actions. The PSLRA raised the standard plaintiffs must meet in alleging that a defendant had wrongful intent, or scienter, but it did not

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raise the standard applicable to claims that a plaintiff reasonably relied on an allegedly fraudulent misrepresentation or omission. Because establishing scienter is difficult for investors with access only to regulatory disclosures by publicly traded companies, while establishing reasonable reliance is more likely to be difficult for putatively sophisticated investors in private placements, investors in publicly accessible transactions face a higher hurdle than private placement investors when alleging fraud.

This Article describes and critiques this effect of the PSLRA, and calls on Congress to revise standards so that investors victimized by fraud have the same chance of recovery through litigation whether or not they purchased securities in a private placement.

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I. INTRODUCTION

In the wake of the 2008 financial crisis, investors who suffered losses did what investors often do—they filed lawsuits. Many were shareholder class action suits alleging that companies failed to disclose the scale of their potential exposure to losses caused by falling real estate prices and rising rates of borrower delinquency. However, many were

1 See Shaila Dewan, Housing Recovery Seems Still on Track, N.Y. Times, Sept. 25, 2013, at B1 (reporting home prices rising after several years of declines following the financial crisis of 2008).

individual actions filed by financial companies that had purchased various types of securities,\(^3\) which fell in value as a result of the same trends; the plaintiffs alleged that the sellers did not disclose the riskiness of the securities. The two types of investor litigation frequently relied on the same federal law, section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"),\(^4\) and arose out of the same or very similar facts. Yet the hurdles confronting plaintiffs were different depending on the circumstances of the purchase. Pleading standards favor investors who bought through private placements, making recovery through litigation potentially easier for these investors relative to investors who did not buy through private placements.

An investor who files a lawsuit alleging fraud after purchasing shares of a publicly traded company, either in an initial public offering ("IPO") or on an exchange, can typically draw on general information about the company from executives' public statements, periodic reports, or, in the case of an IPO, from registration materials filed with regulators.\(^5\) An investor who files a lawsuit alleging fraud after purchasing securities\(^6\) through a private placement (a transaction available essentially by invitation only)\(^7\) can

\(^3\) Some investor plaintiffs who purchased through private placements also sought class action status. See, e.g., Argent Classic Convertible Arbitrage Fund L.P. v. Countrywide Fin. Corp., No. CV 07-07097 MRP, 2009 WL 8572340 (C.D. Cal. Mar. 19, 2009) (plaintiff investors seeking to represent a class of all purchasers of convertible debentures issued by Countrywide Financial Corp.).


\(^5\) These disclosures identify the expected uses of the money raised by the offering, state corporate financial status and performance, specify material contracts, and provide other information about the company and its business. See 15 U.S.C. § 77aa.

\(^6\) This includes shares or preferred shares—a public company may sell securities through a private placement, too.

draw on transaction-specific information that is more detailed and relevant than disclosures in an annual report, for example. That more specific information demonstrates, at a minimum, a defendant seller's interest in persuading the plaintiff to invest. This Article contends that this information disparity puts the second plaintiff in a better position to provide a sufficiently persuasive story to satisfy the pleading requirements applicable to claims under section 10(b). The hurdle for an investor who bought on an exchange or in an IPO is too high, while the hurdle for the investor who bought through a private placement is too low. Overall, the disparity is one more way that the law creates an incentive to use private placements.

The difference in treatment of claims arising from different types of transactions is a symptom of a larger problem, that of financial markets outpacing their legal and regulatory framework. Congress was concerned with protecting public company shareholders when it adopted the antifraud provisions of the Exchange Act. Lawmakers did not offer a rationale for discriminating against investors who buy shares of companies through transactions accessible to the investing public compared to investors in private solicitations.

Prior to a private placement, potential buyers typically receive documentation describing the transaction in detail. Buyers may attend presentations on the securities to be sold and may ask for and receive additional information to enable better analysis of the securities' value and riskiness. See infra Section IV.A.

See Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385, 394–95 (1990) (describing how in the years before the adoption of the Exchange Act, "pressure was mounting for public control of the practices of those who sold corporate securities to public investors"). Private offerings have grown in importance in recent years; in 1981, about $12 billion of securities were offered through private placements, while in 2010, the figure exceeded $900 billion. See Elisse B. Walter, Comm'r, SEC, Remarks at the 2011 SEC Government-Business Forum on Small Business Capital Formation (Nov. 17, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch111711ebw.htm).
placements.\textsuperscript{10} Subsequent legislative action that hinders shareholder lawsuits is the result of advocacy for restrictions that protect public companies from potentially costly litigation.

This Article argues that disparate treatment of investors in publicly accessible transactions, as compared to investors in instruments sold through private transactions, not only lacks justification, but in fact may undermine protection of investors who are more vulnerable to fraud. Investors that buy shares through a publicly accessible transaction (herein referred to as “outsider” investors) typically receive less detailed and less transaction-specific information than do private placement investors (“connected” investors). Because of the different information provided to them, outsider investors may have more difficulty assessing the likelihood of fraud. If pleading standards hinder outsider investors'\textsuperscript{11} efforts to recover through litigation, relative to other investors, then the standards further weaken investors already at an informational disadvantage and reduce the likelihood of realizing positive externalities that some scholars have identified as benefits of shareholder lawsuits.\textsuperscript{12} The disparity matters because of the rapid growth in private offerings in recent years and the increasing frequency of participation in such investments by institutions like public pension funds.\textsuperscript{13}

\textsuperscript{10} The Supreme Court has addressed the private right of action under the Exchange Act in oblique fashion, without articulating a rationale that might explain differential treatment. See Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (observing in a footnote that “[i]t is now established that a private right of action is implied under §10(b)” and citing two prior Supreme Court cases, only one of which (Tcherepnin v. Knight, 389 U.S. 332 (1967)) involved a § 10(b) claim; that case also took for granted that a private right of action existed).

\textsuperscript{11} In this Article, “shareholders” refers to investors who hold shares of publicly traded companies, when those shares were purchased through a transaction available to the investing public.

\textsuperscript{12} See infra Part II.B.

\textsuperscript{13} See Vlad Ivanov and Scott Bauguess, Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption, 1, 3 (Feb. 2012),
Litigation between buyers and sellers in private placements has received less scholarly attention than shareholder class actions; post-private placement litigation clearly benefits the successful plaintiff but less obviously helps anyone else. This Article proposes an overhaul of pleading standards applicable to fraud claims to ease the path to recovery for plaintiffs with less pre-transaction access to information and to make more precise the pleading requirements that investors with relatively greater access to information must meet. This Article is a building block in a larger project exploring the implications of the evolution of the financial markets, a topic approached from different angles by scholars including Steven L. Schwarcz, Steven Davidoff, Usha Rodrigues, and Elizabeth Pollman.

http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf (finding that, for example, private offerings pursuant to Regulation D raised more capital than did debt offerings in 2010; such offerings also raised more than twice as much as public equity offerings).

Indeed, I will argue that these lawsuits, when decided wrongly or perhaps even inconsistently, may create a negative externality by affecting the incentives of parties to securities transactions to disclose or to conduct due diligence. See infra Part IV.B.1.

See, e.g., Steven L. Schwarcz, Disclosure’s Failure in the Subprime Mortgage Crisis, 2008 UTAH L. REV. 1109, 1115 (2008) (questioning the efficacy of a securities regulation regime that makes disclosure a priority when the financial crisis suggests that purchasers of risky securities did not understand the information disclosed).


Professor Pollman has raised a host of difficult questions about the implications of secondary markets for trading of shares of privately held companies, another financial market innovation that poses a challenge to the existing law and regulation of securities. See Elizabeth Pollman, Information Issues on Wall Street 2.0, 161 U. PA. L. REV. 179, 206 (2012).
among others. It also attempts to evaluate how well current legal and regulatory mechanisms protect investors and enhance stability for the identification of potential securities fraud. The Article links these conversations within securities law and conversations outside of securities law involving access to justice and raises questions about who is best placed to prevent, or at least detect, fraud. In a future article, I intend to examine the role that the regime for classification of accredited investors may have played in the financial crisis and propose reforms.

The following discussion has five parts. Part II describes criticisms and offers justifications for private securities litigation. The difference in pleading standards confronting plaintiffs in securities fraud cases raises a significant and difficult question: What is the proper role of private litigation in constraining financial market misconduct? Answering that question is not easy, although it is clear that private litigation represents an important ex post response to fraud. Part II describes criticisms of securities fraud lawsuits and offers a defense. This Part then situates the remedy afforded by section 10(b) in the context of other private rights of action for securities fraud.

Part III describes the pleading standards that fraud claims under the Exchange Act must meet in order to survive a motion to dismiss. Because these cases do not often go to trial, resolutions of motions to dismiss matter, and defeating such a motion preserves the possibility of damages, while a loss precludes recovery. This Part identifies the elements of a fraud pleading that often prove critical to surviving a motion to dismiss. The description of the elements of a securities fraud claim and of the evolution of the applicable pleading regime is a significant contribution of this Article.

Part IV describes the effects of the different pleading standards on different kinds of plaintiffs. This Part explains how the standards may be more or less difficult to satisfy,

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depending on the characteristics of the investment that gave rise to litigation. Additionally, Part IV argues that Congress's selective raising of the pleading standards applicable to claims of securities fraud unfairly and unjustifiably blocks access to justice for outsider investors. Finally, this Part situates barriers to certain securities fraud claimants within a broader trend, recognized by other commentators on civil pleading standards, toward more tightly restricted access to courts. The animating concern of this Article is that the disparity in access to redress through litigation matters. Investors in private placements have an advantage that may translate into greater settlement values in the wake of allegations of fraud.20

Part V contends that disparate treatment of different fraud claims is the result of a failure to update laws and regulations to keep up with changes in financial markets. This Part proposes reforming pleading standards to reduce the height of the hurdles confronting outsider claimants in fraud lawsuits, and to make more precise courts' evaluations of the reasonableness of connected plaintiffs' reliance on a defendant's allegedly fraudulent statements. The proposal briefly outlines what might be required of sophisticated investors claiming they were victims of deceit and discusses the political economy of any reform effort.

II. THE ROLE OF PRIVATE SECURITIES LITIGATION

For decades, the Supreme Court has recognized a private right of action under section 10(b) of the Exchange Act, although the law does not explicitly provide for civil lawsuits by investors.21 Private securities litigation has proven

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20 It may be that, with the continuing rise of institutional investors, investors buying through publicly accessible transactions and investors in private placements are increasingly often the same entities. Even if the investor populations were the same, the disparity in treatment still would beg a rationale.

21 Then-Justice William Rehnquist described private securities litigation under section 10(b) as a "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores,
controversial. Critics complain that investor lawsuits neither punish nor deter actual or potential wrongdoers and do not compensate anyone other than plaintiffs' lawyers.\(^2\) The critics making these arguments include executives at companies named as defendants in fraud lawsuits,\(^3\) scholars who have studied the effects of litigation,\(^4\) and groups advocating stricter control of civil litigation more generally.\(^5\)


\(^2\) For example, the American Tort Reform Association, a group advocating changes to laws governing civil litigation generally, called for investigation of "widespread misconduct by the plaintiff's bar" after two leading securities class action lawyers were convicted of various crimes related to their practice of law. Press Release, American Tort Reform Association, Weiss Sentencing Prompts ATRA to Again Press Congress for Hearings Into Potentially Widespread Trial Lawyer Misconduct (June 2, 2008) (on file with author), available at http://www.atra.org/newsroom/weiss-sentencing-prompts-atra-again-press-congress-hearings-potentially-widespread-trial.

\(^3\) See, e.g., Common Sense Legal Reforms Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the Comm. on Commerce, 104th Cong. 87-92 (1995) (statement of Dennis W. Bakke, President and Chief Executive Officer, AES Corp.) (criticizing the securities laws for empowering "a new class of bully – the class action, securities law plaintiff attorney"). Bakke was a named defendant in, among others, Stafford v. Bakke, No. 1:03CV1132-LJM-WTL, 2005 WL 1656855, (S.D. Ind. July 7, 2005).

\(^4\) See, e.g., Eric Helland, Reputational Penalties and the Merits of Class-Action Securities Litigation, 49 J.L. & ECON. 365, 366 (2006) (finding little evidence that allegations of fraud impose a "reputational penalty" on directors when boards to which they belong are accused of fraud); A.C. Pritchard, Stoneridge Investment Partners v. Scientific Atlanta: The Political Economy of Securities Class Action Reform, 2008 CATO SUP. CT. REV. 217, 225 (warning that "[c]ourts and jurors, with hindsight, may have difficulty distinguishing false statements (which were known to be false at the time) from unfortunate business decisions").

\(^5\) For example, the U.S. Chamber of Commerce has advocated changes that would affect securities fraud claimants. See U.S. CHAMBER OF COMMERCE, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT, AND THE PATH TO REFORM 2 (2008), available at http://www.thehill.com/sites/default/files/ILR_2008SecuritiesClassActionLitigation_0.pdf.
Their arguments may explain lawmakers' readiness to adopt legislation aimed at curtailing securities litigation and the hostility expressed by some Supreme Court justices toward securities class action suits. In several cases, the Supreme Court has imposed strict standards on securities fraud plaintiffs' claims, which this Article explores in Part III.

