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Corporate Corruption and the Complicity of Congress and the Supreme Court - The Tortuous Path from Central Bank to Stoneridge Investment Partners

Charles W. Murdock

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Corporate Corruption and the Complicity of Congress and the Supreme Court - The Tortuous Path from Central Bank to Stoneridge Investment Partners

Charles W. Murdock

This article asserts that Congress and the federal courts are complicit in the widespread corporate corruption that has come to light this past decade. It begins by exploring the notion of bias and then chronicles judicial developments which have protected corporate officials, who have engaged in securities fraud and other wrongful conduct, at the expense of innocent shareholders and investors. It also analyzes the public policy in favor of corruption embodied in the Private Litigation Securities Reform Act, and the actions of federal courts in expanding the protection of PLSRA even beyond that dictated by the language of the statute. It concludes with a strong criticism of the most recent decision of the Supreme Court in Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008), where the Supreme Court once again protected wrongdoers, who had engaged in unconscionable conduct, from judicial accountability.

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Before 1980, share buybacks were discouraged. Returns were driven by dividends. Earnings are a very dubious measure. There are so many tools a CEO can use to "craft" an earnings statement, so many ways to mislead. All asset values, after all, are just based on forecast. There's been too much gaming of the system until it is broke. Capitalism is not working! There has been a corrupting of the system of capitalism.

INTRODUCTION

Who authored the foregoing indictment of corporate management? This would seem to be the kind of statement that a liberal Democrat or a hippie protester at Davos or the World Social Forum might utter. In point of fact, the author of the indictment was Alan Greenspan, the former chairman of the Federal Reserve Board. Unfortunately, Chairman Greenspan did not have the courage to express such sentiments publicly.

Has there been a corrupting of the system of capitalism? What factors led to the adoption of the Sarbanes-Oxley legislation, and are those factors still a concern? This article will suggest that the actions of the courts, particularly the United States Supreme Court and other federal courts, and of the Congress, contributed to the corporate corruption, the headlines of which led to the enactment of Sarbanes-Oxley. It will also suggest that we can expect more examples of corporate corruption, particularly with the increased conservatism of the federal courts, and the reluctance—at least so far—to recognize the damage done by the Private Litigation Securities Reform Act of 1995, coupled with the efforts of business to repeal or eviscerate the Sarbanes-Oxley act. The current state of affairs with respect to Sarbanes-Oxley is analyzed in another article.

The main thrust of this article is that courts and legislatures, particularly the

2. See JOSEPH E. STIGLITZ, MAKING GLOBALIZATION WORK 3-7 (2006); see also Bob Young, Lights! Camera! Teargas! WTO Riots to Be a Movie, SEATTLE TIMES, Sept. 8, 2006, at A1.
4. See infra Parts II.C., III., IV.
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past Republican Congress and the Supreme Court, as well as lower federal courts, are biased in favor of management; moreover that their failure to hold management to account has emboldened management to engage in illicit behavior and has led to supineness, or worse, by gatekeepers, such as accountants and boards of directors. The willingness of federal courts to disregard blatant corruption and give crooks a free pass by engaging in outcome determinative decision making and strained interpretations of the law is epitomized in the recent decision of the Supreme Court, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*

Part I explores the notion of bias and asserts that we are bombarded with so much information that some bias is necessary in order to serve as a filter; the danger is in failing to recognize our biases and their impact upon our decision making process. Part II addresses the notion of complicity and causation/correlation. It then addresses state law developments, such as the concept of special litigation committees and strained interpretations of when demand on the board of directors to initiate litigation is futile that have insulated management from accountability, and have resulted in inattention, passivity, and supineness by boards of directors. While recognizing both the validity and essential function of the business judgment rule with respect to operating decisions by directors, the article asserts that has no relevance to permitting boards of directors, or committees thereof, to determine conclusively whether other directors have engaged in misconduct. Part II concludes by looking at the trilogy of insider trading decisions by the United States Supreme Court in the early 1980s, which undercut the notion of fairness in the securities markets and reflected a trend of inept and outcome determinative judicial craftsmanship.

Part III moves into the 1990s and the disastrous policy reflected in the 1994 *Central Bank* decision and the 1995 Private Litigation Securities Reform Act ("PLSRA"). The *Central Bank* decision was judicial activism at its worst—deciding an issue that was not raised by the parties, ignoring unanimous precedent, and ineptly engaging in outcome determinative decision-making. PLSRA, by requiring specificity in pleading without the benefit of discovery, and by providing that a cautionary warning on a forward-looking statement

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7. 128 S. Ct. 761 (2008); see infra text accompanying notes 286-347.
9. See infra text accompanying notes 32-42.
10. See infra text accompanying notes 43-60.
11. See infra text accompanying notes 305-310.
12. See infra text accompanying notes 33-35.
13. See infra text accompanying notes 75-96.
14. See infra text accompanying notes 144.
15. See infra text accompanying notes 186.
16. See infra text accompanying notes 144-169.
absolves management of any responsibility, even though management knows
that there is no basis for the statements, has created a blase approach to
truthfulness by corporate management. This section also reviews the recent
Supreme Court decision in Tellabs, and criticizes Justice Scalia’s interpretation
of the phrase “strong inference of scienter” to mean the strongest inference,
failing to recognize that there are three degrees of adjectives: strong, stronger,
and strongest.

Part IV analyzes the most recent decision of the Supreme Court in the
securities area, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. It
briefly reviews the distressing corporate corruption that has characterized this
past decade in order to demonstrate that the Supreme Court could not have
been unaware of the impact of its decision. It then analyzes the opinion to
demonstrate that the decision of the Court was not mandated by earlier
precedent, but reflected a continuation of the outcome determinative type of
analysis that has characterized the Court and that has not only exculpated
wrongdoers from liability, but also set a tone that creates a “what, me worry”
mentality in the corporate world. The conclusion asserts that if managements
were less concerned about manipulation and more about the virtue of
truthfulness, they would have less to worry about in terms of corporate
litigation. But this is unlikely unless the tone changes; one way to accomplish
this would be for Congress to reinstitute aiding and abetting liability in civil
lawsuits.

I. THE NATURE AND PERVERSIVENESS OF BIAS

This article is about bias. The assertion in the introduction, that
conservative courts have contributed to corporate corruption, would lead some
readers to be wary that the author might be biased. But in fact, we are all
biased. Some biases are harmless: as a White Sox fan, for many years I was
pleased to see the Chicago Cubs lose. But it needs no citation to assert that
some biases, such as those based on race or gender, have had heinous
consequences.

Psychological research has demonstrated that we are bombarded with such
an array of inputs that some must be filtered in order that we may function
effectively. And bias is one means of screening information. Biases are

20. Id.
21. See Eric I. Knudsen, Fundamental Components of Attention, 30 ANNU. REV. NEUROSCI. 57, 58
(2007). Knudsen is in the Department of Neurobiology at Stanford University, School of Medicine, and
writes that:

To behave adaptively in a complex world, an animal must select, from the wealth of
information available to it, the information that is most relevant at any point in time. This
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most dangerous when they are denied, because then we fail to insightfully analyze the underlying facts to see if our position is justified. While bias may be harmless when it involves rooting for a sports team, when significant decisions are at issue, bias is no excuse for lack of discernment. Significant decisions have consequences; to reach a sound decision, biases must be recognized and underlying facts objectively analyzed.

We are fond of saying that ours is a government of laws and not of men. But this is a naïve oversimplification. The three 5-4 decisions of the Supreme Court at the end of the last term, in effect reversing prior precedents, demonstrated that the attitude and biases of one or two men have a significant impact on the law. While conservatives have railed against the activism of the Warren Court, at least the bias of the Warren Court was to protect the weak against the strong, whereas the bias of the Roberts Court is to favor the strong against the weak.

Information is then evaluated in working memory, where it can be analyzed in detail, decisions about that information can be made, and plans for action can be elaborated. The mechanisms of attention are responsible for selecting the information that gains access to working memory.  

Id. at 69.

In commenting upon the conflict between reason and emotion, and why emotion often prevails, Jack Fuller, a former editor and publisher of the Chicago Tribune who is working on a book about neuroscience and the news media, set forth the following evidence as to why we are nearly drowning in information:

E-mail stacking up, blogs beckoning, cell phones ringing, text messages rushing in, computer screens relaying the second-by-second events of the world, YouTube, Facebook, MySpace, not to mention CNN blaring in airports, television running as you surf the Web, and displaying on movie screens (even in movies) and in elevators, grocery store lines, sports arenas.

Jack Fuller, Reasoning with Feeling, CHI. TRIB., July 15, 2007, at C1, 3.

Mr. Fuller goes on to explain that a crucial function of emotion, from an evolutionary perspective, is to take control of the brain and focus its attention on situations where survival is at issue. He states "I think of hundreds of wild animals moving around chaotically on the savanna. And then a lion. The survivor's brain pays attention to the lion." Id. at 1. The problem today is that we sometimes confuse a lion with a hyena.

22. See, e.g., Philip G. Zimbardo & Michael R. Leippe, The Psychology of Attitude Change and Social Influence 162-63 (1991). The authors note that: But despite all good intentions to "let the facts speak for themselves," biases based on our existing attitudes can sneak into our perception and interpretation of the "facts." What we notice in a message, how we interpret ambiguous message information, and which beliefs in knowledge are conjured from memory during the cognitive response process are all affected in subtle ways by one's existing point of view.