This Part describes some of the virtues of private securities litigation, first briefly describing its role in conjunction with other regulatory mechanisms, then offering a response to criticisms. This Part contends that higher hurdles to shareholder litigation have reduced the effectiveness of post-fraud private litigation as a regulatory tool.

A. The Costs of the Private Right of Action

There are three rationales traditionally used to justify private securities litigation: deterrence of wrongdoing, punishment of wrongdoers, and compensation of victims. Deterrence and punishment in the context of financial markets may have an added benefit, imposing discipline on


27 Just a few years after the footnote acknowledging the private right of action under section 10(b) was written, supra note 10, the Court warned of the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975). The Court has cited that same language in more recent opinions criticizing and limiting the scope of 10(b) liability. See Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc., 552 U.S. 148, 163 (2008) (citing Blue Chip Stamps for "not[ing] that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies").

seller and investor conduct. There are two more implicit justifications, both so obvious that they may often be forgotten: detection and fairness. These goals underlie the private cause of action under provisions of a different law, sections 11 and 12 of the Securities Act of 1933 (the "Securities Act"),\(^{29}\) which permit investors to sue based on misrepresentations or omissions in a registration statement or prospectus, respectively.\(^{30}\)

The private right of action for recovery in cases of securities fraud complements industry self-regulatory regimes,\(^{31}\) as well as government civil and criminal regimes.\(^{32}\) The Financial Industry Regulatory Authority ("FINRA"), an industry self-regulatory organization, may impose monetary penalties.\(^{33}\) The Securities and Exchange Commission ("SEC") may sue under the same provision available to private litigants.\(^{34}\) State and federal prosecutors may pursue criminal charges against wrongdoers whose


\(^{30}\) For a more complete discussion of these other potential causes of action, see infra Part II.C.

\(^{31}\) Professor Fox has argued that perhaps the enforcement regime should be viewed the other way around: public enforcement complements private litigation. See Fox, supra note 28, at 328–29. The proper framing of the relationship between public and private enforcement does not alone respond to criticism of investor securities litigation.

\(^{32}\) In addition to these ex post remedies for fraud, other mechanisms seek to prevent fraud ex ante. Independent auditors review financial statements of public companies, for example, and lawyers advise on what information must be disclosed when.

\(^{33}\) Since 2010, FINRA has investigated and prosecuted potential misconduct by members of public stock exchanges on behalf of the exchanges. FINRA may impose monetary penalties on their members for violations of exchange rules and applicable laws. See NYSE Disciplinary Actions, NYSE EURONEXT, https://usequities.nyex.com/regulation/disciplinary-actions (last visited Mar. 5, 2014).

\(^{34}\) The SEC does not have to satisfy all the same elements of a fraud claim that a private plaintiff must. For example, the agency need not establish reliance because the agency did not in fact purchase the securities at issue. See SEC v. Credit Bancorp, Ltd., 195 F.Supp.2d 475, 490–91 (S.D.N.Y.2002) ("The SEC does not need to prove investor reliance, loss causation, or damages in an action under Section 10(b) of the Exchange Act, Rule 10b-5, or Section 17(a) of the Securities Act.").
conduct is sufficiently egregious. In addition to these ex post remedies for fraud, federal disclosure requirements apply to sales of securities ex ante, and accountants and lawyers act as gatekeepers who are, in theory at least, in a position to deter, detect, and/or disclose potential fraud.

Each mechanism has drawbacks. Self-regulatory organizations, which monitor the conduct of their own members, face structural conflicts of interest, as do lawyers and accountants monitoring the conduct of their clients. The SEC suffers resource constraints that make it difficult to investigate, let alone act upon, every indication suggesting that a transaction may be fraudulent. Moreover, while

35 Drawing the line between civil and criminal securities fraud is no straightforward task. See generally Samuel W. Buell, What Is Securities Fraud?, 61 DUKE L.J. 511 (2011) (describing the fundamental difficulty of defining securities fraud and the ensuing problems in determining the proper scope of Rule 10b-5).

36 The Exchange Act makes it unlawful for any person to sell a security that is not registered with the SEC, unless the security is exempted from the requirement. See 15 U.S.C. § 78l(a) (2012). In its application for registration, the issuer must provide various pieces of information, including the “financial structure and nature of the business.” See id. § 78l(b)(1)(A).

37 Professor Coffee helpfully distinguishes between the gatekeeper as independent preventer of wrongdoing, and the gatekeeper as agent with an incentive to protect its “reputational capital” by refusing to permit wrongdoing on its watch. See JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2–3 (2006). The gatekeeper is hired by the issuer of securities, so the gatekeeper’s incentive to protect its reputation and prevent improper disclosure, for example, may be in tension with its interest in getting paid to complete the deal and in being hired to advise on subsequent deals. Id. at 4.

38 See, e.g., Jill E. Fisch, Top Cop or Regulatory Flop? The SEC at 75, 95 VA. L. REV. 785, 800–01 (2009) (describing FINRA’s “obvious shortcomings” in responding to questionable conduct, including research analysts’ conflicts of interest and the scandal following claims of poor disclosure of the riskiness of auction rate securities).

39 In congressional testimony regarding the SEC’s budget, SEC Chair Mary Jo White warned that the agency’s “current level of resources still presents significant challenges as we seek to keep pace with the growing size and complexity of the securities markets and fulfill our broad mandates and responsibilities.” Mary Jo White, Chair, SEC, Testimony on SEC Budget Before the Subcommittee on Financial Services and General
some frauds represent glamorous opportunities for prosecutors seeking career advancement, criminal securities cases threaten to be long, difficult, and fiercely litigated. \footnote{In addition, in an area subject to multiple sources of regulation, it is possible that the result will be too little enforcement. William W. Buzbee has described this as a challenge of the "regulatory commons," in which regulatory resources are not aligned with needs. \textit{See} William W. Buzbee, \textit{The Regulatory Fragmentation Continuum, Westway and the Challenges of Regional Growth}, 21 J.L. \\& Pol. 323, 324 (2005). A system that relies on fragmented enforcement mechanisms could produce excessive regulation or insufficient regulation. Yet, "much of this fragmentation is unavoidable, barring major constitutional restructurings and discarding America's usual subject-based modes of regulation." \textit{Id.} at 355–58.}

Advocates of tighter restrictions on securities litigation have consistently argued that the private right of action achieves none of its goals. First, individual wrongdoers may face strong incentives, in the form of higher personal compensation, to engage in fraud yet they are unlikely to suffer individually from of investor claims, \footnote{This is true because individual directors and officers typically enjoy both the protection of liability insurance and, if necessary and under certain circumstances, of company indemnification.} and so private investor lawsuits do not deter fraud. \footnote{See John C. Coffee, Jr., \textit{Reforming the Securities Class Action: An Essay on Deterrence and its Implementation}, 106 COLUM. L. REV. 1534, 1536 (2006) (identifying the "fundamental problem" of securities class action litigation as the failure either to compensate victims of fraud or deter potential wrongdoers).} Second, for the same reason, individual wrongdoers who perpetrate a fraud do not suffer meaningful punishment as a result of investor litigation. \footnote{See Helland, \textit{supra} note 24, at 366.} Third, compensation of investors affected by

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fraud creates a new set of victims because current shareholders, who arguably did nothing wrong, effectively pay prior shareholders harmed by a past fraud. Finally, other critics warn that plaintiffs' lawyers have too great an incentive to pursue fraud claims in the interest of obtaining a large fee award, and that the private right of action causes too much enforcement. All these criticisms apply to individual or class action litigation and to claims arising out of purchases on public exchanges or through private placements; critics have not drawn distinctions based on the nature of the investment.

B. The Benefits of the Private Right of Action

While critics of investor lawsuits warn of the harm such litigation causes issuers of securities, aggrieved investors, like purchasers of any other defective good, have a legitimate demand for a remedy. Fraud claims also serve an expressive purpose, condemning conduct that caused harm. Some scholars advance other justifications for investor lawsuits—or at least for shareholder lawsuits—beyond the traditional list. Professor Lawrence E. Mitchell argues that investor lawsuits improve corporate governance at publicly traded companies because the prospect of paying damages creates an incentive for proper oversight of corporate management. This rationale applies to lawsuits filed by shareholders, as opposed to claims brought by investors holding other types of

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44 Professor Lawrence E. Mitchell disputes this characterization of current shareholders and argues that because they have power over corporate and executive conduct, they are not blameless when that conduct is wrongful, and they should pay compensation to victims of past fraud. See Lawrence E. Mitchell, The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits, 2009 Wis. L. Rev. 243, 289–90 (2009).

45 See Coffee, supra note 422, at 1537.

46 See, e.g., James J. Park, Rules, Principles, and the Competition to Enforce the Securities Laws, 100 Cal. L. Rev. 115, 121 (2012) (describing criticisms of decentralized securities law enforcement, which may lead "enforcers to bring more cases than is socially optimal").

47 See Mitchell, supra note 44, at 292.
securities, because those other circumstances would not implicate corporate governance. The private right of action may be more important than ever as a regulatory tool given the difficulty of monitoring transactions that have grown tremendously in number and complexity.

Deterrence, too, may not be as easily dismissed as critics suggest. At a minimum, the threat of securities litigation weighs on executives' minds. If it did not, corporate trade groups would not invest such time and energy in seeking restrictions on investor lawsuits. There is good reason for this concern—not because the impact on individual executives is likely to be great, as mentioned above, but because claims of fraud embody a moral judgment about corporate conduct: investor lawsuits are, again, expressive. Either settlement or, in the exceedingly rare case of a lawsuit that goes to trial, a verdict for the plaintiff reinforces the impression of improper conduct. The plaintiffs have alleged securities fraud, and fraud has no positive connotations. In investing, appearances make a difference.48 Defendants in fraud cases understand this.

Appearances matter in another way: the more difficult fraud litigation appears to be, the less trusting and, indeed, the more cynical investors will become. Changes to regimes through which victims of fraud can recover at least some portion of their damages have implications for markets and for investor willingness to participate in financial markets more generally. Consequently, tougher standards for plaintiffs in securities fraud cases, the subject of Part IV, matter. Despite the criticisms of private securities litigation, fraud constitutes a wrong against investors, and fraud litigation has potential, positive externalities.

48 John Maynard Keynes famously compared investing to participating in a competition to pick not the most beautiful contestant in a beauty contest but the contestant whom other judges would think the most beautiful. John Maynard Keynes, The General Theory of Employment, Interest and Money 156 (1936).
C. The Multiple Paths Permitting Private Securities Litigation

Section 10(b) of the Exchange Act does not provide the only path to recovery for investors who allege securities fraud. The existence of alternate means of recovery offers further evidence that lawmakers considered private litigation an essential component of regulation and enforcement. Section 11 of the Securities Act explicitly permits an investor to sue if the registration statement for a security "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 12(a)(2) of the Securities Act makes the seller of a security liable if the seller's prospectus "includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading."

Neither section 11 nor section 12(a)(2) requires a plaintiff to establish scienter, frequently the stumbling block for outsider investors in fraud lawsuits under section 10(b). Both provisions are available to such investors, but section 11 is not available to private placement investors buying

49 When this Article refers to § 10(b), it encompasses Rule 10b-5 thereunder. See 17 C.F.R. § 240.10b-5 (2013).
50 A registration statement filed with the SEC is required by § 6 of the Securities Act, 15 U.S.C. § 77f (2012), and contains such information as the corporate address, the identities of directors, a description of the business, etc. See id. § 77aa.
51 See id. § 77k(a).
52 A prospectus is "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale." See id. § 77b(a)(10).
53 See id. § 77l(a)(2). The provision goes on to provide for an affirmative defense for the seller, if the seller can show that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." Id. This is one way that the private right of action under § 11 differs from that under § 12.
54 See Part IV infra.
unregistered securities. The Supreme Court has limited the ability of investors in private placements to sue under section 12(a)(2); a majority of the Court concluded in *Gustafson v. Alloyd Co., Inc.* that the statute only permitted claims alleging an omission or misstatement in prospectuses "related to public offerings by an issuer or its controlling shareholders." Thus, in the wake of *Gustafson*, investors in private placements may be limited to claims under section 10(b).

The focus of this Article is claims under section 10(b), which are available to both connected and outsider investors. Both connected and outsider investor plaintiffs rely on section 10(b). Thus, the discussion in Part IV, which describes the disparate effects of pleading standards on different types of plaintiffs alleging fraud, compares cases.

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55 *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 569 (1995). Depending on the meaning of *Gustafson*, an investor who purchased through a private placement under SEC Rule 504 or 505 may be able to sue relying on § 12(a)(2) and need not establish scienter, but an investor who purchased under Rule 506 may not be able to rely on section 12(a)(2) and thus faces the challenge of establishing scienter. See DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 317 (3d ed. 2011). These differences exist because Rules 504 and 505 rely on § 3 of the Securities Act, while Rule 506 relies on § 4. *Id.* at 4–5, 317.