Id. In a study in which subjects who disagreed about capital punishment were exposed to mixed evidence about its effectiveness, the subjects "... became even further separated after reading the mixed evidence...." This peculiar in effect appears to be the result of biased interpretation. The subjects tended to accept at face value the data that supported their position while actively counter arguing for nonsupportive findings. Id. (emphasis in original); see also Albert Bandura, Social Foundations of Thought and Action 223 (1986) ("People generally overestimate the adequacy of their knowledge, especially in areas of limited familiarity. ... They favor confirmatory evidence but disregard contradictory evidence.").

23. See App'x 1 (listing excerpts from the three opinions illustrating the various Justices' views on stare decisis).

24. For example, in this first term of the Roberts Court, the court required employees to file a wage discrimination complaint within 180 days of the wage being set, even though there was not data then available that would enable the employee to appreciate that there was in fact discrimination. Ledbetter v.
Hopefully, the assertion of bias with regard to the foregoing decisions, which involve issues of broad public interest, will make the reader more open to the forthcoming assertions of bias in the corporate and securities world, where the subject matter is more arcane and turgid and less likely to involve the reader emotionally. However, the corporate world is where power exists and we need to be aware of the system in which this power operates.

II. COMPLICITY: THE SCENE FROM THE LATE 1970S TO THE EARLY 1980S

A. What is Complicity?

It is a somewhat shocking assertion to posit that the courts or legislatures bear some responsibility for the corporate corruption in the late 1990s and early 2000s. At the outset, “complicity” in this article is not used in the way Black’s Dictionary defines the word, namely, “[a]ssociation or participation in a criminal act; the act or state of being an accomplice.” Rather, it is used in the layman’s sense of the word as meaning an associate or partner in, or facilitator of, wrongdoing that does not need to rise to the level of criminality.

The legal mind is trained to accept only linear causation. In a first-year torts class, many instructors spend days on the Palsgraf case and the concept of proximate cause. In point of fact, in the real world, causation is much more complicated. Not only can there be more than one cause but there is a continuing relationship between cause and effect.

However, the fact that there is a correlation between two events does not mean that there is a causal connection between them. For example, consider the very controversial example in Freakonomics where the authors assert that there is a correlation between Roe v. Wade, which led to increased abortions.

Goodyear Tire & Rubber Co., 550 U.S. 618 (2007). Similarly, the Court overturned a $79.5 million punitive damage award against Philip Morris, Philip Morris USA v. Williams, 549 U.S. 346 (2007), even though the Oregon Supreme Court had denounced the company’s 40 year history of denying the connection between smoking and cancer as “extraordinarily reprehensible.” Williams v. Philip Morris Inc., 127 P.3d 1165, 1181 (Or. 2006).


26. WEBSTER’S NEW WORLD DICTIONARY (2d ed. 1982). See also the Supreme Court’s use of that term in the Stoneridge decision. Stoneridge, 128 S. Ct. at 766.


28. See FRITJOF CAPRA, THE HIDDEN CONNECTIONS: INTEGRATING THE BIOLOGICAL, COGNITIVE, AND SOCIAL DIMENSIONS OF LIFE INTO A SCIENCE OF SUSTAINABILITY 87 (2004) (stating that “we discover that culture arises from a complex, highly nonlinear dynamic. It is created by a social network involving multiple feedback loops through which values, beliefs, and rules of conduct are continually communicated, modified, and sustained.”).


in the late 1970s and early 1980s, and a decrease in crime rate. There is no question that abortions increased after the *Wade* decision. There is also no question that, in the states that early legalized abortion, violent crime decreased in the late 1980s and early 1990s. Thus, there is a correlation, but reasonable people could differ as to whether there was a causal connection. Moreover, even if you accept a causal connection, most people, including myself, would not advocate abortion as a means of reducing crime. There are other, more socially acceptable and effective, ways of reducing crime than encouraging low income and minority women to have abortions.

Nevertheless, the possibility of a causative, and not just correlative, relationship should not be denied simply because the policy implications may be undesirable.

With respect to judicial decisions, we like to see them as solving problems, not creating them. For many, the *Wade* decision solved a problem, for example, unsafe back alley abortions, while for many others the decision created a problem, which is a lack of respect for life and the encouragement of abortion. People who disagree with the *Wade* decision believe that it created a “tone” that has affected morality in America.

One need only review the recent furor surrounding the appointment of Justices Roberts and Alito to conclude that the Christian right believes that the Supreme Court, as previously constituted, had been complicit in furthering the increase in abortion. However, it can hardly be said that the Supreme Court “caused” any particular abortion. On the other side, “liberals” feared the potential complicity of Roberts and Alito in joining with the other conservative justices to overrule *Roe v. Wade*.

Why would we expect the same phenomenon not to exist in decisions affecting business? Why wouldn’t we expect legal decisions to influence the attitudes and actions of businessmen? Before addressing the impact of the Supreme Court decisions and Congressional actions in the mid-1990s, let us first go back to the late 1970s and early 1980s where the conservative trend in judicial decisions replaced the prior liberal pattern in the federal courts, and

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31. For example, no one would question the characterization of the Warren Court as having a liberal bent. President Nixon was clear in his policy to appoint conservative members to the Supreme Court and the Burger Court, in the mid-1970s, announced a trilogy of decisions in the securities area which reversed the expansionist decisions of the Warren Court. *Compare* Super. of Ins. of the State of New York v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (broad construction of “in connection with”) and Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (broad construction of reliance) with *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (only an actual purchaser or seller of securities has standing to sue under rule 10b-5), *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (the requisite culpability required for a defendant under rule 10b-5 is intent and not mere negligence), and *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (deception, and not mere corporate mismanagement, is necessary for fraud under rule 10b-5).

While this trilogy of decisions in the mid-1970s met with some criticism, the decisions, other than *Blue Chips*, reflected a sound judicial approach to legislative interpretation. *Ernst & Ernst* recognized that a rule cannot be broader than the statute pursuant to which it is promulgated and that, if negligence

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state courts, particularly Delaware, exhibited a strong, pro-management bias.

B. State Law Developments in This Period

1. Special Litigation Committees

While Delaware has contributed most to insulating management decisions from judicial scrutiny, it was the New York Court of Appeals, in *Auerbach v. Bennett*, that opened the floodgates that led to director supineness and, ultimately, the debacle of corruption that led to Sarbanes-Oxley.

*Auerbach* dealt with the business judgment rule, a concept with which all attorneys and corporate executives are familiar. Essentially, the business judgment rule is a presumption that directors of a corporation make business decisions on an informed basis, in good faith, and with the honest belief that the course taken was in the best interest of the corporation. The American Law Institute offered the following rationale for the business judgment rule:

The business judgment rule provides special protection to informed business decisions as distinguished, for example, from continued inattention to directorial obligations. The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. Shareholders, with expectations of greater profit, accept the risk that an informed
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business decision—honestly undertaken and rationally believed to be in the best interests of the corporation—may not be vindicated by subsequent success. The special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private-sector business decision-making. 34

In this context, one cannot quarrel with the existence of the rule and the policy behind it. The business of business is taking risks; according to valuation theory, shareholders receive a higher return for taking greater risk. 35 If a decision does not pan out, officers and directors should not be guarantors for the fortunes of shareholders. The risk of bad decisions and unanticipated events can be hedged by investors through a diversified portfolio. But investors should not bear the risk of malfeasance by corporate management.

Auerbach supposedly dealt with such alleged malfeasance. Executives of the company had paid bribes and kickbacks to foreigners totaling more than $11 million. 36 The company initiated an internal investigation and reported the results to its shareholders. 37 Auerbach then filed a derivative suit against the directors and auditors. Since there was no personal benefit that had been appropriated by the executives, the case was a duty of care suit, as opposed to a duty of loyalty one. The Board appointed a special litigation committee composed of board members who joined the board after the challenged transaction and the committee moved to dismiss the action.

The court focused its attention on the “second tier” decision of the special litigation committee, rather than upon the alleged “first tier” wrongdoing. In so doing, the court held that the board of directors has primary responsibility for initiating corporate litigation and upheld the dismissal on the basis that the committee of the board had exercised its business judgment in determining that the litigation should not proceed.

In passing on the motion to dismiss, the inquiry of the court was limited to three issues: was the committee disinterested, was an appropriate investigation done, and did the committee act in good faith. Thus the focus was upon procedures. With respect to the substantive decision, the court stated:

Inquiry into such matters would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee. Its substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach. 38

34. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 135 (1994).
35. See LARRY J. KASPER, BUSINESS VALUATIONS: ADVANCED TOPICS 120 (1997) (“In general, in a rational market, CAPM [Capital Asset Pricing Model] predicts that investors will receive higher expected returns only if they are willing to bear risk. CAPM suggests the relationship between reward (risk premium) and risk borne.”).
36. 393 N.E.2d at 997.
37. Id. at 996-97.
38. Id. at 1002. A subsequent case in Delaware, Zapata v. Maldonado, 430 A.2d 779 (Del. 1980),
What the court, in effect, did was to create a safe harbor for corporate wrongdoing. It has been said that bad facts make bad law and, in this case, bad public policy. The suit in Auerbach could be characterized by some as a strike suit. There was no personal gain to the corporate executives flowing from the decision they made and it was not unusual at this time for companies to pay bribes to foreign officials as the price for getting business. Viewed strictly from an economic perspective, it made sense to pay a five dollar bribe to get a $100 contract. During this period, there was a split among highly reputable people as to whether the Foreign Corrupt Practices Act of 1977, which, among other matters, prohibited bribery, was sound public policy.39

There are two fundamental, and related, fallacies undergirding the Auerbach decision. The first is to view this decision as being within the business judgment genre. It is one thing to indulge in a positive presumption when a businessman makes a decision as to how many widgets to produce or whether to sue a competitor; it is quite another thing to indulge the same type of presumption when a businessman is judging the arguably wrongful conduct of a fellow businessman with whom he has a close working relationship.