57 Plaintiffs can sue based on violations of multiple provisions, citing both § 10(b) and § 11 or § 12(a)(2). See Herman & MacLean v. Huddleston, 459 U.S. 375, 382–83 (1983) ("[W]e see no reason to carve out an exception to Section 10(b) for fraud occurring in a registration statement just because the same conduct may also be actionable under Section 11").

58 This comparison may seem arbitrary, because shareholders who purchase through an IPO have the option of suing based on § 11 or on § 10(b). Thus, the argument might be made that § 10(b) plaintiffs have an advantage over private placement investor plaintiffs, mitigating any
filed by insider investors and suits filed by outsider investors. In either case, as discussed below, the private placement investor typically has access to transaction-specific information beyond what an outsider investor receives through registration materials or through public companies' periodic reports to regulators.

One response to the arguments below could be that investors in IPOs have litigation options not available to investors in private placements. Perhaps the pleading standards correctly treat different types of investors differently. The question becomes, are differences in the form of investment relevant to the determination of eligibility for recovery through litigation? This Article suggests that how investors purchased securities should not determine the relative ease of ex post fraud litigation.

unfairness. However, as discussed infra in Part III, the information contained in the registration statement is unlikely to enable § 11 claims related to the financial crisis, for example, because unlike the information provided to private placement participants, the registration materials describe the company, not specific transactions it engages in. When the underlying facts are the same or similar and preclude a § 11 claim, the pleading standards applicable to § 10(b) claims favor private placement investor plaintiffs.

Investors who purchased shares in an IPO can also use § 11 of the Securities Act if the registration statement included material misstatements or omissions. However, in the realm of § 10(b), this Article contends that the pleading standards (described in Part III infra) favor private placement investors.

See supra notes 57 and 55 and accompanying text.

Perhaps, for example, the different pleading standards are intended to reward the investors' due diligence in private placements; outsider investors may not perform such due diligence because they rely on the wisdom of a highly liquid financial market. If so, though, the reliance requirement discussed below should function to screen out those connected investors who did not in fact conduct due diligence. This point has received greater recognition of late. See, e.g., Floyd Norris, When a Deal Goes Bad, Blame the Ratings, N.Y. TIMES, Nov. 15, 2013, at B1 (describing in derisive terms the arguments of securities fraud claimants that admitted that they conducted low levels of due diligence before entering transactions that produced extremely poor results).

A related issue is this Article's treatment of initial purchasers and secondary market purchasers of securities together: perhaps the
III. THE PATH TO RECOVERY THROUGH SECTION 10(B) SECURITIES LITIGATION

Congress did not explicitly set out to create two different legal regimes for plaintiffs alleging a federal securities law violation. Rather, decisions by federal legislators seeking to erect hurdles to what they described as frivolous shareholder class action litigation had the effect of putting different obstacles, of different sizes, in the path of different types of claims. Given Congress’ concern with shareholder class actions, it is not surprising that lawmakers enacted a regime that hampers shareholder claims. However, the pleading standards do not apply only to class actions or to shareholder lawsuits. The requirements apply to all investor claims and claimants alleging securities fraud.

This Part takes the first step of demonstrating ways in which treatment of a fraud claim brought by outsider investors differs from treatment of a fraud claim brought by connected investors in securities in private transactions. It does so by summarizing the legal standards applicable to claims of securities fraud when plaintiffs face a motion to dismiss. These standards are the product of legislation and judicial interpretation. The first section of this Part

information disparity that advantages connected investors does not exist for secondary market purchasers, whether those purchases took place through publicly accessible or private transactions. To respond to this question, I intend to disaggregate the cases reviewed for this Article, in order to compare the types of evidence used by claimants under § 10(b) filed by initial connected investors and initial outsider investors.


64 For purposes of this Article, the Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.) (“SLUSA”) is not relevant. SLUSA bars shareholders from filing securities fraud class action suits in state court or under state law in federal court and thereby sidestepping the requirements of the PSLRA. See 15 U.S.C. § 78bb (2012). This legislation did not affect the pleading standards set by the PSLRA, nor did it explicitly favor particular kinds of plaintiffs, id., although at least one
describes the standards applicable to fraud claims alleging violations of section 10(b) of the Exchange Act, then explores the Supreme Court's elaboration of the particular scholar has found that federal courts are not consistent in applying SLUSA, and some jurisdictions are possibly more favorable to certain types of litigants. See John M. Wunderlich, "Uniform" Standards for Securities Class Actions, 80 TENN. L. REV. 167, 196 (2012). SLUSA also did not bar filing of fraud claims in state court by individual plaintiffs not seeking certification as a class. See 143 CONG. REC. S10475 (daily ed. Oct. 7, 1997) (statement of Sen. Phil Gramm) (noting that SLUSA is limited to "the case of class-action suits, and class-action suits only"). Consequently, a number of post-crisis lawsuits have been filed in state court.

The PSLRA amended the Exchange Act. Plaintiffs may sue under other laws, which have different pleading requirements. Plaintiffs alleging that the seller of a financial transaction should be liable for damages—but did not necessarily engage in fraud—may base a claim on either a misstatement or omission in a registration statement, see Securities Act of 1933 § 11, 15 U.S.C. § 77k, or in a prospectus or oral communication connected to a sale. 15 U.S.C. § 77l. The misstatement or omission must involve information that would have been material to the plaintiff when weighing whether to invest. Under § 11, an investor may sue a specified set of entities if a registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." See id. § 77k. Courts have determined that a "material" misrepresentation or omission is one that, in context, would have misled a reasonable investor. In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 360 (2d Cir. 2010). Unlike a claim alleging a violation of Rule 10b-5, a claim under the Securities Act "need allege neither scienter, reliance or loss causation." City of Ann Arbor Emps.' Ret. Sys. v. Citigroup Mortg. Loan Trust, No. CV 08-1418, 2010 WL 6617866, at *6 (E.D.N.Y. Dec. 23, 2010) (noting the difference in requirements of Exchange Act and Securities Act claims and denying defendants' motion to dismiss claims asserting violations of §§ 11, 12(a)(2), and 15 of the Securities Act). A claim alleging a violation of the Securities Act is narrower than a § 10(b) claim in that it focuses on a particular security described in a registration statement or prospectus. In contrast, a plaintiff suing under § 10(b) may allege a "broader course of conduct." Emps.' Ret. Sys. v. J.P. Morgan Chase & Co., 804 F. Supp. 2d 141, 150 (S.D.N.Y. 2011) (contrasting causes of action under § 10(b), which "allows a plaintiff to claim that it was harmed by fraudulent representations that are 'connected to' a security that the plaintiff purchased or sold," and causes of action under § 11, which applies if a "specific registration statement contain[ed] misrepresentations," or under § 12, which applies if a "specific prospectus or oral communication" contained misrepresentations).
elements of a securities fraud claim—scienter, reliance, and loss causation—that are often at issue at the time of disposition of a motion to dismiss. The second section describes the heightened pleading standard applicable to allegations of fraud under the Federal Rules of Civil Procedure. The third section then describes the impact of the PSLRA.

Understanding the requirements of federal securities fraud claims requires diving into a complicated and evolving area of jurisprudence. This understanding is essential to determining how changes in pleading standards have the effect of easing the path to recovery for connected investors relative to outsider investors. This more favorable treatment of particular claimants, as contended below, is consistent with predictions of past scholarship on the advantages held by potential litigants who are repeat players and who consequently have the ability to mold legal regimes over time. This shaping can occur through case outcomes or, as in the case of the PSLRA, through legislative advocacy.

A. The Elements of a Claim of Fraud Under the Exchange Act

The Exchange Act prohibits the "use or employ[ment], in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe."66 The courts for years have recognized a private right of action for violation of this provision of the Act, and the Supreme Court has identified six elements of a fraud claim under section 10(b) and its implementing regulation, Rule 10b-5: (1) a material representation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the

66 15 U.S.C. § 78j(b). The provision is implemented through Rule 10b-5, 17 C.F.R. § 240.10b-5 (2013), which does not add detail to the law.
misrepresentation or omission; (5) economic loss; and (6) loss causation.67

The meaning of each of the above elements has been the subject of litigation,68 but clarity has remained elusive, in part because of the highly context-dependent nature of any inquiry into fraud.

Securities fraud lawsuits filed following the 2008 financial crisis often turned on only a subset of the elements identified above. A review of dozens of securities fraud cases filed in state and federal courts found that resolutions of motions to dismiss focused generally on scienter, reliance,


68 See, e.g., Matrixx Initiatives, 131 S. Ct. at 1318–19 (explaining that materiality of information does not depend on statistical significance or other “bright-line rule,” but on the “total mix’ of information made available” (quoting Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988))); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 309 (2007) (deciding that “an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent”); Basic, 485 U.S. at 246 (finding that merger discussions were material to reasonable investors and that investors’ reliance could be established by their assumption that market prices reflected all publicly available information and “hence, any material misrepresentations”); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342–43 (2005) (rejecting the argument that payment of an inflated price at the time of purchase as a result of a misrepresentation constituted economic loss); Erica P. John Fund, 131 S. Ct. at 2183, (plaintiff seeking certification of a class in a securities fraud action need not prove loss causation). While in Erica P. John Fund the Court stated that a plaintiff need not prove loss causation, the justices reached this conclusion only after an intriguing detour in the unanimous opinion concerning reliance. The Court distinguished between “transaction causation” and “loss causation”: the former referred to reliance on a misrepresentation “when buying or selling” and the latter to proof of economic loss as a result of the misrepresentation (or correction of the misrepresentation, as was alleged). Id. at 2186. “[W]hen considering whether a plaintiff has relied on a misrepresentation, we have typically focused on facts surrounding the investor’s decision to engage in the transaction,” id., and this tantalizing observation raises the question of whether the Court is preparing to address questions posed in this Article about what level of diligence is due and what it means to be sophisticated.
and loss causation. The other elements appear less often as sources of controversy. With respect to materiality, in post-financial crisis litigation it is often clear that information about massive exposure to, or the magnitude of losses resulting from, home loan defaults would be material to reasonable investors.\(^{69}\) The connection to the purchase or sale of a security is typically clear. In the absence of economic losses, a lawsuit would likely not have been filed in the first place. Below I very briefly describe how scienter, reliance, and loss causation are critical and summarize how the Supreme Court has analyzed them.

1. Scienter

To allege that a defendant acted with scienter, a plaintiff must assert facts that reveal an intent to "deceive, manipulate, or defraud."\(^{70}\) The Supreme Court has interpreted the language of the PSLRA, which requires a "strong inference" of scienter\(^{71}\) to mean that the inference must be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged."\(^{72}\) Thus, courts must consider innocent explanations of the alleged conduct.\(^{73}\) In the Second Circuit, showing "reckless

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\(^{69}\) See, e.g., In re Bear Stearns Cos., Inc. Sec., Derivative, & ERISA Litig., 763 F. Supp.2d 423, 488–89 (S.D.N.Y. 2011) (finding that defendants' alleged failure to disclose that they had "inflated their asset values while underestimating their risk . . . [was] properly alleged to be significant to the reasonable investor making an investment decision"). Of course, defendants may contend in some cases that the information allegedly concealed or mischaracterized was not certain or significant enough to make a failure to disclose material. See, e.g., Richman v. Goldman Sachs Grp., Inc., 868 F. Supp.2d 261, 274 (S.D.N.Y. 2012) (dismissing shareholders' § 10(b) claims against investment bank because defendant was not under obligation to disclose receipt of Wells notice given that litigation was not "substantially certain to occur").

\(^{70}\) Tellabs, 551 U.S. at 313.


\(^{72}\) Tellabs, 551 U.S. at 324.

\(^{73}\) Id. at 323–24.
disregard for the truth" 74 can satisfy the scienter requirement.

The PSLRA complicates this story, though, because it adds a "safe harbor" protecting a speaker making certain statements from liability in any private litigation based on an allegation that the speaker made an untrue statement of a material fact or failed to state a material fact necessary to make a statement not misleading. 75 The law protects "forward-looking statements," meaning those statements that, for example, provide a projection of revenues, income, or loss, or other financial items; or that describe business plans and objectives. 76 When an investor argues that a defendant committed fraud by making a materially false, forward-looking statement, 77 the scienter requirement is more demanding. The plaintiff must prove that the forward-looking statement was made "with actual knowledge . . . that the statement was false or misleading." 78 This showing of actual knowledge must be made in accord with the PSLRA's requirement that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 79 This inquiry can be complex. 80

74 S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 109 (2d Cir. 2009).
76 See id. § 77z-2(i)(1). The provision identifies several other types of information that might constitute a "forward-looking statement," such as projection of capital expenditures, dividends, earnings or losses per share, descriptions of product or service offerings or objectives, etc.
77 Or omitting a statement necessary to make a statement not misleading.
79 See id. § 78u-4(b)(2)(A).
80 See, e.g., Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 709 (7th Cir. 2008) (discussing relationship of the PSLRA safe harbor to the law's pleading requirements but reframing the "critical question . . . [as], how likely it is that the allegedly false statements . . . were the result of merely careless mistakes . . . rather than of an intent to deceive or a reckless indifference to whether the statements were misleading" rather than whether the speaker had "actual knowledge" of falsity).
2. Reliance

The reliance element can be disaggregated. First, there is the question of actual reliance. Second, there is the question of whether the investor's reliance on the allegedly fraudulent statement or omission was reasonable. In the securities fraud class action lawsuits that have reached the Supreme Court, the justices have addressed actual reliance.81 In cases in lower courts, in particular in cases filed since the financial crisis of 2008, judges have grappled with the reasonableness of alleged reliance.82 The focus in this Article is on reasonable reliance.