Secondly, while the appropriate decision was probably reached by the Board committee in Auerbach, the breath of the court’s opinion has undoubtedly insulated substantial wrongdoing from judicial review. Even adopted the three-pronged test set forth in Auerbach but added an additional element, namely, that the court could review the decision of the committee using the court’s “business judgment.” The notion of a court having the business judgment to be able to review a decision of a board committee has been mocked by many commentators. See Julian Velasco, Structural Bias and the Need for Substantive Review, 82 WASH. U. L.Q. 821, 850 (2004). Velasco noted that:

This second step is an odd one. According to the Delaware Supreme Court, "the second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit . . . ." This is a perfectly reasonable concern. However, the method adopted by the court is theoretically and doctrinally suspect. Recognition of courts' incompetence to make business decisions is one of the foundations of the business judgment rule. Yet the Delaware Supreme Court - perhaps the ultimate judicial oracle on corporate law matters - decided to give lower courts the discretion to apply their own business judgment over and above that of the directors who already would have been determined to be independent.

Id. See also Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U. L. REV. 913, 941 (1982). Fischel warned:

It is difficult to see how this second step of the Zapata test can be reconciled with the goal of maximizing shareholders' welfare. Indeed, the whole notion of a court exercising business judgment flies in the face of one of the most basic premises of corporate law—that courts are unable to make business decisions. This decision has been widely criticized, and many courts have refused to follow its lead.

Id.


Arguments against criminalizing the payment of bribes abroad include contentions that (a) the FCPA imposes a competitive disadvantage upon U.S. firms operating abroad; (b) market mechanisms can provide more effective, less costly, less severely punitive means of inhibiting international corruption than the FCPA; and (c) condemnation of bribery is a cultural construct, so that efforts to control bribery in other nations may constitute moral imperialism.

Id.
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though the litigation in *Auerbach* may have been unfounded, history has shown that special litigation committees invariably move to dismiss the lawsuit. It is a statistical improbability that all lawsuits are unfounded. We need only review the events surrounding the enactment of Sarbanes-Oxley to realize that there is a substantial amount of corporate malfeasance. I believe it is safe to conclude, based upon cases such as *Enron* and *Hollinger*, and many others of the recent past, that corporate management has no particular expertise in evaluating the alleged wrongful conduct of its fellow board members.

On the other hand, while courts have no particular expertise in business matters, such as how many widgets to produce, courts have for centuries monitored conflicts of interest and other wrongdoing by fiduciaries.

2. **Overriding Demand "Futile" With Demand Required**

Subsequent to *Auerbach*, the Delaware Supreme Court, in *Zapata*, modified the *Auerbach* approach by holding that the trial court could exercise

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40. See James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 963 (1982) (“Whatever one's view about the impact of the factors that feed a committee's structural bias, the committee's record is itself disquieting; although there have been more than a score of special litigation committee cases to date, in all but one the committee concluded that the suit in question was not in the corporation's best interest.”). As the court in Alford v. Shaw, 324 S.E.2d 878, 886 (N.C. Ct. App. 1985), stated:

Moreover, our review of the cases yields one telling statistic: not one committee, in all these instances, has decided to proceed with suit. Some have recognized the existence of valid claims and settled them, as in the present case, but these have generally constituted a minor portion of the overall claim, as also happened here. This strongly suggests that the problem of structural bias is indeed real.

Id. More recent studies have come to the same conclusion. See Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1358-59 (1993):

Regardless of the theory's validity, plaintiffs' allegations in practice virtually never impress special litigation committees; in only a handful of cases has a committee recommended anything other than discontinuance of the action. In doing so, the committees usually recount the same generalized and conclusory justifications for dismissal. Thus, regardless of the extensive commentary and court opinions championing the importance of permitting corporate management the opportunity to evaluate shareholder allegations fully and fairly, the statistics seemingly belie that lofty sentiment. Given the opportunity to consider plaintiff's grievances, management will, most typically, flatly reject the plaintiff's concerns.

Id. See also ROGER J. MAGNUSON, SHAREHOLDER LITIGATION § 9:23 (Suppl. 2007) (“No cases have come to the author's attention suggesting that such a special litigation committee, no matter how apparently neutral, has ever recommended anything but dismissal of the action.”).  

41. See infra text accompanying notes 283-299.  

42. See, e.g., *Wall Street Journal Wins 2 Pulitzer Prizes; History of Civil Rights Reporting Also Wins*, N.Y. TIMES, April 17, 2007:

The Wall Street Journal won the Pulitzer Prize for public service yesterday for uncovering the unethical practices of business executives who had rewarded themselves millions of dollars by backdating stock options. The articles, by Charles Forelle, James Bandler, Mark Maremont and Steve Stecklow, have led to the federal investigation of more than 130 companies, and at least 70 top executives have lost their jobs.

Id. For a listing of more than 20 of the more spectacular examples of corporate corruption during this period, see HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE App'x. D (2007).  

43. 430 A.2d 779 (Del. 1981).
its own business judgment to review the decision of the special litigation committee. This decision created an outcry in the corporate world, and the Delaware Supreme Court, not wanting Delaware to lose its preeminent position in the corporate world, recognized the error of its liberal approach in Zapata. Accordingly, a Delaware court gave corporate management an even better present than did the Auerbach decision in New York. In its subsequent decision in Aronson v. Lewis, the Delaware Supreme Court took a very restrictive view of when demand on the board of directors is excused or "futile."

When a special litigation committee moves to dismiss litigation, there is already a matter pending before the court. The ideal protection for corporate management is to be able to avoid being brought into court in the first place.

In order to bring a derivative suit, as a general rule a plaintiff must first make a demand on the board of directors. On the other hand, demand may be excused if it is clear that the board of directors, for example, by virtue of its own involvement in the wrongdoing, will not act appropriately on behalf of a corporation.

Aronson dealt with a 1981 employment agreement between Meyers Parking System, Inc. and its principal shareholder, Leo Fink, who controlled 47% of Meyers. Prior to 1979, Meyers was a wholly owned subsidiary of Prudential Building Maintenance Corp., of which Fink apparently also owned 47% of the stock. He retired as an employee of Prudential in 1980 and had a 10 year employment contract with Prudential which would pay him about $200,000 per year.

The 1981 employment agreement with Meyers had a five-year term, pursuant to which Fink would receive $150,000 per year, plus a bonus of 5% of

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44. See supra note 38.
46. FED. R. CIV. P. 23.1(b)(3) ("The complaint ... [shall] state with particularity any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and the reasons for not obtaining the action or not making the effort.").
47. See 7C CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE & PROCEDURE, FEDERAL RULES OF CIVIL PROCEDURE §1831 (Suppl. 2007). The authors contend: [T]he general approach is to determine whether requiring plaintiff to make a demand on the board of directors to take action would force plaintiff to undertake a purely ritualistic act. An obvious example of a situation of this type is when the basis of plaintiff's complaint is mismanagement or fraud on the part of a majority of the directors themselves. Rigid adherence to Rule 23.1 in this context would oblige plaintiff to demand that the directors bring suit against themselves, a futile gesture. Thus, a demand may be excused when plaintiff alleges, with supporting facts, that the individual directors are the alleged wrongdoers or are under the control of the real defendants. Notably, it is not sufficient that some directors are alleged wrongdoers, if the board is not controlled by them or could reach an independent decision to pursue the claims despite their presence. The question is whether, given the composition and structure of the board, it would be futile to expect it to respond to the shareholder's concerns.

Id.
48. 473 A.2d at 809.
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pretax profits over $2.4 million. When the contract terminated, Fink would receive $150,000 per year for the first three years, $125,000 for the next three years, and $100,000 thereafter for life. To put the foregoing compensation in perspective, it would be necessary to apply about a factor of about 2.5. In other words, in current dollars, Fink would be receiving about $750,000 a year from the two corporations for an extended period of time. Fink was 75 years old at the time.

A shareholder filed a derivative suit but did not make demand on the board of directors on the basis that it would be futile since Fink, by virtue of his forty seven percent ownership, controlled the board. In addition, all the directors were sued because they approved and acquiesced in what was alleged to be a waste of corporate assets. Plaintiffs further alleged that Fink performed little or no services and, because of his advanced age, could not be expected to perform any substantial services.

Both the trial court and the Delaware Supreme Court took the position that the business judgment rule is applicable to a determination by the board whether to initiate litigation. However, if the directors are on both sides of the decision or receive a personal financial benefit, the business judgment rule is not applicable. The Chancellor opined that demand need not be made if there is a reasonable inference that the business judgment rule would not be applicable, but the Supreme Court rejected that view and held that, for demand to be excused, plaintiff must allege particularized facts creating a reasonable doubt “(1) that the directors are disinterested and independent, and (2) that the challenged transaction was ‘otherwise’ the product of a valid exercise of business judgment.”

While the foregoing two-prong test might appear to be reasonable, the pleading burden to meet it is almost insurmountable. According to the Supreme Court, the “mere threat of personal liability for approving a questioned transaction” is insufficient to challenge either the independence or disinterestedness of directors. The decision reflects a basic lack of understanding of human nature. Would a director, who is charged with failing to exercise due care in approving an allegedly egregious transaction, be likely to let the litigation go forward to determine whether or not the transaction was egregious, if the director could simply bar the litigation by rejecting the demand to file suit?

49. Id. at 812.
50. The CPI index can be found at http://www.bls.gov/cpi/. Adjusting a dollar in 1980 to current prices would require a factor of about 2.5.
51. 473 A.2d at 809.
52. Id. at 812.
53. Id. at 814.
54. Id. at 815.
Moreover, the Supreme Court held the “shorthand shibboleth of ‘dominated and controlled directors’ is insufficient.” In Delaware, stock ownership alone, “at least when it amounts to less than a majority,” is not sufficient proof of domination or control.

As applied to the facts of the *Aronson* case, the foregoing statement is absurd. In order that Fink would not have control, forty-eight percent of the shares would need to be allied against him. It is almost a statistical improbability that ninety-five percent of the shares, in a non-closely held corporation, will show up at a meeting. Even if one-hundred percent of the shareholders attended the meeting, Fink would only need to rally three percent of the remaining fifty-three percent to prevail. If Fink were selling his shares, he would have no trouble convincing an investment banker that his shares carried control.

The Supreme Court also dismissed the possibility that the foregoing level of compensation for a seventy-five year-old man, who was not performing full-time services for the corporation, could be a waste of corporate assets. The court focused upon the “presumption of propriety” that is inherent in the business judgment rule. The court observed that “the complaint as now drafted may not even state a cause of action, given the directors’ broad corporate power to fix the compensation of officers.”

The court had little sympathy for the minority shareholders who owned approximately one half of the stock. If the two corporations had about $1.5 million in spare cash, it could have distributed such funds to the shareholders as a dividend, in which case Fink would receive about half and the other shareholders the other half. But Fink wanted it all for himself. This, the Delaware supreme court permitted him to do with impunity.

3. *Smith v. Van Gorkom, and Its Aftermath*

In order to complete the picture of how difficult it is to challenge the actions of management, we need to look at *Smith v. Van Gorkom,* and the legislative response that it triggered.

*Van Gorkom* dealt with the sale of Trans-Union after the Board of Directors, in mid-September 1980, approved the sale of the company to Pritzker, based upon a 20 minute oral presentation by Van Gorkom, the CEO. Van Gorkom had met with Pritzker a few days earlier and had suggested the

55. *Id.* at 816.
56. *Id.* at 815.
57. *Id.* at 816.
58. *Id.* at 817.
59. 488 A.2d. 858 (Del. 1985).
60. *Id.* at 868.
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price of $55 per share, a fact he did not disclose to the board.\(^{61}\) The Delaware Supreme Court reviewed the investigation, or rather the lack thereof, of the transaction by the board of directors and determined that the board members were personally liable.

The case was criticized by commentators on both sides of the aisle. First of all, the court held that the standard by which the duty of care is measured is not ordinary negligence, but rather gross negligence.\(^ {62}\) This offended the shareholder advocates. Under tort law, liability flows from the failure to exercise "ordinary" care. But, in the corporate context, the court clarified that liability for "carelessness" is actionable only if it involves gross negligence. Moreover, to be protected by the business judgment rule, the judgment need not be reasonable but only rational.\(^ {63}\)

The net effect of this determination is that, in general, the duty of care becomes not a substantive brake on the quality of a business decision, but rather a procedural hurdle that must be surmounted. But the procedural hurdle—being informed—can be easily met. Just hire an investment banker, who will tell you what you want to hear anyway, \(^{64}\) or produce reams of paper in lieu of a mere oral presentation. The meeting can even be devoted to socializing\(^ {65}\) because corporate counsel generally knows how to sanitize

\(^{61}\) Id.

\(^{62}\) Id. at 873.

\(^{63}\) See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01 (1994):

If a director or officer acts in good faith and in accordance with § 4.01(c)(1) and (2) with respect to a business judgment, the standard in § 4.01(c)(3) will provide insulation from liability unless the director or officer does not rationally believe that the business judgment is in the best interests of the corporation. This standard is intended to provide directors and officers with a "wide ambit of discretion." It is recognized that the word "rational," which is widely used by courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred. Stated another way, the judgment of a director or officer will pass muster under § 4.01(c)(3) if the director or officer believes it to be in the best interests of the corporation and that belief is rational. Either in the ALI principles of corporate governance dealing with the duty of care (possibly section 4.01) or the model business Corporation act (about section 8.30 et seq.) -- and probably in both -- it should state that the judgment need only be rational not reasonable.

\(^{64}\) See Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del., 1988). Macmillan's financial advisors first valued the company at $64.15 per share, but recommended rejection of the $64 Bass offer because it was "inadequate." Shortly thereafter, they opined that the Bass $73 cash offer was inadequate, and that the "pre-tax break up" value of Macmillan was between $72 and $80 per share. Another advisor valued the company at between $66 and $80 per share. However, they later opined that Maxwell's $80 all cash offer was inadequate. It appears that the valuations were driven, not by the intrinsic worth of the company, but by a willingness, at management's behest, to furnish an opinion of value higher than any unwanted suitor had bid. Id. at 1270, 1271-73.

\(^{65}\) Governor Thompson, in the Hollinger situation, as a member of the audit committee, investigated the reasonableness of the millions of dollars Conrad Black charged the company in
minutes.

However, the *Van Gorkom* court additionally determined that, in fact, the board had been grossly negligent in not being adequately informed before approving the sale. Even though the logic of the decision is unassailable—to be protected by the business judgment rule, a director must be making a business judgment, and you cannot exercise judgment without being informed—this offended the management advocates and led to "corrective" legislation.

The furor over the *Van Gorkom* decision led to the enactment of what is now section 102(b)(7) of the Delaware code which, in effect, authorizes a charter provision by which directors would be exculpated from all liability, except that arising from breach of the duty of loyalty, failure to act in good faith, or intentional conduct or knowing violation of the law. In other words,

management fees while having a cup of coffee. See *Report of Investigation by the Special Committee of the Board of Directors of Hollinger International Inc.*, August 30, 2004, at 134.

66. *Id.* at 874. The directors (1) did not adequately inform themselves as to *Van Gorkom*'s role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency. Had the board done an adequate investigation, the court suggested it would have learned the following information:

Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. On the record before us: The Board rested on Romans' elicited response that the $55 figure was within a "fair price range" within the context of a leveraged buy-out. No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. No director asked to see the study; and no director asked Romans whether Trans Union's finance department could do a fairness study within the remaining 36-hour period available under the Pritzker offer.

Had the Board, or any member, made an inquiry of Romans, he presumably would have responded as he testified: that his calculations were rough and preliminary; and, that the study was not designed to determine the fair value of the Company, but rather to assess the feasibility of a leveraged buy-out financed by the Company's projected cash flow, making certain assumptions as to the purchaser's borrowing needs. Romans would have presumably also informed the Board of his view, and the widespread view of Senior Management, that the timing of the offer was wrong and the offer inadequate.

The record also establishes that the Board accepted without scrutiny *Van Gorkom*'s representation as to the fairness of the $55 price per share for sale of the Company—a subject that the Board had never previously considered. The Board thereby failed to discover that *Van Gorkom* had suggested the $55 price to Pritzker and, most crucially, that Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out. No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

*Id.* at 877.

67. 8 *Del. Code Ann.* §102(b)(7) (West 2005). This section provides that a corporation may include in its charter:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper
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duty of care violations, even those amounting to gross negligence, would not be
actionable for any company which had incorporated the appropriate charter
provision.

Accordingly, today in Delaware, a director has very little likelihood of
liability under state law when the director fails to exercise due diligence. To
start with, to be liable any director must be grossly negligent. But even if he or
she were grossly negligent, there will be no liability if the corporation had the
appropriate charter amendment exculpating directors from liability. It would be
a rare publicly held company that would not have such a charter amendment. 68
As the Delaware Supreme Court stated with respect to the effect of such a
provision:

The statutory enactment of Section 102(b)(7) was a logical corollary to the common
law principles of the business judgment rule. Since its enactment, Delaware courts
have consistently held that the adoption of a charter provision, in accordance with
Section 102(b)(7), bars the recovery of monetary damages from directors for a
successful shareholder claim that is based exclusively upon establishing a violation
of the duty of care. Accordingly, in Malpiede, this Court held that if a shareholder
complaint unambiguously asserts only a due care claim, the complaint is dismissible
once the corporation's Section 102(b)(7) provision is properly invoked. 69

Thus, if a plaintiff files a complaint charging that the directors were grossly
negligent, the defendant need only bring the charter amendment to the attention
of the court in a motion to dismiss, and the motion will be granted. 70

As developed earlier, plaintiff will not even be able to get into court as long
as all the directors are not guilty of wrongdoing, because plaintiff must first
make demand on the board of directors to bring suit. History tells us that it is
very unlikely that the board will initiate suit against a fellow director. Even if

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68. Press Release, NYSE Board Releases Report of Corporate Accountability and Listing Standards
policymakers not to reduce the protections available to directors through state-law exculpation
provisions). The release noted that if a substantial number of New York Stock Exchange listed
companies do not have such provisions, the Exchange would not be taking this position. Id.

A.2d 1075, 1093 (Del. 2001)).