The reasonableness of reliance plays a significant role in post-crisis litigation initiated by investors who purchased in private placements. Such plaintiffs typically claim that they decided to invest because they believed misleading or false information about a transaction provided by the defendants.83 Defendants in turn challenge plaintiffs'
assertions of victimhood by pointing out that (a) prior to the transaction, the plaintiffs held themselves out as sophisticated investors fully capable of evaluating risks, and (b) information available to the sophisticated investor made plain what those risks were. In many cases, investing financial institutions explicitly acknowledged, before entering into the transaction, that they were not relying on any representations made by the seller, that the

proximity of allegedly fraudulent conduct to the transaction that the plaintiff entered. See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008) (deciding that vendors' role in defendant's fraudulent scheme to inflate reported earnings was "too remote" to make them liable in civil action under § 10(b)). Some scholars have questioned courts' use of the fraud on the market theory to satisfy the reliance element of a claim. See, e.g., Roberta S. Karmel, When Should Investor Reliance Be Presumed in Securities Class Actions?, 63 BUS. LAW. 25, 53 (2007) (calling for, among other things, "apply[ing] the presumption of reliance narrowly to false or misleading statements in filed documents made by issuers").

84 For example, in Dandong v. Pinnacle Performance Ltd., No. 10 Civ. 8086(LBS), 2011 WL 5170293, at *13–14 (S.D.N.Y. Oct. 31, 2011), in which the defendants argued that their motion to dismiss should be granted because they had "disclosed the risks... and that by accepting those warnings, Plaintiffs held themselves out to be sophisticated investors," the court determined that the reasonableness of reliance turned on facts and so was not amenable to resolution on a motion to dismiss. But see Terra Sec. ASA Konkursbo v. Citigroup, Inc., 740 F. Supp. 2d 441, 453 (S.D.N.Y. 2010) (finding that two plaintiffs were sufficiently sophisticated that their reliance on defendants' characterization of a transaction was "unreasonable as a matter of law").


86 For example, in ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., No. 650027/2011, 2012 WL 1425264, at *9 (N.Y. Sup. Ct. Apr. 23, 2012), the defendant argued that "ACA cannot reasonably have relied on an alleged misrepresentation when a signed contract disclaims reliance." The trial court rejected this argument because the disclaimers were "boilerplate" and did "not go to the specific misrepresentation alleged... ." Id. at 10. But see San Diego Cnty. Emps. Ret. Ass'n v. Maounis, 749 F.
transaction was conducted at arms' length, and that they had the capacity to assess the riskiness of the transaction. As a result, defendants argue, the plaintiff investor cannot reasonably claim to have been the victim of any fraudulent statement or omission by the selling institution.

The determination of reasonableness, then, is critical. It is highly contextual and turns on several factors, including: (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of longstanding business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

No single factor is decisive and there is no precise definition of a sophisticated investor; that, too, may depend on context. However, a plaintiff's degree of sophistication

Supp. 2d 104, 121 (S.D.N.Y. 2010) (granting motion to dismiss after finding that in light of the sophistication of the plaintiff retirement investment fund "and the clear, unambiguous language of the non-reliance provisions," the plaintiff's "purported reliance . . . [was] unreasonable").


88 In such a case, reliance would not be reasonable. See Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (private placement purchasers of ownership interest in the defendant company sued under § 10(b) alleging misrepresentations and omissions regarding the company's prospects and court found for the defendant because the plaintiff investors did not read warnings in the private placement memorandum and so did not reasonably rely on any allegedly fraudulent statement).


90 For example, in denying the defendants' motion for summary judgment in Owens, Judge P. Kevin Castel concluded that a "reasonable juror could conclude either that Owens was reasonable or unreasonable in relying solely on uncontradicted oral statements" by the defendants.
affects how courts weigh the other criteria. For example, the more sophisticated the investor, the more likely a judge is to ask why that investor did not ask for access to relevant information. 91 A judge might expect a sophisticated investor to detect signs of fraud more easily. 92 Courts do not make explicit the relationship between an analysis of the reasonableness of reliance and of a buyer's obligation to conduct due diligence. 93

Only an investor who has adequately studied a transaction ahead of time may be permitted by law to pursue a fraud claim. 94 However, even a sophisticated investor who has taken appropriate precautions can be fooled. Both

Because of the dispute over this material fact, the judge denied the motion. Id. at *5.

91 See, e.g., Ashland Inc. v. Morgan Stanley & Co., Inc., 700 F. Supp. 2d 453, 471 (S.D.N.Y. 2010) (granting motion to dismiss in part because "[a]s a sophisticated institution contemplating the investment of tens of millions of dollars, it was unreasonable for [plaintiff] to rely upon the highly general statements alleged as misstatements in this case . . . [and] perhaps reckless . . . to not insist upon receiving, in writing . . . and terms of purchase before making its initial investment").

92 See Terra Sec. ASA Konkursbo v. Citigroup, Inc., 740 F. Supp. 2d 441, 449 n.5, 453 (S.D.N.Y. 2010) (determining that municipal plaintiffs are "not sophisticated investors for the purposes of this inquiry," and thus denying defendant's motion to dismiss, but granting the motion for claims brought by sophisticated investors).

93 In an article that foreshadows the argument made below in this Article, Professor Margaret V. Sachs wrote that the Supreme Court has at least implicitly suggested that common law tort doctrines imported into securities law may be subordinated to public policy goals. Therefore, fraudsters should not be able to escape civil liability even if they can show plaintiffs failed to take due care. See Margaret V. Sachs, The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?, 71 CORNELL L. REV. 96, 137 (1985). In fact, she suggested abandoning the requirement that a plaintiff show that due care was taken before investing. See id. at 140.

94 See, e.g., Hirsch v. DuPont, 553 F. 2d 750, 763 (2d Cir. 1977) ("The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment [and s]uch investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.").
federal and state courts have recognized that if information that would have enabled the plaintiff to detect the fraud was "within the peculiar knowledge of [d]efendants and unavailable to" plaintiffs, then the plaintiff's claimed reliance may have been reasonable. However, if judges are too generous to plaintiffs making this claim, then the requirement that reliance be reasonable becomes weaker. Investors may then do less to protect themselves through due diligence, because the allocation of risk of losses will have shifted in their favor. This concern drives the argument below that the standard applicable to claims of reasonable reliance should be refined. The harm suffered by an investor plaintiff could have two causes: misconduct of the defendant and/or negligence of the plaintiff. In the

95 Terra Sec., 740 F. Supp. 2d at 449.


97 In a pre-PSLRA article examining the implications of the conduct of plaintiff investors for 10b-5 claims, Theresa A. Gabaldon argued that it was unlikely that the possibility of recovery through litigation would affect investment decisions. See Theresa A. Gabaldon, Unclean Hands and Self-Inflicted Wounds: The Significance of Plaintiff Conduct in Actions for Misrepresentation Under Rule 10b-5, 71 MINN. L. REV. 317, 342 (1986) ("It is unlikely . . . that a plaintiff would make what is probably a bad investment in the hope of eventually receiving damages through litigation."). However, I contend that it is rather more likely that an investor would refrain from making a bad investment if the likelihood of recovery through litigation becomes more remote, and fewer bad investments reduces the likelihood of systemic crises.

98 If the defendant essentially argues that the plaintiff would have suffered losses regardless of the defendant's conduct, that counterfactual need not bar recovery. See Mark P. Gergen, Causation in Disgorgement,
context of securities fraud, decisions about what degree of reliance is reasonable matter because they may affect the conduct of parties to future transactions. Judicial evaluations of other elements of a claim of fraud do not have the same potential incentive effects.99

3. Loss causation

Establishing that the alleged fraud actually caused a plaintiff's losses can be difficult because so many events can affect the price of an investment. The inquiry must be fact-intensive. A judge might consequently deny a motion to dismiss because determining the extent to which a plaintiff's losses resulted from a defendant's conduct requires a careful analysis of facts and the factual record might not be sufficiently developed. When seeking to survive a motion to

92 B.U. L. REV. 827, 837 (2012). The competing causes of harm need not mean that wrongdoing goes unpunished and/or a victim recovers nothing. Rather, “they show the normative importance of deciding what is a permissible counterfactual.” Id.

99 For example, accepting a particular showing of scienter does not implicate the level or kind of diligence an investor should perform before deciding whether to participate in a transaction. In addition, financial institutions in many cases already have e-mail messages or other documentary evidence enabling them to establish “a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2)(A) (2012). Loss causation, discussed below, similarly does not relate to the question of the adequacy of a plaintiff's due diligence and in any event is likely to raise problems for a plaintiff at a later stage in proceedings; a defendant may argue that the plaintiff's losses were the result of a general market downturn, for example, or some other event unrelated to the defendant's conduct. See, e.g., Dodona I, LLC v. Goldman, Sachs & Co., 847 F. Supp. 2d 624, 649 (S.D.N.Y. 2012) (denying motion to dismiss despite defendant's argument that plaintiff's losses “coincided with the general market downturn and therefore cannot be linked with the alleged fraud, [because] the law does not require plaintiffs to plead facts sufficient to exclude other non-fraud explanations. . . . [T]hat is an issue to be determined by the trier of fact on a fully developed record” (citations omitted)). The parties then contest the allocation of blame for losses among competing causes. That action is likely to raise questions of fact not suitable for resolution on a motion to dismiss. See King Cnty., Wash. v. IKB Deutsche Industriebank AG, 708 F. Supp. 2d 334, 342 (S.D.N.Y. 2010).
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dismiss, the plaintiff need not allege facts that "exclude other non-fraud explanations."\(^{100}\) It may be that at a later stage, a court would have to wrestle with the apportionment of losses to various causes. A general market downturn might have pushed prices downward, but misconduct particular to a defendant might have pushed the value of a particular transaction down even more.\(^{101}\) However, establishing the link between alleged fraud and economic losses in the context of a more general negative economic event may be complicated for any securities fraud plaintiff, whether an investor who bought through a publicly accessible transaction, or a participant in a private placement. For this reason, this Article will not discuss loss causation further.\(^{102}\)

B. The Federal Rules of Civil Procedure

Courts explaining the Exchange Act have identified the elements of a claim of securities fraud under federal law. Rule 9(b) of the Federal Rules of Civil Procedure then specifies the pleading standard that such claims must meet. The rule requires the plaintiff to "state with particularity the

\(^{100}\) *IKB Deutsche Industriebank AG*, 708 F. Supp. 2d at 342.

\(^{101}\) For example, in *Dodona I*, Judge Victor Marrero held that it was inappropriate to determine the cause of the plaintiff's losses when resolving a motion to dismiss. Judge Marrero cited prior cases stating that determination of causation was "an issue to be determined by the trier of fact on a fully developed record." *Dodona I*, 847 F. Supp. 2d at 649 (quoting *In re Bear Stearns Cos., Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 507 (S.D.N.Y. 2011)). Because the plaintiff successfully pleaded the other elements of a securities fraud claim under § 10(b), Judge Marrero denied the defendant's motion to dismiss. *Id.* at 650.

\(^{102}\) Courts may actually blur the distinction between reliance and loss causation, however. See Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 825–26 (2009) (describing some courts' decision to analyze together reliance and loss causation, requiring plaintiffs to show loss causation in order to establish reliance, in securities class actions in which plaintiffs use a theory of fraud on the market).
circumstances constituting fraud or mistake." ¹⁰³ Federal courts in New York have interpreted the requirement of "particularity" to mean that a plaintiff must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." ¹⁰⁴ The plaintiff need not allege reliance on direct communications from the defendant, nor specify who relied on such communications. ¹⁰⁵ In actions initiated by connected investors, these four requirements generally do not pose as much of a hurdle as they do for outsider investors. Private transactions are preceded by presentations, meetings, and exchanges of transaction-specific e-mail, prospectuses, offering memoranda, and other documents. ¹⁰⁶

C. The PSLRA

Lawmakers in the 1990s concluded that Rule 9(b) was not an adequate device for blocking meritless claims of securities

¹⁰³ Fed. R. Civ. P. 9(b). This heightened standard does not apply to allegations of "[m]alice, intent, knowledge, and other conditions of a person's mind," which remain subject to the general pleading standard of Rule 8. See Ashcroft v. Iqbal, 556 U.S. 662, 686 (2009). Rule 8 requires a "short and plain statement of the claim showing that the pleader is entitled to relief," Fed. R. Civ. P. 8(a)(2), which the Court stated means that "a complaint must contain sufficient factual matter, accepted as true . . . [to allow] the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." Id. at 678.