70. This situation has led to the Delaware Supreme Court to recognize good faith as a fiduciary
duty separate and distinct from the duty of care and the duty of loyalty. As the court stated in Brehm v.
Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27, 66 (Del. 2006):

That leaves the third category of fiduciary conduct, which falls in between the first two
categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from
gross negligence. This third category is what the Chancellor's definition of bad faith-
intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to
capture. The question is whether such misconduct is properly treated as a non-exculpable,
non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be,
for at least two reasons.

Id.; see also In re Emerging Communications Inc. Shareholders Litigation, No. 16415, 2004 WL
1305745 (Del. Ch. 2004) (finding directors who engaged in conduct that did not implicate the self-
dealing typical in a duty of loyalty case, but yet were not protected by the exculpation statute since their
conduct was deemed to violate the fiduciary duty of good faith).
plaintiff can surmount the demand required hurdle and get into court, the board will appoint new directors, constitute them as a special litigation committee, and the special litigation committee will dismiss the litigation.

While directors and their political allies constantly cry about the specter of litigation, the foregoing gestalt is not one that should strike fear in the hearts of a reasonable director. The likelihood of liability is extremely remote. Arguably, these legal developments, coupled with the publicity and discussion surrounding them, led to the smugness and supineness that facilitated subsequent corporate wrongdoing.

C. A Quick Look at the Supreme Court’s Insider Trading Trilogy

Insider trading is only tangentially related to the problems of fraudulent disclosure in the securities markets that gave rise to Sarbanes-Oxley. Nevertheless, the Supreme Court trilogy that the court handed down in the 1980s is of interest in the context of the present article because these decisions have been relied upon by the Supreme Court in Stoneridge, and also because they illustrate the impact of untoward judicial decisions upon the legal and


The litigation explosion has also had a great impact upon the way day-to-day corporate activities are conducted. In order to protect themselves against claims of all varieties, corporations have been forced to adopt policies of every kind and nature and to reduce those policies to manuals which are regularly distributed to corporate personnel and updated it as the laws are modified by the courts and the legislatures. As a result, American industry has become much more governed by the policy and procedural manuals than ever before and now to tend to function in a manner not dissimilar to the various branches of the armed forces.

Id. See also Robert H. Roshe, New York’s Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D & O Insurance, 54 BROOK. L. REV. 1305 (1989) (“An alarming amount of litigation has been aimed at corporate directors and officers throughout the United States. Corporate executives have become increasingly concerned with how to best immunize themselves from personal liability exposure, often at the expense of implementing sound business policies that benefit the corporation.”); Barbara Franklin, Director Relief Bill Would Let Companies Shield Board from Liability, N.Y.L.J., Jul. 16, 1987, at 5, col. 2 (“More and more of [directors’] decisions are being made not so much [for] the long-term interests of the company, but with an attempt to avoid any type of litigation.”).

72. See Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. S.E.C., 463 U.S. 646 (1983); Carpenter v. U.S., 484 U.S. 19 (1987). The first trilogy, in the mid-1970s, was referenced supra in note 32. Carpenter is of limited interest from the standpoint of Securities law since the Supreme Court split 4-4 on the issue of whether R. Foster Winans, and his cronies, could be convicted under rule 10b-5 pursuant to the misappropriation theory. Carpenter, 484 U.S. at 24. Winans wrote the "Heard on the Street" corporate gossip column in the Wall Street Journal. Id. at 22. Winans and his cronies bracketed trading around his columns. Id. If the column was positive about a company, they went long before the column and sold after the resulting price rise. Id. Conversely, if the column was negative, they would sell short before the column and buy back at a lower price later. Id. at 23. The Second Circuit upheld the conviction on both rule 10b-5 and the mail and wire fraud statutes. Id. at 24. The Supreme Court affirmed the convictions under the mail and wire fraud statutes and left the conviction under rule 10b-5 stand when it split evenly. Id. The Supreme Court, over two decades later, recognized the misappropriation theory in a situation similar to Chiarella but involving an attorney in a law firm representing the bidder. See United States v. O’Hagan, 521 U.S. 642 (1997).

73. See infra text accompanying note 324.
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business culture, which in turn led to the explosion of insider trading scandals in the wake of these decisions. The rampant increase in the scope and size of insider trading after these decisions has been well documented. Once again, correlation does not necessarily equate to causation but, if you were unscrupulous, how would you react to these first two decisions?

1 Chiarella and the Failure to Understand the Significance of Cady, Roberts

The first case in the 1980s trilogy was Chiarella v. United States. Chiarella was a markup man for a printer that had been engaged by a bidder to prepare offering documents in connection with an offer to purchase shares of the target company from its shareholders. While the names of the parties were concealed until the night of the final printing, Chiarella was able to discern who the parties were and purchased stock of the target company prior to the offer by the bidder. He then benefited from a rise in price once the bid was announced. Chiarella was indicted and convicted of violating rule 10b-5 because he “used material, nonpublic information at a time when he knew other people trading in the securities market did not have access to the same information.”

The majority reversed on the basis that, when silence is involved, there cannot be fraudulent conduct without a duty to speak. According to the majority, the jury instructions in effect posited a duty “to the market as a whole.” The majority never clearly explained why someone in the securities business, who appropriates information to which he is not entitled, should not have a duty “to the market as a whole.” The Court relied upon the Cady, Roberts & Co. decision by the SEC to support its opinion. But, Cady, Roberts actually undercuts the majority opinion. In Cady, Roberts, a director learned that his company was going to cut the dividend and, while unaware that the information had not been made public, informed his colleague at a brokerage firm of the dividend cut. The colleague then sold existing holdings and also sold short.

This was a “bad news” situation. In a “good news” situation, for example, if the dividend had been increased, the “insider” would be a buyer. And the only person from whom the insider could buy would be an existing shareholder. Traditionally, corporate insiders owed a fiduciary duty to their shareholders.

74. See H.R. REP. No. 98-355 (hereinafter "1984 ITSA report"), reprinted in 1984 U.S.C.C.A.N. 2274, 2278 ("The current commission has made the prosecution of insider trading a priority, and has brought more such cases during the past four years than in all previous years combined."). See also JAMES B. STEWART, DEN OF THIEVES (1992).

75. Chiarella, 445 U.S. at 231.

76. Id.

But in a "bad news" situation, the insider would be selling and, very conceivably, could be selling to a non-shareholder to whom, under the common law, the insider would have no fiduciary duty.

This possibility was explicitly recognized in the Cady, Roberts opinion, where the commission stated:

Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.78

The court recognized that Cady, Roberts "involved the sale of stock to persons who previously may not have been shareholders in the Corporation."79 The court even noted the analysis of Judge Learned Hand: "it would be a sorry distinction to allow him [the insider] to use the advantage of his position to induce a buyer into the position of the beneficiary although he was forbidden to do so once the buyer had become one."80

Nevertheless, the court blithely ignored the reasoning of decisions it supposedly relied upon, and fell back upon the necessity of breach of a common law fiduciary duty as a prerequisite to liability under rule 10b-5. The court failed to realize that the securities laws had been enacted because the common law was inadequate. Even worse, the court stated that the SEC in Cady, Roberts had recognized that a relationship of trust and confidence existed between insiders and their shareholders, even though the SEC explicitly rejected the need for a common law duty to uphold liability, and further recognized that the insider might well be dealing with non-shareholders.

The majority explicitly rejected the notion of "equal access to information"81 and the notion of "parity-of-information."82 The court’s rationale in part relied upon the provision of the Williams Act which permits a perspective bidder to purchase a limited amount of stock in advance of the offer. But this analogy fails because the bidder is using its own information, not that which it has improperly appropriated.

Chief Justice Burger, whose conservatism led him to chastise what he considered illegal behavior, coined a classic analysis of the defendant’s conduct. The Justice stated that "Chiarella, working literally in the shadows of the warning signs in the print shop misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."83 While the majority rejected Justice Burger’s analysis on the basis that it had not

78. Id. at 914.
79. 445 U.S. at 227.
80. Id. (citing Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951)).
81. 445 U.S. at 232.
82. Id. at 233.
83. Id. at 245.
been presented to the jury, his opinion later became the foundation of the misappropriation theory, upon which clones of Chiarella were later convicted. \(^84\)

2. **Dirks: Two Views of Reality**

If Chiarella was bad, Dirks was worse. Dirks was a securities analyst for Delafiel Childs, a broker-dealer, who was contacted by Secrist, a former officer of Equity Funding Corporation of America. Secrist, on March 7, 1973, informed Dirks that Equity Funding had been creating fictitious life insurance policies to maintain an impressive growth rate and boost the value of the stock. They were even killing off people but, fortunately, they only killed some of the fictitious people they had created. Secrist estimated that, by 1972, Equity Funding had 40,000 fictitious policies representing at least one third of its outstanding life insurance business. \(^85\)

Dirks investigated the matter and discussed the information he obtained with a number of clients and investors, some of whom liquidated holdings of more than $16 million. Dirks also contacted the Wall Street Journal on March 12, but the Journal did not run a story until April 2. During the interim, the price of equity funding fell from $26 to $15 per share, which led the New York Stock Exchange to halt trading on March 27. On March 27, Dirks also informed the SEC.

The SEC followed with an investigation of Dirks, determined that he had aided and abetted violations of the securities laws by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock, and censured him. Dirks appealed.

According to the Supreme Court, Dirks was a hero, \(^86\) rather than a violator of the securities laws. The majority treated Dirks as a tippee and did recognize that there is a “need for a ban on some tippee trading.” \(^87\) But, according to the

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\(^{84}\) See S.E.C. v. Mat&ria, 745 F.2d 197 (2d Cir. 1984). The facts in Mat&ria were nearly the same as those in Chiarella, but a contrary result was reached on the misappropriation theory. The court first held that the theft of non-public information was within the “fraud or deceit” language of Rule 10b-5 and that the fraud was perpetrated on “any person” within the language of the rule, namely, the employers. Id. at 201. According to Mat&ria, it is not necessary under Rule 10b-5 that the fraud be perpetrated upon a purchaser or seller to whom the defendant has a duty to disclose. Id. The court pointed out that the information the defendant stole had “no value whatsoever except 'in connection with' his subsequent purchase of securities. The fraud perpetrated on his employer was part and parcel of a larger design, the sole purpose of which was to reap instant no-risk profits in the stock market.” Id. at 203. See also United States v. O’Hagan, 521 U.S. 642 (1997) (discussed infra at note 93).

\(^{85}\) In the Matter of Raymond L. Dirks, 21 S.E.C. Docket 1401 (1981).

\(^{86}\) 463 U.S. at 652, n.8 (“It is clear that Dirks played an important role in bringing [Equity Funding’s] massive fraud to light, and it is also true that he reported the fraud allegation to [Equity Funding’s] auditors and sought to have the information published in the Wall Street Journal.” (citing 21 S.E.C. Docket at 1412) . . . “Largely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding.” (citing 681 F.2d at 829)).

\(^{87}\) 463 U.S. at 659 (emphasis added).
majority, a tippee sins only if his tipper sins:

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his Cady, Roberts duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

The majority then determined that “[a]ll disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.” The majority stated that “we do not believe that the mere receipt of information from an insider creates such a special [fiduciary] relationship between the tippee and the corporation’s shareholders.” It articulated the following test for determining whether there has been a violation of the insider trading laws:

Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

The beauty of this test, according to the majority, is that it focuses upon objective facts and circumstances: “whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.”

The SEC argued that “it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information” The majority countered: “We think the SEC is unduly concerned.” We will shortly look at the Barry Switzer case to see who had the better insight: the SEC or the majority.

Applying the law that it had just established to the facts of the case, the majority determined that there was no violation. Dirks himself was a stranger to Equity Funding and had no pre-existing duty to its shareholders. Moreover,
Secrist had not violated his fiduciary duty because, according to the majority, he derived no monetary or personal benefit from revealing the information to Dirks. According to the majority, Secrist only wanted to expose a fraud and, since he had not sinned, neither did Dirks.

The dissent was watching a different movie. Secrist informed Dirks so that Dirks would inform his clients, who would then dump shares, triggering market drop which would lead to an investigation. The majority praised Dirks’s efforts to expose the fraud; however, Dirks first informed his clients so that they could get out ahead of the market drop. If Dirks wanted to expose the fraud, his path should have been first to the SEC, state regulators, or the US attorney. The path that Dirks instead chose led to his broker-dealer receiving a $25,000 fee from one of the institutions that Dirks tipped.

The dissent also cast doubt on the efficacy of Dirks’ efforts in uncovering the fraud. Secrist had also told his story to the New York insurance regulators the same day he informed Dirks; they passed the information on to the California regulators, who then informed the Illinois officials. Illinois investigators conducted a surprise audit of Equity Funding’s Illinois subsidiary and, on March 30, seized control of it.

According to the dissent, Secrist could not legally have personally traded on his inside information. Nor should he be able to use Dirks as his proxy to do the same thing. The fact that Secrist did not profit did not reduce the injury to Equity Funding’s shareholders. In the view of the dissent, holding that a tippee sins only where the tipper has an improper purpose in disseminating the information heretofore has had no basis in law and was likely to work mischief.

3. The Tone and Effect of These and Related Federal Decisions

Let us now look at how an unscrupulous person would view the teaching of the Supreme Court and other federal courts with respect to insider trading. First of all, a securities professional owes no duty to the market as a whole. There is no right to equal access to information or any notion of parity-of-information. “[N]ot every instance of financial unfairness constitutes fraudulent activity under §10(b).”97 “All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.”98 “[T]he mere receipt of information from an insider [does not create] a special relationship between

96. 463 U.S. at 666-67: “It is clear that neither Secrist nor the other Equity Funding employees violated their Cady, Roberts duty to the corporation’s shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding’s secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud.”
98. Dirks, 463 U.S. at 661-62.
the tippee and the corporation's shareholders."

As a result of lower federal court decisions, someone trading on inside information need not worry about civil liability, either from the use of company specific inside information under the classical theory of insider trading, or from the use of market information under the misappropriation theory. Even if a private cause of action could proceed, damages could be limited to the insider's gain, with the result that a plaintiff might only recover a pro-rata portion of her "loss." In this situation, the trader would have no incentive to refrain from trading since, if sued, he would only lose his ill-gotten gain.

In this state of the law, an explosion of insider trading would not be surprising. And that is exactly what happened. Moreover, the SEC's concern that, under the *Dirks* approach that traders could "fabricate some ostensibly legitimate business justification for transmitting the information" came to

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99. Id. at 656 n.15.

100. In Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), the Sixth Circuit held that sellers of stock could not sue an insider who had purchased shares in open market, knowing that the company was going to be acquired at a premium. Id. at 313, 323. According to the court, the purchase by the insider did not "cause" the sale by the shareholders, whose trading was separated by weeks and months from that of the defendant. Id. at 315. The court was concerned about the possibility of draconian liability: defendants profit from insider trading was only $13,000, but he was held liable in the lower court for $361,186.75. Id. at 308-09. An earlier, "liberal" decision, Schapiro v. Merrill Lynch Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), upheld liability in favor of buyers of Douglas Aircraft stock against Merrill Lynch, which had learned that Douglas' earnings were deteriorating while acting as a lead underwriter for Douglas, and the institutions which Douglas "tipped." Id. at 231. The institutions dumped 165,000 shares, almost half the trading volume during the relevant period. Id. at 232. The court determined that causation existed under the *Affiliated Ute* approach. Id. at 235-36. It should be noted that, in this case, liability to the market as a whole would not even result in treble damages. Treble damages are now within the discretion of the SEC to impose. See infra text at note 113.

101. The Supreme Court in *O'Hagan*, 521 U.S. at 651-52, described the classical theory as follows: Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the "necessity of preventing a corporate insider from ... tak[ing] unfair advantage of ... uninformed ... stockholders."" The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.

(citations omitted).

102. See 1984 ITSA report, reprinted in 1984 U.S.C.C.A.N. 2274, 2277 (1983) ("Thus, if a purchaser of a target company's securities in a tender offer has information received from the investment banker of the bidder, this 'market' information may be considered inside information for purposes of the anti-fraud provisions.").

103. Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d. Cir. 1983) (holding that a selling shareholder of a target company could not sue an investment adviser for the bidder or persons tipped by the investment adviser because they had no duty to the targets selling shareholders under the logic of Chiarella).

104. Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

105. See STEWART, supra note 74.

106. See supra text accompanying note 93-94.
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pass in SEC v. Switzer.\textsuperscript{107}

Switzer was the head football coach at Oklahoma and had a radio program sponsored by Texas International Company ("TIC"). Platt was the CEO and Chairman of the Board of TIC, which also owned over 50% of Phoenix Resources Company. On June 5, 1981, Platt had decided to recommend the disposition of Phoenix or its assets, which were undervalued.

On June 6, Switzer and Platt met at a track meet at which their sons were competing. They visited with each other several times and discussed "their sons’ participation in the meet, the oil and gas business, economy, football and the respective personal investments."\textsuperscript{108} However, according to Switzer and Platt, while they discussed the oil and gas business and the economy, they did not discuss the pending sale of Phoenix. Nevertheless, later that weekend, Switzer met with Mrs. Kennedy, Hodges and Hoover, who then bought sufficient shares of Phoenix to be major buyers in the market the following week. Kennedy was a close personal friend of Switzer and the other two were only acquaintances.

On the following Monday and Tuesday, Kennedy purchased 6,000 shares of Phoenix, Hoover purchased 16,500 shares, and Hodges purchased 13,000 shares.\textsuperscript{109} The total investments approximated $260,000, $725,000, and $575,000, respectively. Hodges and Hoover agreed to put up over $1.25 million but agreed to split the profits with Switzer and a colleague, neither of whom made any investment. On Wednesday, the plans for Phoenix were publicly announced, the stock price rose dramatically, and the three parties sold their stock, realizing profits of $118,587, $267,728, and $205,055, respectively. Switzer and his friend received $110,491 from Hoover and $85,310 from Hodges, without ever having any money at risk.

The aforementioned trading looked suspicious and the SEC brought an action. According to Switzer, during the course of the track meet, he had laid down on the bleachers behind where Platt and his wife were having a conversation about Platt's plans for the week and the planned disposition of Phoenix. According to Mr. Platt, when he appears distracted his wife inquires as to what is on his mind and he will talk to her about his problems, even though Mrs. Platt "does not have an understanding of nor interest in business matters."\textsuperscript{110} According to the three buyers, Switzer told them he overheard some information that indicated that the stock of Phoenix would go up, but did not identify his source.

How likely is it that friends and acquaintances would invest, in today’s
dollars, about $3.5 million, based upon an overheard conversation with an unidentified person, and that they would provide the informant with $200,000 of their profit? The trial judge appeared dubious, but believed he had to credit the testimony of the live witnesses over the circumstantial evidence produced by the SEC. Is Switzer's story believable or is it a concoction? Have you ever lay down on the bleachers at an outdoor sporting event with hundreds of people present and tried to listen in on a confidential conversation one or two rows away?