¹⁰⁴ Rombach v. Chang, 355 F.3d 164, 170 (2d Cir. 2004) (citation omitted).


¹⁰⁶ Investors who purchased securities through private placements enjoy access to a different level of information, relative to investors purchasing publicly traded instruments on public exchanges. Shareholders alleging fraud must generally rely on public statements by corporate executives and corporate filings with regulators, and those statements may describe corporate activities but of necessity do so in abbreviated fashion. Offering memoranda and other documents provided before a private placement offer specific information about the characteristics of that deal. See infra Part IV.A.
fraud. In enacting the PSLRA, they raised the bar for specific elements of the claim, thereby adjusting how the law balanced the competing goals of allowing "defrauded investors . . . [to] recover their losses,"\textsuperscript{107} on the one hand, and blocking "abusive and meritless" claims on the other.\textsuperscript{108} Fear of the effects of shareholder litigation on the conduct of business animated members of Congress.\textsuperscript{109} Lawmakers worried that "strike suits"—claims filed upon a company’s announcement of bad news sufficient to affect stock prices—were sapping potentially productive corporate resources solely to line the pockets of lawyers representing classes of shareholders.\textsuperscript{110} With the PSLRA, Congress sought to

\textsuperscript{107} H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730. For a more complete discussion of the filtering role played by the pleading standards applicable to claims under federal securities laws, see Geoffrey Miller, \textit{A Modest Proposal for Securities Fraud Pleading After Tellabs}, 75 LAW & CONTEMP. PROBS. 93, 93, 104–05 (2012). See also James D. Cox, Randall S. Thomas & Lynn Bai, \textit{Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses}, 2009 Wis. L. REV. 421, 451–52 (suggesting that \textit{Tellabs} was a "missed opportunity . . . to bring uniformity into the interpretation of the PSLRA" and finding that differences in pleading requirements across jurisdictions did not result in forum shopping by plaintiffs, but also did not address the question of whether the standards deterred some claimants in certain jurisdictions from filing class action suits).

\textsuperscript{108} H.R. REP. NO. 104-369, at 31. Whether there was a crisis of "frivolous" securities litigation at the time of passage of the PSLRA—or indeed in the years since—has been the subject of scholarship and political debate. For a critique of the language used by supporters of restrictions on securities litigation, see Miller, \textit{supra} note 107, at 98–99; for more detailed analysis of whether companies settle securities lawsuits regardless of the merits, see Stephen J. Choi, \textit{Do the Merits Matter Less After the Private Securities Litigation Reform Act?}, 23 J.L. ECON. & ORG. 598 (2007).


\textsuperscript{110} Senator Alfonse M. D’Amato, Republican of New York and a supporter of the PSLRA, offered this definition of a "strike suit":
discourage the filing of "frivolous" actions alleging securities fraud and to enable defendants to terminate litigation quickly by filing a motion to dismiss. 111

The legislation responding to the perceived threat of abusive litigation included two critical steps relevant here. First, lawmakers added a requirement that lead plaintiffs in securities class action lawsuits be investors with substantial losses. 112 Adoption of this requirement sought to preclude litigation controlled by lawyers whose clients were very small investors—perhaps holding just one or two shares of the defendant corporation—by ensuring that a large

A strike suit occurs when a lawyer searches very carefully for negative news announcements by a company or a decline in a company stock price. Then these lawyers race to the courthouse to file a suit alleging securities frauds, alleging mismanagement, or misinformation. I look to my colleagues on the floor from Alaska for an analogy—there is gold in the hills if a firm offers a security. There are lawyers who are mining that gold for themselves. Sometimes, even if a stock price goes up, lawyers will race to bring suits because they allege that they were not given information that this company would have higher earnings than anticipated. Imagine. If there is bad news, you are vulnerable. If there is good news, you are vulnerable.

141 CONG. REC. S8885, S8891 (daily ed. June 22, 1995) (statement of Sen. Alfonse M. D’Amato). While he did not specify that his concern was class action litigation, the examples he cited involved class action lawsuits, and other senators criticized the lack of client input in securities lawsuits, arguing that lawyers for a class of plaintiffs actually controlled cases. For example, Senator Paul Sarbanes said that “plaintiffs’ attorneys appear to control the settlement of the case with little or no influence from either the ‘named’ plaintiffs or the larger class of investors.” Id. at S8894.

Provisions of the PSLRA other than the changes to pleading standards attempted to address this issue.

111 H.R. REP. NO. 104-369, at 32 (illustrating that, to combat “abusive securities litigation,” the PSLRA “implements needed procedural protections to discourage frivolous litigation”).

112 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2012) (requiring courts to presume that “the most adequate plaintiff in any private action” is the investor who “has the largest financial interest in the relief sought by the class,” but permitting another member of the class to challenge the presumption).
investor, presumably with the expertise, incentive, and ability to control litigation strategy, would oversee the lawsuit. The "lead plaintiff" provision was aimed squarely and precisely at the potential problem of abusive shareholder class actions.

The second step taken by Congress in the PSLRA was not so narrowly tailored. Lawmakers selectively raised pleading requirements applicable not just to suits by shareholders or to class action suits, but to any private litigation alleging securities fraud. The PSLRA requires that a plaintiff's "complaint . . . specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." The PSLRA further requires the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," and put on the plaintiff the burden of establishing loss causation. The PSLRA did not raise the standard that claims of reliance must meet.

The imposition of special pleading requirements, more demanding than those for other civil claims, aided corporate defendants in disposing of claims before incurring the cost of

114 See id. § 78u-4(b)(2)(A). In adopting the PSLRA, lawmakers focused on curbing "frivolous" shareholder class action lawsuits, and the higher standards specified in the legislation appear to have focused on the elements of a claim more likely to be relevant to that class of litigation.
115 See id. § 78u-4(b)(4).
116 This is not to say that lawmakers did not have the issue of reliance on their minds; they almost certainly did, because a few years earlier, the Supreme Court endorsed the "fraud on the market" theory of reliance, which aided shareholder plaintiffs in fraud lawsuits. See Basic Inc. v. Levinson, 485 U.S. 224, 250 (1988). Courts have recognized that reliance is not subject to a heightened pleading standard. See, e.g., In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1198 (C.D. Cal. 2008) (finding reliance element subject to the lower standard of Rule 9(b) "because it is one of the 'circumstances constituting fraud' not subject to PSLRA standards").
complying with discovery requests (and potentially trial). Lawmakers thus intentionally put more risk onto plaintiffs that purchased securities, making it more difficult for such investors to survive a defendant’s motion to dismiss. The legislative record suggests that lawmakers intended the shift to block meritless claims; they did not consider the possible effects on incentives that might change investor behavior, such as the incentive to take more care before buying.117

Judges have not focused on the incentives created by the pleading standards either, although they have questioned the degree of care exercised by plaintiffs who bought securities and then challenged the transaction. The party that enters a transaction with closed eyes cannot later claim to have fallen victim to fraud; the law permits recovery only by an investor who behaves reasonably. Securities fraud suits involving sophisticated investors force courts to engage in a line-drawing exercise, distinguishing cases in which the plaintiffs’ efforts to protect themselves from fraud were reasonable from those in which they were unreasonable.118 In the former cases, defendants’ motions to dismiss may be denied; in the latter, granted. This scheme makes sense if viewed as reflecting an unstated, but nevertheless clear, moral judgment: although a fraud may ensnare the prudent alongside the careless, only the former deserves the protection of the law.119 The availability of recovery through

117 Indeed, at least one scholar has suggested that one result of the PSLRA was underdeterrence of securities fraud because the law made it less likely that potential plaintiffs would sue. See Barbara Black, Eliminating Securities Fraud Class Actions Under the Radar, 2009 COLUM. BUS. L. REV. 802, 816–17 (2009) (describing the impact of hurdles Congress erected to claimants alleging securities fraud).


119 This is a longstanding principle embodied in law governing both federal and state securities fraud claims. See Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983). Professor Sachs has argued that the unreasonable reliance on a fraudulent statement should not result in a finding of no liability because such an outcome undermines the
the courts is itself an incentive to take care because, at least in theory, the courts aim to help those who have already tried to help themselves.

Lawmakers also did not discuss how this step would affect plaintiffs suing as individuals rather than as a class. Put another way, the choice of which elements of a fraud claim would face a higher pleading standard was not made based on an explicit determination that toughening particular elements would narrowly target shareholder class actions but not other types of litigation alleging securities fraud. The legislative record contains no hint of such a rationale.120 Nor, for that matter, does the legislative record

effectiveness of the securities law in addressing fraud. See Sachs, supra note 93, at 106–07.

120 Proving a negative claim is difficult, but public records of legislative proceedings preceding the enactment of the PSLRA do not reveal discussion of this issue. Instead, lawmakers focused on the potential harm of shareholder class action litigation. The House Conference Report stated:

[A]busive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

contain findings that lawsuits by investors in private placements are more or less likely to be frivolous and/or more or less likely to siphon corporate defendants’ resources from more productive uses. Congress did not consider the potential systemic costs of litigation by connected investors. As a result, it has not addressed, for example, whether the pleadings of connected investor plaintiffs, who claim great investing expertise, should meet a higher standard because they should be less vulnerable to seller deception.

At the time, popular and congressional attention did not focus on lawsuits arising out of private placements. It took the financial crisis of 2008, which spawned litigation pitting financial companies that were party to private placements against one another, to provoke any degree of scrutiny. In passing the PSLRA, lawmakers did not intend to hamper

In contrast, opponents of the bill warned that the PSLRA would not “protect the interests of the honest, innocent and small investors,” adding that:

[U]nder the requirements for Scienter in the pleadings in this legislation a person who has been wronged by securities fraud will need not only a layer [sic] but he will need a psychiatrist and a psychic to tell him what was going on inside the mind and head of the wrongdoer.

Id. at H2754 (statement of Rep. John Dingell). But that is as close as anyone got to addressing the potential impact of the revisions on the pleading standards on different types of investors.

121 Many financial companies purchase securities through private placement transactions, in which sellers sell securities under an exemption to registration requirements of the Securities Act. See THOMAS P. FITCH, DICTIONARY OF BANKING TERMS 356 (6th ed. 2012). Section 4 of the Securities Act exempts certain securities transactions from registration requirements, 15 U.S.C. § 77d (2012), and SEC Rule 506, for example, permits an issuer to sell securities through private placements to no more than 35 buyers who are “capable of evaluating the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(ii) (2013). The underlying idea is that investors who can protect themselves and absorb potential losses should be allowed to engage in transactions deemed too risky for the less savvy or less wealthy. A buyer purchasing securities not registered with the SEC is likely to receive transaction-specific documents useful in the event of ex post litigation.
outsider claims relative to connected investors' claims.\textsuperscript{122} But, as this Article will show, their choice of which pleading standards to raise had that effect.\textsuperscript{123}

Instead of focusing on the potentially disparate effects of the PSLRA, opponents of the law warned that it would hurt victims of securities fraud generally. Senator Paul Sarbanes cautioned that as a result of the PSLRA, "[i]ndividual investors, local governments, pension plans, all will find it more difficult to bring fraud actions and to recover their full

\textsuperscript{122} Scholars have commented on and criticized the differential impacts of procedural rules. Some have indeed called for more sophistication in pleading standards, shifting away from a uniform system in which claimants comply with the same procedural rules regardless of the nature or size of the case. \textit{See, e.g.}, Stephen N. Subrin, \textit{The Limitations of Transsubstantive Procedure: An Essay on Adjusting the "One Size Fits All" Assumption}, 87 DENV. U. L. REV. 377, 394 (2010) (arguing for three different "tracks" applicable to claims). Such a shift would have the virtue of making explicit the political nature of procedural decisions, as Professor Subrin notes. \textit{Id.} at 384 ("If one requires, for instance, more rigorous pleading in securities cases in order to make such cases more difficult to bring, it is hard to say this is not a political decision with substantive results."). However, it is far from clear that the combination of selectively raised pleading standards and relative access to potential evidence is the result of reflection, or that it is fair that an information-advantaged claimant, like a connected investor, should effectively face a less demanding pleading standard.