4. A “Liberal” Response

As previously indicated, there was an explosion of insider trading cases after the Chiarella and Dirks decisions. In response, as a result of action by the Democratically controlled House of Representatives, two major pieces of reform legislation were enacted, the 1984 Insider Trading Sanctions Act and the 1988 Insider Trading Securities Fraud Enforcement Act. The 1984 House Report took a dim view of the Dirks decision, stating that “if the Dirks decision is properly and narrowly construed by the courts, the Commission’s insider trading program will not be adversely affected.” The report referred to the Cady, Roberts case as a “seminal” one, and was much more concerned about fairness in the securities markets than was the Supreme Court in the Dirks and Chiarella decisions, stating:

The abuse of informational advantages that other investors cannot hope to overcome through their own efforts is unfair and inconsistent with the investing public’s legitimate expectation of honest and fair securities markets where all participants play by the same rules.

The primary concern of the 1984 legislation was the lack of consequences to deter insider trading if disgorgement of profits were the only penalty. Accordingly, the 1984 Act added a new subparagraph to section 21(d) of the 1934 Securities and Exchange Act which would authorize the SEC to seek a penalty of up to three times the amount of the profit gained or loss avoided by the person trading on inside information. The 1984 report is also of interest because of its references to aiding and abetting insider trading violations under rule 10b-5. This will be discussed in the next section.

111. See supra note 74.
115. Id. at 2287.
116. Id. at 2278 (emphasis added).
119. See infra text accompanying notes 145-70.
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Subsequent to the 1984 legislation, the scope of insider trading increased and involved prominent individuals in Wall Street investment banking firms and risk arbitrageurs.\(^{120}\) The 1988 legislation was much broader than the 1984 legislation and included, in addition to provisions dealing with the treble damage penalty and increased criminal penalties, increased supervision requirements for securities professionals, a bounty provision, and express private right of action for those injured by insider trading.\(^{121}\) The 1988 report noted that the *Chiarella* and *Dirks* decisions represented a "narrowing approach" to illegality,\(^{122}\) and reasserted that curbing insider trading is crucial to capital formation by ensuring "investor confidence in the fairness and integrity of our securities markets."\(^{123}\)

The 1988 report offered two important insights: first, that the "wave of insider trading cases in recent years has demonstrated the potential for abuse in even the largest and most prestigious of Wall Street securities firms" and that accordingly there "is a clear need for an institutional, rather than merely individual, response to this problem."\(^{124}\) Secondly, it recognized the difficulty in prosecuting an insider trading case, which the Supreme Court, in *Chiarella* and *Dirks* glossed over:

Unless there is an obvious connection, which is rare, the success of the case usually depends on getting someone who knows about the inside trading to talk. According to the testimony of U.S. Attorney Giuliani, there are generally two people who can provide direct evidence that the insider trading has occurred—the source of the information and the trader. It is very rare for one of these two persons to admit that they have engaged in insider trading. Most cases are based largely on circumstantial evidence.\(^{125}\)

The difficulty in convicting a defendant in an insider trading case, and the complications created by *Dirks*, are illustrated by *United States v. Reed*, where the court relied on the statement in *Dirks* that described *Walton*\(^{126}\) as "[a]n example of a case turning on the court’s determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information":\(^{127}\)

In this connection, the Court must register its reluctance to apply the confidential relationship concept with the same liberality displayed by equity in cases of unjust enrichment. ... The charges confronting defendant are serious and the stigma they carry is substantial. Accordingly, at trial this Court will be vigilant to require the Government to prove beyond a reasonable doubt not merely that by engaging in the disputed transactions Reed disappointed and embarrassed his father, but that these options trades breached an actual and pre-existing confidential relationship between

\(^{121}\) Id.
\(^{122}\) Id at 6046.
\(^{123}\) Id at 6045.
\(^{124}\) Id. at 6051-52.
\(^{125}\) Id. at 6052.
\(^{126}\) Walton v. Morgan Stanley Inc., 623 F.2d 796 (2d Cir. 1980).
father and son. 128

To the layman’s eye, Reed would seem to be a classic, and clear, case of insider trading. Reed Sr. was a member of the Board of Directors of a company that was engaged in confidential merger negotiations. Within five days after the chairman of the two companies met, Reed Jr. purchased 500 out-of-the-money call options\textsuperscript{129} in his father’s company shortly after he talked with his father by telephone. A month later, the Board of Directors of the acquirer approved the merger and communicated this fact to the directors of the target company, including Reed Sr. who was vacationing in Barbados. Thereafter the son again spoke with his father by telephone and purchased another 500 out-of-the-money call options. For an investment of just over $3,000, Reed Jr. obtained a profit of $431,000.

The Reed case, like the Switzer case, supports the SEC’s concern, which the Dirks’ majority downplayed, that the parties can always fabricate some explanation to avoid liability under the Dirks test.

The 1988 legislation also created a statutory private cause of action for victims of insider trading.\textsuperscript{130} The 1988 report reflects the fact that Congress, both houses of which were now controlled by the Democrats, was not pleased with some of the judicial approaches to insider trading:

In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant’s violation is premised upon the misappropriation theory. See e.g., Moss v. Morgan Stanley, 719 F.2d 5 (2d cir. 1983). The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful.

The report also recognized that persons other than contemporaneous traders can be injured by insider trading and opined that rule 10b-5 is sufficiently flexible to provide a remedy in such situations.\textsuperscript{132}

\textsuperscript{128} Id. at 718.

\textsuperscript{129} An “out of the money” call option would be one in which the strike price is higher than the market price. See Investopedia, Out of the Money, http://www.investopedia.com/terms/o/outofthemoney.asp.

\textsuperscript{130} See 15 U.S.C.A. §78t-1.

\textsuperscript{131} 1988 U.S.C.C.A.N. at 6063-64.

\textsuperscript{132} The report stated:

Despite the absence of explicit statutory language for private rights of action outside of the contemporaneous trader plaintiff situation, the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders. In the view of the Committee, Section 10(b), Rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded, or harmed by a violation of any provision of this title or the rules or regulations thereunder by another person's purchasing or selling a security while in the possession of material, nonpublic information, or communicating such information to others.

The most prominent example of the non-contemporaneous trader suit which came to the attention of the Committee involved a suit filed by Anheuser-Busch Companies, Inc. against
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Thus, it is clear that a substantial gulf existed between the conservative approach taken by the courts and the more liberal attitude of Congress. Probably the most important action taken by Congress to stem the tide of insider trading and to change the tone with respect to control of insider trading was to require institutional responsibility to curb insider trading and institutional responsibility for the failure to do so.

This brought home to securities professionals, such as investment bankers, investment advisors, lawyers, and accountants that they have responsibility to ensure that confidential information that comes into their possession is not misused by their employees. Almost a decade later, the Supreme Court, in United States v. O'Hagan, reversed the Eighth Circuit, which had held that liability for insider trading under rule 10b-5 could not be predicated upon the misappropriation theory, and validated this theory.

III. THE 1990S: ENDORSEMENT OF FRAUD BY THE SUPREME COURT AND CONGRESS

Since Richard Nixon, Republican presidents have appointed 13 justices of the Supreme Court, whereas Democratic presidents have appointed two, both by President Clinton. Some members of the present "liberal" block would hardly have been considered liberal, based upon their track record prior to

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Paul Thayer, a former director of the corporation. See Anheuser-Busch Cos., v. Thayer, CA3-85-0794-R (N.D. Texas 1986). In that case, the plaintiff alleged that it was defrauded not as a result of trading with the defendant, but by having information secretly stolen and by having the subsequent trading on the information concealed. According to the complaint in this case, prior to public dissemination, the tipper disclosed to several parties the plans of Anheuser-Busch to acquire Campbell Taggart, Inc. The alleged misappropriation of Anheuser-Busch's confidential information proximately caused a significant increase in the market price of Campbell Taggart stock before Anheuser-Busch announced its offer. This forced Anheuser-Busch to raise its tender offer price, and the company eventually paid approximately $80 million more as a result of the illegal insider trading. Clearly, in such a case, the plaintiff corporation was a victim of the defendant's misappropriation. In the view of the Committee, where the plaintiff can prove that it suffered injury as a result of the defendant's insider trading, the plaintiff has standing to sue in this circumstance, and the remedial purposes of the securities laws require recognition of such an action.

In the view of the Committee, it was also important to note that in situations such as the Anheuser-Busch case and others, the potential harm to the plaintiff from the defendant's insider trading or tipping may be far greater than the profit gained or loss avoided by that defendant. The Committee recognizes that where the plaintiff demonstrates that he was defrauded by the defendant's insider trading and suffered actual damages proximately caused by the defendant's behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate. Rather, in such an implied private cause of action, the plaintiff should be able to recover the full extent of those actual damages.

136. See Supreme Court of the United States, About the Supreme Court, http://www.supremecourtus.gov/about/about.html (follow Members of the Supreme Court hyperlink).
coming to the court. Moreover, Justice O'Connor, who came to be viewed as a moderate, was in fact fairly conservative. The fact that conservative justices end up being categorized as liberal is a testimony to just how conservative the court has become. In the corporate and securities area, as in many other areas, there have been practical consequences to the ideological split on the court. One such consequence, as this article suggests, is that the court has been complicit in setting a permissive tone for corporate morality that led to the corporate corruption crisis around 2000.