\textsuperscript{123} Scholars have analyzed other effects of the PSLRA. Michael A. Perino finds that the legislation had an effect on shareholder class actions, but that the effect was mixed. Whether the goal of the legislation was achieved likely depends on one's view of what the goal was: the number of shareholder suits did not decline, but the "quality" of the cases filed may have risen. Michael A. Perino, \textit{Did the Private Securities Litigation Reform Act Work?}, 2003 U. ILL. L. REV. 913, 976 (2003). A survey of studies on the impact of the PSLRA concluded that the effect of the PSLRA was more modest, finding that "there are as many securities class action filings now as before" and that while dismissal rates rose (consistent with Professor Perino's interpretation of the data), more than two-thirds of suits still ended with a settlement. RICHARD PAINTER, MEGAN FARRELL & SCOTT ADKINS, \textit{PRIVATE SECURITIES LITIGATION REFORM ACT: A POST-ENRON ANALYSIS} 17 (2002) available at https://www.fed-soc.org/docib/20070323_PSLRAFINALII.PDF. Unlike this Article, both articles focused on class action claims.
damages as a result of this legislation." Senator Sarbanes did not distinguish between class action lawsuits and individual suits, between retail and institutional investors, between shareholders and holders of other types of securities, or between outsider investors who bought in public offerings on exchanges and connected investors who did so through private placements. Lawmakers could have deliberately distinguished between lawsuits brought by outsider investors and connected investors, but they did not. The standards apply alike to individual investors, institutional investors, and to investors aggregated in a class; they also apply to investors in publicly accessible transactions and investors in private placements. However, the effects of the selective raising of pleading standards are not so equitable.

IV. IMPLICATIONS OF SELECTIVELY RAISING PLEADING STANDARDS FOR OUTSIDER INVESTORS

The preceding discussion described the pleading requirements applicable to claims of securities fraud. This Part describes the implications.

Because successfully alleging scienter is a critical challenge for outsider investor claimants, raising the


125 Although the tougher standards imposed by the PSLRA apply to investors large and small, they address the kind of facts plaintiffs must allege, and in many cases pose a more significant hurdle to claims by shareholders than to claims by financial institutions. For this reason, courts at times disaggregate securities fraud actions, addressing shareholder claims and financial institution claims in separate proceedings. Judge Mariana Pfaelzer consolidated securities claims against the defendant in three cases: shareholder litigation, derivative litigation, and litigation initiated by qualified institutional buyers. See In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1142 n.2 (C.D. Cal. 2008). The court isolated the third set of claims "because it anticipated that reliance issues in the private placement market—the fraud on the market presumption and actual reliance—would raise unique issues." Id.
standard for that element makes outsiders' claims more difficult to substantiate. Connected investors who purchased securities through a private placement and subsequently allege fraud benefit from a more hospitable legal environment because the challenge for them is more likely to be demonstrating reasonable reliance, and lawmakers did not raise the standard applicable to claims of reliance.\footnote{One could imagine a different regime in which sophisticated investors who purchased publicly traded shares were held to a higher standard than other, smaller scale investors, even when alleging fraud on the market. This approach makes sense because sophisticated investors should be better able to evaluate publicly traded stocks, just as they should be better able to make decisions about other private transactions. This is not, however, the path that courts have taken, instead finding that a successful allegation of fraud on the market is sufficient to establish reasonable reliance for a securities fraud plaintiff whether sophisticated or not. This highlights some of the inconsistency that persists in courts' treatment of sophistication. That inconsistency has been surveyed thoroughly by Professor Fletcher, see supra note 118, but in some key respects his article is out of date; namely, it was written before it became clearer that the question of reasonable reliance is distinct from causation. See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (stating that "reliance [is] often referred to in cases involving public securities markets (fraud-on-the-market cases) as ‘transaction causation’") (citing Basic Inc. v. Levinson, 485 U.S. 224, 248–49 (1988)).}

The first section of this Part describes how the selective raising of pleading standards affects different kinds of investors. It describes two cases involving allegations of securities fraud, one initiated by holders of publicly traded shares and the other by purchasers of securities that were not publicly traded, to show how different pleading standards create a higher hurdle for outsider investors. The second section identifies some of the risks of requiring different kinds of plaintiffs to meet different standards when making similar claims.

A. Selectively Raising Pleading Standards Burdens Outsider Investors

Plaintiffs filing securities fraud lawsuits face a difficult challenge. They must tell a persuasive story about the
defendant's alleged misconduct, citing specific evidence without the benefit of discovery. This evidence must overcome the demanding standards described in Part III above. In the typical shareholder lawsuit, plaintiffs start with regulatory filings and public remarks by corporate executives to analysts or reporters, then contrast those disclosures and subsequent revelations against the true condition of the company, its product, or some other development relevant to the defendant's business. Without more, perhaps from a confidential informant or inadvertent disclosure of insider discussions, the plaintiffs must essentially argue that executives had to know of the falsity of the public statement or regulatory filing on which investors relied.

For connected investors, gathering evidence of a defendant's intent is less difficult because private transactions are typically preceded by presentations, informal exchanges of e-mail messages, provision of detailed prospectuses, and, sometimes, supporting data. This is the case regardless of whether the seller in the private placement is a publicly traded company or has a different corporate form. A review of more than 100 resolutions of motions to dismiss section 10(b) claims in the Southern District of New York found that in all of the lawsuits filed by

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128 The initial review covered 213 judicial decisions made between 2008 and May 2012 to resolve motions to dismiss in the Southern District of New York, the most active securities litigation docket in the United States. See LEGALMETRIC, LEGALMETRIC CUSTOM REPORT: MOTIONS TO DISMISS IN SECURITIES CASES (SELECTED DISTRICT) (2012) (on file with author). This list of cases covers a time period intended to capture post-financial crisis litigation. These numbers are still preliminary; I continue to analyze the cases included in the sample.
investors who purchased through private placements, the plaintiff cited such transaction-specific documents to support a claim.\(^{129}\)

In the following subsection, a typical case involving shareholder allegations of securities fraud is described. The case illustrates the relative difficulty of meeting the pleading standards imposed on different types of claimants alleging securities fraud.

1. Outsider Investors' Difficulty Developing Evidence of Scienter

After the onset of the financial crisis in 2008, shareholders of the bank holding company Wachovia filed a fraud lawsuit alleging violations of section 10(b), among other wrongs.\(^{130}\) The plaintiffs claimed that they purchased Wachovia stock as a result of false and misleading statements by the bank and its executives about its exposure to potential losses on home loans. Thus, shareholders alleged that when the housing market declined and default rates among borrowers rose, shareholders were caught by surprise and suffered losses as the price of a Wachovia share

\(^{129}\) Drawing conclusions about the impact of access to this information on the success of a plaintiff's claim is very difficult, because the effect is unlikely to be manifested only through the decision of a judge deciding whether to grant a motion to dismiss. Investors who purchased through private placements may be more likely to initiate litigation in the first place, relative to investors who bought publicly accessible securities; this would be consistent with findings by some scholars that the quality of shareholder class action claims may have risen as plaintiffs and their lawyers adjusted to the PSLRA's requirements. See Perino, supra note 123, at 915.

\(^{130}\) See In re Wachovia Equity Sec. Litig., 753 F. Supp. 2d 326 (S.D.N.Y. 2011). A critical element was Wachovia's purchase of Golden West Financial Corporation ("Golden West"), a mortgage lender based in Oakland, California, in 2006; while Wachovia before the acquisition made mostly traditional, fixed-rate home loans, Golden West's "main product" was an adjustable rate mortgage, which "allowed borrowers to choose from multiple payment options each month." One of the options was making a payment that did not cover the monthly interest due, thereby increasing the outstanding principal balance of the home loan. Id. at 342.
fell below $1. The evidence cited by shareholders included public statements by Wachovia executives extolling the company’s “conservative underwriting” standards in extending home loans, describing the “superior credit quality” of the company’s mortgage portfolio, and emphasizing that the company “actively managed our business to minimize our exposure to the subprime market.” These statements, made between 2006 and early 2008, gave way in 2008 to disclosures of losses on home loans as borrowers defaulted. The bank’s market value fell by $109.8 billion between early 2007 and the third quarter of 2008.

The stumbling block for the plaintiffs was establishing scienter to satisfy the PSLRA’s high standard. When Wachovia and the Wachovia executives named in the complaint moved to dismiss the action, the plaintiffs had to support their claim that the defendants knew that their public statements were false. Judge Richard Sullivan outlined two paths to sufficient allegations of scienter: (1) showing that the defendants had “motive and opportunity” to defraud, or (2) offering “strong circumstantial evidence of conscious misbehavior or recklessness.” Considering the first option, Judge Sullivan observed that the defendants clearly had the opportunity to defraud. A showing of motive was more difficult because any employee would have had an incentive to improve an employer’s prospects and something more was necessary. The plaintiffs tried to use

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132 Id. at 342–43.
133 Id. at 343.
134 Id.
135 Id. at 346.
136 Id. at 348.
137 Id. at 349.
138 Id.
evidence of stock sales by insiders to show motive. They argued that defendants hid the risks to the company until they sold their shares.\footnote{139} But Judge Sullivan noted that regulatory filings showed that, overall, the defendant Wachovia executives increased their stock holdings in the period of the alleged fraud.\footnote{140} In any event, stock sales were, at best, indirect indicators of motive. The judge similarly disposed of the argument that executives masked poor financial performance in order to enable a corporate acquisition\footnote{141} or to boost their own compensation.\footnote{142}

Judge Sullivan found that the plaintiffs had similarly failed to allege sufficient facts showing recklessness because they could not show that, at the time that Wachovia executives made the allegedly false and misleading statements about the bank’s lending practices and potential losses, the executives knew or should have known that the statements were untrue.\footnote{143} For example, the plaintiffs failed to “specify which reports [to the executives] revealed the widespread lending problems.”\footnote{144} Confidential witnesses relied upon by the plaintiffs failed to state that they shared any concerns with senior executives such that they would have been on notice of potential problems; the lack of communication “undermine[d] the inference that Defendants recklessly disregarded the truth about Wachovia’s mortgage portfolio while publicly trumpeting the virtues of” its loans.\footnote{145}

\footnote{139} \textit{Wachovia}, 753 F. Supp. 2d at 349.
\footnote{140} \textit{Id}.
\footnote{141} The timing did not work because the acquisition in question involved Golden West: executives had no reason to inflate stock prices after the merger was consummated. \textit{Id} at 350.
\footnote{142} \textit{Id}. at 351–52 ("[f]l if scienter could be pled on the sole basis of executive compensation, 'virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions.’" (quoting \textit{Acito v. IMCERA Grp., Inc.}, 47 F.3d 47, 54 (2d Cir. 1995)).
\footnote{143} \textit{Id} at 352.
\footnote{144} \textit{Id}.
\footnote{145} \textit{Id}.
Without the benefit of discovery, Wachovia shareholders did not have access to internal documents, e-mail messages, reports, or other materials that might have shown either (a) that executives at the bank actually realized the degree of exposure to losses on home loans and deliberately concealed both the financial reality and their knowledge of it, or (b) that executives should have known of the company's exposure in light of information provided to them, and were reckless in not recognizing the potential losses. Unlike participants in private placements, the plaintiffs did not have transaction-specific documents containing allegedly false descriptions of asset quality that could be compared to the truth. Because the plaintiffs did not successfully allege scienter, Judge Sullivan dismissed the shareholders' claims.\textsuperscript{146} There was thus no investigation into whether they had adequately pleaded the other elements of securities fraud.\textsuperscript{147}

2. Connected Investors' Allegations of Reliance

\textsuperscript{146} \textit{Wachovia}, 753 F. Supp. 2d at 366-67 (finding that "Plaintiffs have failed to plead facts giving rise to a strong inference that Defendants acted with the intent 'to deceive, manipulate, or defraud.' The more compelling inference, at least based on the facts as they are alleged in the complaints, is that Defendants simply did not anticipate the full extent of the mortgage crisis . . . . Although a colossal blunder with grave consequences for many, such a failure is simply not enough to support a claim for securities fraud" (citation omitted)).

\textsuperscript{147} The example here is not meant to signal that every shareholder claim founders on the shoals of scienter. \textit{See, e.g., In re MBIA, Inc., Sec. Litig.}, 700 F. Supp. 2d 566, 590–91 (S.D.N.Y. 2010) (finding plaintiff shareholders adequately alleged scienter on part of corporate defendant, if not individual executives, in making public statements about potential exposure to losses resulting from exposure to rising rates of default on home loans); \textit{In re CIT Grp. Inc. Sec. Litig.}, No. 08 Civ. 6613(BSJ), 2010 WL 2365846, at *4 (S.D.N.Y. June 10, 2010) (finding plaintiff adequately stated a § 10(b) claim based on recklessness by alleging that defendants "knew about CIT's lowered lending standards—and, in some cases, affirmatively approved them—while publicly touting the company's 'conservative' and 'disciplined' approach to subprime lending; and . . . learned of the deterioration of CIT's home loan and student loan portfolios, while making public statements indicating that CIT was outperforming the market and would suffer only minimal losses").
Face a Less Demanding Standard

The pleading standard applicable to claims of reasonable reliance, which is less demanding than that applicable to allegations of scienter, correspondingly benefits connected investors. Here, briefly, is a description of a case that illustrates the standard that allegations of reasonable reliance must clear.148

An investment company with a sole managing member, Dodona I LLC (“Dodona”), purchased securities in 2007 with a face value of $4 million from Goldman, Sachs & Co. (“Goldman”).149 The value of the securities depended on the performance of assets, selected by Goldman, which in turn depended on repayment of residential mortgages.150 Dodona sold the securities less than one year after the purchase, losing more than ninety percent of the value of the investment.151 Dodona sued, alleging violations of section 10(b) and common law fraud, among other wrongs.152 The plaintiff charged that Goldman deliberately constructed the securities in a way that ensured they would lose value; Dodona claimed that the transaction had shifted the risk of losses due to increased home loan defaults from Goldman to the purchasers of the securities.153 Goldman moved to dismiss Dodona’s lawsuit, contending that Dodona was crying “fraud by hindsight” because there was no way that Goldman could have known with certainty how the value of

148 The case described is not a class action, unlike the shareholder lawsuit against Wachovia discussed above. In analysis of the impact of the pleading standards, however, this distinction does not make a difference because the same requirements must be met for an individual action as for a class action.


150 Id. at 634.


153 Id. at 645–46.
the underlying home loans might change and that Dodona, as a sophisticated investor, could not have reasonably relied on alleged omissions in information provided about the securities. For example, Goldman noted that Dodona received information on credit scores and average loan-to-value ratios of borrowers whose home loans backed the securities underlying the securities sold. Goldman argued that Dodona was sophisticated enough to have determined on its own the risk of defaults and resulting losses on the mortgage-linked securities but had failed to avail itself of the opportunity, and should not be permitted to recover through litigation.

Judge Victor Marrerro did not grant Goldman's motion to dismiss. He concluded that Dodona had adequately alleged scienter by presenting evidence of Goldman executives' determination to reduce the company's own exposure to the risk of losses caused by defaults on home loans. The record included excerpts of e-mails that Dodona had obtained in which at least one Goldman employee derided the quality of the assets underlying the securities. Judge Marrerro concluded that Goldman omitted material information when it failed to disclose the riskiness of the securities.

In discussing whether Dodona reasonably relied on alleged misstatements and omissions by Goldman, Judge Marrerro noted that the plaintiff's complaint "rather conspicuously avoids discussing the nature of Dodona's business or making any representations regarding Dodona's level of sophistication." And whether Dodona was a sophisticated investor or not, Judge Marrerro wrote, "it is unclear to the Court whether 'the information necessary to unmask the alleged fraud [would] have been accessible to the

154 Dodona I, 847 F. Supp. 2d at 644.
155 Id. at 648.
156 Id. at 648.
157 Id.
158 Id. at 646.
159 Id. at 642.
160 Id. at 645.
161 Id. at 648.
Permitting the case to proceed to discovery was appropriate to determine both whether Dodona was sophisticated and whether sophistication would have mattered in detecting the fraud alleged.\textsuperscript{163}

The case illustrates judges’ discretion in evaluating the reasonableness of a plaintiff’s claimed reliance on an allegedly fraudulent statement or omission. If a higher standard had applied to this element of a claim of fraud, the plaintiff’s complaint almost certainly would have had to include at least some representation regarding its sophistication and some description of the steps taken to protect itself from potential losses. But no such “particularity” was necessary and the case proceeded.\textsuperscript{164}

The descriptions above are not meant to suggest that all claims by connected investors succeed. They have not.\textsuperscript{165} Nor do I mean to suggest that an investor who purchases securities through a private placement establishes \textit{ipso facto} that reliance on an allegedly fraudulent statement or omission was reasonable. But I do suggest that connected investors, unlike outsider investors who may typically receive only information contained in regulatory filings or other public statements, often receive transaction-specific information.

\textsuperscript{162} \textit{Dodona I}, 847 F. Supp. 2d at 649 (quoting Terra Sec. ASA Konkursbo v. Citigroup, Inc., 740 F. Supp. 2d 441, 449 (S.D.N.Y. 2010)).

\textsuperscript{163} \textit{Id.}


\textsuperscript{165} \textit{See}, e.g., Terra Sec. ASA Konkursbo v. Citigroup, Inc., 450 F. App’x 32, 34–35 (2d Cir. 2011) (dismissing claims by plaintiffs other than Norwegian municipalities because they were “clearly sophisticated investors” and they did not allege “that they conducted any independent investigation prior to making their investments”). \textit{See also} Landesbank Baden-Württemberg v. Goldman, Sachs & Co., 821 F. Supp. 2d 616, 624 (S.D.N.Y. 2011) (dismissing common law fraud claim because plaintiffs failed to allege particular fraudulent statements and dismissing negligent misrepresentation claim because plaintiff “represented that it was a sophisticated investor and had adequately researched and accepted the risks associated with its . . . investment”).
information of a type that is not available to the general, investing public. That information is particular to the transaction in a way that, for example, disclosures in an annual report cannot be and do not claim to be. These transaction-specific documents illustrate, at a minimum, a defendant seller's interest in persuading the plaintiff investor to participate in the deal. Any incentive to mislead, then, is the result of a desire to conduct a particular transaction with a specific investor, and not only of a more general desire to benefit the seller.

B. Negative Consequences of Favorable Pleading Standards for Connected Investors

The law's different demands of securities fraud claimants based on characteristics of their investments have significant consequences, not least because of the rapid growth in private offerings in recent years. In this section, I first identify the potential systemic consequences of favoring certain claims and/or claimants, and then place the differential treatment in the larger context of increasingly demanding requirements facing plaintiffs in civil litigation generally.

1. Lower Reliance Standards May Discourage Investor Care

The potential systemic effects of smoothing the road to recovery for connected investors is arguably a great concern. The prospect of recovery through litigation could make private transactions more appealing than they already are, resulting in further growth in private placements. The benefit of that outcome is unclear. Connected investors may invest less in due diligence before participating in risky financial transactions of precisely the sort that may contribute to financial crises, and executives of companies

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166 See Ivanov and Bauguess, supra note 13, at 1 (describing the "significant increase in use of private market capital").

167 Of course, individual corporate executives with a role in managing investment practices may still lack an incentive to take due care on behalf
selling such transactions may have too great an incentive to engage in socially wasteful, fraudulent conduct. The popularity of private transactions may grow yet further as a result of the greater likelihood of recovery through litigation in the event of seller misconduct. If one goal of regulators is to foster systemic stability, then creating stronger rather than weaker incentives to conduct due diligence makes sense, because it is in the best interest of all who depend on well-functioning markets that investors avoid taking on too much risk. Otherwise, the danger persists of recreating the conditions that preceded the 2008 financial crisis: excessive participation in risky transactions despite a significant possibility that the outcomes of investments will adversely impact not just counterparties but also the ability of financial markets to function. Taxpayers smarting from the government’s emergency steps to protect financial companies after the 2008 crisis may well want to promote a healthy sense of caution in the investors who participated in transactions involving mortgage-linked securities.

When purchasers of securities obtain recoveries, they have succeeded in putting the burden of losses on sellers, and the resulting distribution of risk may not reflect the underlying intent of the PSLRA. It seems unlikely that judges resolving individual motions to dismiss take into

of an employer. Compensation practices are a part of the story of the financial crisis. For a more complete discussion of the role of such incentives, see Donald C. Langevoort, Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture, and Ethics of Financial Risk Taking, 96 CORNELL L. REV. 1209, 1212 (2011) (observing that, for example, portfolio managers might have knowingly decided to invest their principals’ money in poor quality assets linked to home loans because the managers “had compensation-based incentives to deliberately ignore the long-term risk”).

Whether further growth in popularity of private transactions is a good thing is a question beyond the scope of this paper, but certainly some scholars have questioned the trend in that direction in recent years. See Rodrigues, supra note 17, at 3392.

This shifting of risk from buyers to sellers may actually have the effect of concentrating systemic risk. See Robert A. Brown, Financial Reform and the Subsidization of Sophisticated Investors’ Ignorance in Securitization Markets, 7 N.Y.U. J.L. & BUS. 105, 173 (2010).
account the systemic incentive effects of their rulings, or that judges are better placed than lawmakers to determine how risk ought to be allocated generally between buyers and sellers of securities. Congress, I suggest below, should take up this task—bearing in mind that changes might affect the behavior of would-be and actual fraudsters. The perpetrator of a fraud might engage in wrongful conduct more readily if recovery by the victim is more difficult. But post-crisis litigation complicates that story; in many of those cases, buyers alleging fraud did receive disclosures from sellers and later either contended that the disclosure was insufficient or confessed that they did not review the information with care. If defendants consistently won in such lawsuits, then the incentive to disclose would remain strong, because disclosure would protect sellers by making it harder for investors to succeed with their claims. Indeed, it is the incentive effect for connected investors that most strongly supports refinement of the standard applicable to pleading of reasonable reliance.

2. Raising Pleading Standards for Outsider Investors as Part of the Trend of Restricting Civil Recovery

At a higher level, the more demanding pleading standard for outsider investors is but one example of barriers to redress through civil litigation. Scholars have identified other mechanisms that effectively narrow access to the courthouse for certain potential civil claimants, thus making the securities fraud issue discussed in this Article part of a larger phenomenon. Examples of other mechanisms

170 It is difficult to predict how future perpetrators of fraud will react to any change in legal regime; fraud takes advantage of change to exploit the ignorant, and change itself – let alone the opportunities change creates – can be difficult to predict. See Samuel W. Buell, Novel Criminal Fraud, 81 N.Y.U. L. REV. 1971, 2015–16 (2006).

171 See, e.g., Catherine Albistion, The Dark Side of Litigation as a Social Movement Strategy, 96 IOWA L. REV. BULL. 61, 69–74 (2011) (noting that the courts are an ineffective vehicle for social reform); Marc Galanter, Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal
include judicial decisions favorable to litigants whom Professor Marc Galanter identified as “repeat players,” who can choose when to settle and when to litigate with an eye toward generating precedents likely to hinder future opponents. Additionally, some observers identify recent Supreme Court decisions describing—and, in the eyes of critics, raising—the standard plaintiffs must meet when alleging violations of constitutionally protected rights, or when alleging conduct that, while not fraudulent, would violate the law. Yet another example is legislation demanding that plaintiffs show the strength of their case at early stages in the proceedings, such as the PSLRA.

The Supreme Court has raised hurdles for civil plaintiffs in particular contexts. In Ashcroft v. Iqbal, the Supreme Court evaluated the claims of a Pakistani citizen who was arrested and detained in the United States and who claimed that he suffered abuse while in government custody. The Court concluded that the plaintiff had not alleged sufficient

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172 Plaintiffs’ lawyers may be repeat players in one sense, but their interest in winning a large fee award in any given case may not necessarily cause them to adopt a long-term view of the most favorable legal precedent to try to generate. See Galanter, supra note 171, at 102.


175 See supra Part III.C (describing legislative requirements that securities fraud pleadings must meet to survive a motion to dismiss).

176 The cases doing so have generated considerable commentary; see, e.g., Miller, supra note 171, at 68, 71 (criticizing higher barriers to courts for civil plaintiffs).
facts to survive a motion to dismiss.\textsuperscript{177} Two years earlier, in \textit{Bell Atlantic Corporation v. Twombly}, the Court reached a similar conclusion about consumers' allegations of antitrust violations by companies providing telephone and Internet services. However, neither \textit{Iqbal} nor \textit{Twombly} involved Rule 9 of the Federal Rules of Civil Procedure because neither case involved allegations of fraud; and because neither case involved a claim under section 10(b), neither had to satisfy the PSLRA. While consistent with the trend toward restricting access to the courts, \textit{Iqbal} and \textit{Twombly} differ significantly in context from the securities claims that are the subject of this Article.

Critics contend that these barriers to judicial remedies block claims that deserve adjudication on their merits. In an article lambasting the trend, Professor Arthur R. Miller argues that the tougher stance adopted by the Supreme Court in recent years is the result of "too much attention paid to claims by corporate and other defense interests of expense and possible abuse and too little on citizen access, a level litigation playing field, and the other values of civil litigation."\textsuperscript{178} His arguments are consistent with what Professor Galanter would have predicted forty years earlier: repeat players, such as corporations, with the wealth to

\begin{quote}
\textsuperscript{177} Describing the standard that a plaintiff's claim must meet to overcome a motion to dismiss, the Court, citing to \textit{Twombly}, wrote:

\begin{quote}
[A] complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face. A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a complaint pleads facts that are merely consistent with a defendant's liability, it stops short of the line between possibility and plausibility of entitlement to relief.
\end{quote}
\end{quote}

\textit{Iqbal}, 556 U.S. at 678 (citations and internal quotation marks omitted). This standard clearly differs from that required under Rule 9 and the PSLRA.

\textsuperscript{178} Miller, \textit{supra} note 171, at 2.
retain excellent representation, have succeeded in tilting the playing field against their potential opponents.¹⁷⁹

Scholars chronicling a decline in accessibility of legal redress paint a bleak picture, describing those who are blocked from the courthouse doors do not have the political or economic clout to improve their status. However, in the aftermath of the 2008 financial crisis, large, wealthy financial institutions that were outsider investors have sued equally wealthy and powerful adversaries. As a result, a powerful constituency might favor changes to pleading standards. The financial crisis has blurred historical battle lines, which in the past clearly divided investor plaintiffs and their advocates, on one side, from corporate defendants and their officers and directors, on the other. Corporate defendants in the years leading up to passage of the PSLRA successfully characterized their situation as dire and in need of legislative intervention, but with the rise of financial company plaintiffs after 2008, corporate interests may have become more diverse. An opportunity may therein lie for modification of fraud pleading standards.

¹⁷⁹ See Galanter, supra note 171, at 97. Erecting barriers to civil plaintiffs generally would be concern enough, but others warning of such a trend have described an effort to hinder vindication of civil rights in particular. Catherine Albiston uses militaristic language, describing an "attack on civil rights." She identifies, as evidence, a variety of judicial moves, such as expanding the scope of sovereign immunity and restrictions placed on the activities of legal services lawyers. See Catherine R. Albiston & Laura Beth Nielsen, The Procedural Attack on Civil Rights: The Empirical Reality of Buckhannon for the Private Attorney General, 54 UCLA L. REV. 1087, 1131 (2007). She does not discuss litigation by aggrieved investors, who may appear to be less sympathetic victims. However, differential treatment of claimants in a manner that favors the powerful should be considered in this context: why should investors in private placements, who have considerable resources at their disposal and who affirmatively choose to take advantage of exemptions to otherwise applicable disclosure regimes in their pursuit of higher rates of return, enjoy an easier path to recovery than investors who purchase publicly accessible securities?
V. PROPOSING NEW STANDARDS

The preceding discussion suggests that pleading standards applicable to securities fraud claims are too low for investors in securities purchased in private placements. This criticism implicates the regulatory framework that classifies investors, permitting only some investors to participate in private placements. I have also suggested that the effects of too-low standards are undesirable, in part because of the negative incentive effects on connected investor due diligence. Regulation has failed to keep pace with the changing characteristics of financial markets, the rise of institutional investors, and the growth of private offerings.\footnote{180}{See Ivanov and Bauguess, supra note 13, at 3.}

This Part proposes ways to address the problems identified. Creating fair playing fields for investors holding securities of different types requires two sets of changes. First, pleading standards demand review, with an eye toward reducing the burden on shareholders alleging fraud by demanding less evidence of wrongful intent to survive a motion to dismiss.\footnote{181}{An alternative would be to raise the standard applicable to assertions of reasonable reliance by putatively sophisticated investors—a move decisively criticized by Professor Sachs more than twenty-five years ago. See Sachs, supra note 93, at 107.} Second, what constitutes reasonable reliance requires reconsideration—not to hinder plaintiffs that invested in private placements, but rather to ensure adequate pre-transaction diligence.

A. Reducing the Hurdle’s Height for Pleading Scienter

Correcting the pleading standards requires recognition that the rationale permitting recovery by connected investors is no different from the justification for recovery by outsider investors. The path to recovery should be as smooth for the typical outsider individual, retail investor, or pension fund, as it is for a connected financial company investor engaged in
proprietary trading, in order to permit claims with merit to proceed.\textsuperscript{182}

Therefore, the standard applicable to allegations of scienter should be lowered, in recognition of the differing abilities of differently situated plaintiffs to obtain the information necessary to plead with particularity. Pleading standards should not exacerbate the informational advantages of connected investor plaintiffs relative to outsiders. Readopting Rule 9(b) of the Federal Rules of Civil Procedure as the guiding and binding standard for claims of securities fraud, without the higher standard of the PSLRA, would ensure that plaintiffs making viable accusations of fraud litigate on the same playing field, regardless of investor or investment.

Pleading standards might also be made more specific, to enable analysis of the reasonableness of reliance by plaintiffs.\textsuperscript{183} In litigation arising out of private placement sales, plaintiffs who purchased securities could be required to describe at the pleading stage the due diligence they conducted, the reasoning underlying that level of due diligence, the extent to which they followed their own past practice and/or standard industry practices, and the reasons for any deviations.\textsuperscript{184} This amendment would shift risk to

\textsuperscript{182} If the lead plaintiff requirement has led to filing of higher-quality cases, see Perino, supra note 123, at 976, then, in this way, securities litigation by shareholders can better achieve deterrence of misconduct. See John C. Coffee, Jr., Reforming The Securities Class Action: An Essay on Deterrence and its Implementation, 106 COLUM. L. REV. 1534, 1535–36 (2006) (identifying the “fundamental problem” of securities class action litigation as the failure either to compensate victims of fraud or deter potential wrongdoers).

\textsuperscript{183} Or, as Professor Sachs has suggested, this analysis—requiring review of due diligence by an investor—could be jettisoned as inconsistent with the goal of deterring, detecting, and/or punishing fraud. See Sachs, supra note 93, at 131.

\textsuperscript{184} The goal of requiring such a statement would be prophylactic: the requirement of a description would force executives to think beforehand, explicitly and specifically, about the nature and degree of due diligence performed, helping to counter any tendency to rely on longstanding practice or unquestioned assumptions. For a comprehensive discussion of the potential role of intellectual biases on decision-making prior to the
purchasers from sellers. While lawmakers, who lack expertise, should not presume to tell businesspeople how to evaluate investment opportunities, they may reasonably require plaintiffs to describe the evaluation they performed.

Sophisticated investors would have to explicitly identify the potential weaknesses of the due diligence approach taken—the sources of risks of error in evaluation—and describe the representations and warranties demanded of the seller in order to address those weaknesses. Investors would have to justify any failure to obtain such representations and warranties. Together, these documentation requirements would force investors to think carefully before entering a transaction and, afterward, would promote consistency among judges evaluating whether plaintiffs alleging fraud were reasonable in relying on the information they obtained. The requirement makes shifting losses from buyers to sellers through litigation more difficult.

This is not, per se, a call for a tougher pleading standard applicable to assertions of reliance, but rather a description of a more precise pleading standard that judges could apply consistently when evaluating whether a plaintiff's reliance on an allegedly fraudulent statement or omission was reasonable.\footnote{185} Plaintiffs would have to describe industry financial crisis, see Geoffrey P. Miller and Gerald Rosenfeld, \textit{Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008}, 33 HARV. J.L. & PUB. POLY 807 (2010); see also Tom C.W. Lin, \textit{A Behavioral Framework for Securities Risk}, 34 SEATTLE U. L. REV. 325, 362–63 (2011) (discussing a proposal with similar goals). If an investor did not conduct due diligence, then that investor's claims would have great difficulty obtaining the aid of the court in obtaining redress—although judges would have to retain discretion in evaluating deviations from industry practice and in evaluating the wisdom of industry practices themselves.

\footnote{185} Professor Karmel has advocated adopting a presumption of reasonable reliance in cases based on the theory of fraud on the market, but the proposal is limited to cases involving allegations of fraudulent statements or omissions in regulatory filings. See Roberta S. Karmel, \textit{When Should Investor Reliance Be Presumed in Securities Class Actions?}, 63 BUS. LAW. 25, 53–54 (2007). The proposal would not, then, address the disparate treatment of claims by shareholders relative to claims by other types of investors.
practices and compare those practices to the steps taken to conduct due diligence. Judges would consequently have relevant benchmarks for evaluating claims, as well as explanations of deviations. Judges would still retain discretion in deciding whether a particular degree of deviation should preclude the possibility of recovery, or whether an industry norm is itself dubious, but potential plaintiffs would at least consider how to justify choices made about due diligence and would likely demand more extensive representations and warranties from sellers.

Precision—not the same as particularity, and not resting on information inaccessible to the plaintiff—would not discourage all lawsuits. Shareholder litigation did not cease following the enactment of the PSLRA. And following any widespread financial catastrophe, institutions that lose money will almost certainly seek mitigation of losses through litigation. The argument made here is not that this litigation should be prevented. Rather, the goal is better allocation of risk between the parties and quicker disposition of those cases in which sophisticated, connected investors did not take adequate steps to protect themselves from potential losses before deciding to participate in transactions. The effect would be a reallocation of risk to buyers in private placements from sellers, encouraging buyers to be more cautious and, perhaps, more conservative. This should counter the possibility that sellers would not care about outcomes subsequent to a sale; buyers would have a stronger incentive ex ante to investigate an investment carefully.\(^{186}\)

The clear costs of this shift would be the burden of satisfying the requirement of the pleading standard in any litigation, the cost of due diligence that a buyer might otherwise not have conducted, and perhaps the cost of transactions that might not transpire at all.

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\(^{186}\) The price mechanism ought to achieve this same effect. However, buyers may not consciously bargain for a lower price based on a decision not to conduct due diligence, unless forced to grapple with the question of how much diligence is due.
B. Reforms Are Possible

Changing the procedural requirements imposed on claimants requires legislative and regulatory action. Lawmakers, who in the past have attempted to balance the interests of aggrieved buyers against those of sellers, could better determine the pleading standard that should apply to investors in private placements. Perhaps they would have done so in the PSLRA, had anyone pointed out that connected investors may engage in litigation as “frivolous” as an abusive shareholder class action lawsuit. In the wake of the financial crisis, lawmakers required more detailed disclosure of the characteristics of assets underlying transactions, but those rules will not compel buyers to review the information provided. With the benefit of information on the effects of changes to pleading standards on all players in the industry, lawmakers are well-positioned to draw a line between sellers’ duty to disclose and buyers’ duty to investigate. What lawmakers require is a spur to act.

There is reason to think they might find one. While public companies supported the barriers to investor claims in the PSLRA, businesses would likely be less unified in support of modifying requirements applicable to fraud claims involving securities sold through private placements. Increasing diversity of investors may make it easier to modify the pleading standards, both by lightening the burden imposed on plaintiffs who are outsider investors and

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187 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 942(b), 124 Stat. 1376, 1897 (2010) (codified at U.S.C. § 77g (2012)) (ordering the SEC to adopt regulations “requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security,” including disclosure of “asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence”).

by specifying the requirements imposed on connected investors’ claims that their reliance on allegedly fraudulent statements or omissions was reasonable. After all, large investors are both shareholders of companies that they have accused of committing fraud and also investors in private placements. The magnitude of financial crisis-related losses forced institutional investors who formerly might have hesitated to participate in investor litigation an incentive to sue. As a result, the front in favor of the current pleading regime’s standards for allegations of scienter is likely less united than it was before the financial crisis. At the same time, any argument that the standards applicable to claims of reasonable reliance should be more precisely defined is likely to find enthusiastic support among defendants in litigation involving securities sold through private placements. Lowering barriers to outsider investor plaintiffs may encounter less resistance now than in the past, and imposing consistency on connected investor plaintiffs’ claims of reasonable reliance may find more support today than it did previously.

VI. CONCLUSION

This Article argues that different pleading standards for different elements of claims of securities fraud affect investors in distinct ways, depending on the context of the purchase. For outsider investors, the scienter element of a fraud claim poses special difficulty. Scienter is subject to the heightened pleading standards of the PSLRA, which requires plaintiffs to present facts sufficient to create a “strong inference” of wrongful intent.189 For investor plaintiffs who purchase a security through a private placement, the reliance element poses a more significant hurdle. Plaintiffs must establish that their reliance on an allegedly fraudulent statement or omission was reasonable. The more sophisticated the purchaser, the more difficult it may be to demonstrate reasonable reliance because a more sophisticated investor is expected to better detect warning

signs of fraud. Reliance, however, is not subject to a heightened pleading standard.

This Article contends that pleading requirements should not disfavor outsiders for two reasons. First, outsider and connected investors have different degrees of ability to protect themselves ex ante from fraud, and pleading standards should take this reality into account. Second, connected investors, perceiving greater ease of recovery through litigation in the event of a calamitous purchase, may adopt too lax an approach to due diligence.

This Article suggests that judges weighing investors' claims probably do not and should not take into account the potential incentive effects of their decisions. The Article has proposed lightening the pleading burden that the current legal regime places on outsider investor claims in order to facilitate the protection of investors who may have less access to information. In addition, it has proposed requiring connected investors to document the due diligence undertaken prior to investing in a private placement as a prerequisite to asserting the reasonableness of their claimed reliance on an allegedly fraudulent statement or omission. The PSLRA already imposes a significant and effective constraint on potentially abusive securities class action litigation by favoring large, institutional investors, such as state pension funds, in controlling roles in lawsuits.\(^{190}\)

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\(^{190}\) The PSLRA presumes that the most desirable lead plaintiff in a shareholder class action lawsuit is the investor who has the greatest financial interest in the outcome of the case—typically a large financial institution rather than an individual investor. The presumption seeks to prevent lawyers, whose interests might diverge from those of investors, from controlling the litigation: a large institution would have the means and the incentive to monitor counsel. An empirical analysis of the effect of the lead plaintiff provision by Professor Perino finds that involvement of institutional investors in shareholder class actions causes at least some of the beneficial effects intended by lawmakers in 1995. When public pension funds are lead plaintiffs, settlement amounts are larger, and attorney fee requests and fees actually awarded are lower. See Michael Perino, Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions, 9 J. EMPIRICAL LEGAL STUD. 368, 390 (2012).
Fraud victims who are outsider investors deserve a fair chance at recovery.