However, the Democrats were much more successful on the congressional front. They controlled both houses of Congress from 1954 until 1994, with the exception of the Senate for a six year period from 1981 to 1987. But this changed in 1994. In 1995, as part of seeking to carry out Newt Gingrich's "Contract with America," the Republican-controlled Congress passed the Private Securities Litigation Reform Act of 1995 ("PLSRA"). This act made it exceedingly difficult to bring a securities fraud claim, particularly because of the provisions limiting discovery, mandating specificity in pleading without the benefit of discovery, and providing a safe harbor for forward-looking statements even if management knows they are unrealistic. The act itself was harsh, but some federal courts took the provisions of the act even beyond a rational interpretation.

Before examining the impact of PLSRA, let's first look at two Supreme Court decisions in the mid-1990s, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. and Gustafson v. Alloyd Co., which represent judicial activism, by a supposedly conservative court, to undercut established precedent.

137. See Ford Chooses a Chicagoan for Supreme Court Seat; Nominee is Appeals Judge, N.Y. TIMES, Nov. 29, 1975 ("Judge Stevens is regarded as something of a centrist, neither extremely conservative nor extremely liberal. Legal experts and colleagues suggested ... it was likely that Judge Stevens ... would take his place in the middle area of the Courts justices, with Potter Stewart, Byron R. White, and Lewis F. Powell, Jr.").

Justice Souter was recommended by John Sununu, the White House chief of staff at the time, who assured then President Bush that Justice Souter would uphold conservative values and who would be a strict constructionist with basic conservative attitudes. Attorney General Dick Thornburgh was impressed with "the crispness, the logic, the flow, and the structure," of Justice Souter's opinions. Sununu Tells How and Why He Pushed Souter for Court, N.Y TIMES, July 25, 1990.

138. See A Reputation for Excelling, N.Y. TIMES, July 8, 1981 ("She is said, by friend and foe alike, to be notably bright, extremely hard-working, meticulous, deliberate, cautious and, above all, a Republican conservative.").

139. In Steps Big and Small, Supreme Court Moved Right, N.Y. TIMES, July 1, 2007, at 1.


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A. The Demise of Aiding and Abetting

While the Supreme Court, as constituted in 1994, was supposedly a conservative Court, Central Bank was an egregious example of judicial activism. The issue that the Court decided was that a private plaintiff may not maintain an aiding an abetting action under the 1934 Securities Exchange Act; however, this was not the issue litigated in the courts below, nor was it the issue presented by the parties on appeal. The order granting certiorari provided as follows:

Petition for writ of certiorari to the United States Court of Appeals for the Tenth Circuit granted limited to Question 2 presented by the petition. In addition to Question 2, the parties are directed first to brief and argue the following question: “Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.”

Justice Stevens’s dissent, which was joined by Justices Blackmun, Souter and Ginsburg, offered a truly conservative perspective, when he stated “[a]s I have said before, ‘the adversary process functions most effectively when we rely on the initiative of lawyers, rather than the activism of judges, to fashion the questions for review.’”

The judicial activism of the Court was further reflected by the fact that all eleven Courts of Appeal which had considered the question had recognized that a private cause of action against aiders and abettors existed under rule 10b-5. With respect to that fact, Justice Stevens commented that “[w]hile we are now properly reluctant to recognize private rights of action without an instruction from Congress, we should also be reluctant to lop off rights of action that have been recognized for decades, even if the judicial methodology that gave them birth is now out of favor.” Justice Stevens approach reflects a true conservative philosophy and a policy of judicial restraint.

The facts in Central Bank were not of the sort that would generate sympathy for the defendant. Basically, Central Bank breached its fiduciary

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147. 511 U.S. at 201.
148. The Court set forth the facts as follows: In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (Authority) issued a total of $26 million in bonds to finance public improvements at Stetson Hills, a planned residential and commercial development in Colorado Springs. Petitioner Central Bank
duty to its beneficiaries by failing to disclose or follow up on information that would have alerted the beneficiaries to the fact that the real estate underlying their investments provided inadequate security. Plaintiffs charged that Central Bank aided and abetted the seller of the bonds in defrauding the investors.

As justification for its outcome determinative decision, the majority set forth two reasons: (1) that the text of section 10(b) precluded aiding and abetting liability, and (2) if this were not the case, the structure of the 1933 and 1934 securities acts reflects an intention by Congress not to permit aiding and abetting liability under section 10(b). The Court’s reasoning is not only fallacious, but flies in the face of prior decisions by the Court.

With respect to the first point, the majority stated that “the language of Section 10(b) does not in terms mention aiding and abetting liability” and, relying upon *Santa Fe*, concluded:

> The statute prohibits only a making of a material misstatement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.

The reasoning is actually embarrassing. First of all, the cause of action under rule 10b-5 is not a cause of action specifically provided for in the statute, but rather one that is judicially created. If you do not find the cause of action itself in the statute, why would you expect to find a provision in the statute imposing aiding and abetting liability upon those who assist the perpetrator in activities giving rise to the cause of action? Secondly, while there are statutory

of Denver served as indenture trustee for the bond issues.

The bonds were secured by landowner assessment liens, which covered about 250 acres for the 1986 bond issue and about 272 acres for the 1988 bond issue. The bond covenants required that the land subject to the liens be worth at least 160% of the bonds’ outstanding principal and interest. The covenants required AmWest Development, the developer of Stetson Hills, to give Central Bank an annual report containing evidence that the 160% test was met.

In January 1988, AmWest provided Central Bank with an updated appraisal of the land securing the 1986 bonds and of the land proposed to secure the 1988 bonds. The 1988 appraisal showed land values almost unchanged from the 1986 appraisal. Soon afterwards, Central Bank received a letter from the senior underwriter for the 1986 bonds. Noting that property values were declining in Colorado Springs and that Central Bank was operating on an appraisal over 16 months old, the underwriter expressed concern that the 160% test was not being met.

Central Bank asked its in-house appraiser to review the updated 1988 appraisal. The in-house appraiser decided that the values listed in the appraisal appeared optimistic considering the local real estate market. He suggested that Central Bank retain an outside appraiser to conduct an independent review of the 1988 appraisal. After an exchange of letters between Central Bank and AmWest in early 1988, Central Bank agreed to delay independent review of the appraisal until the end of the year, six months after the June 1988 closing on the bond issue. Before the independent review was complete, however, the Authority defaulted on the 1988 bonds.

*Id.* at 167-68.

149. *Id.* at 175.

150. See 430 U.S. at 462, 473.

151. 511 U.S. at 177-78.
provisions creating aiding and abetting liability, aiding and abetting is also a common law doctrine generated by the courts. To look in the statute to see if there is aiding and abetting liability with respect to a cause of action that is judicially, rather than legislatively, created, can only be explained by an outcome determinative mentality.

The second purported justification for eliminating aiding and abetting liability under rule 10b-5 is equally specious. The Court sought to glean congressional intent as to whether Congress intended that there be aiding and abetting liability with respect to an implied, rather than an express statutory, cause of action by looking at the structure of the express remedies in the securities acts. As stated above, this is an oxymoronic approach.

However, there is a further weakness in that the express causes of action referenced by the majority, with the exception of sections 9 and 20A of the 1934 act, all sound in negligence. Historically, aiding and abetting liability did not attach with respect to actions involving mere negligence. Section 876(b) of the Restatement of Torts was a new development in extending aiding and abetting liability to a negligence cause of action. As the majority itself points out, “[i]n some States, it is still unclear whether there is aiding and abetting tort liability of the kind set forth in § 876 (b) of the Restatement.”

On the other hand, aiding and abetting liability originated in the criminal law sphere, with respect to intentional conduct. The Ernst & Ernst decision required scienter in a rule 10b-5 cause of action in order to differentiate it from the express private causes of action set forth in the securities laws. Since the express actions sounded in negligence, you would not expect that Congress included aiding and abetting liability in connection with these underlying actions.

With respect to Section 9(e) of the 1934 Act, this provision imposes liability upon any person “who willfully participates” in any violation of the other provisions of Section 9. Such language could be sufficiently broad to encompass, not only the trader or primary violator, but also those who assist him. Thus, this language does not necessarily suggest congressional antagonism to aiding and abetting liability.

The insider trading provision in the 1988 amendments, rather than reflecting antagonism to aiding and abetting liability, reflected a desire to impose primary liability without the need to prove the elements of aiding and

152. See, e.g., 18 U.S.C.A. § 2 (general aiding and abetting statute applicable to all federal criminal offenses).
153. See generally RESTATEMENT (SECOND) OF TORTS § 876(b) (1979).
155. 511 U.S. at 181.
abetting with regard to the tipper. Accordingly, the statute as amended imposes a primary liability not only on the trader or tippee, but also upon the tipper.\(^{159}\)

The legislative history of the 1988 act explained that the act contained a technical amendment so that the statute could not be read “that tippers are liable for the penalty only if their conduct, in addition to constituting a direct violation, also satisfies the elements of aiding and abetting a violation by the trader.”\(^{160}\) In other words, Congress wanted to ensure that a tipper could be held liable as a primary violator without the necessity of proving the elements of an aiding and abetting cause of action against him. It is clear from the legislative history of the 1988 act that Congress recognized the existence of aiding and abetting liability under rule 10b-5.\(^{161}\)

As indicated above, the majority’s analysis flies in the face of its prior precedents. When the decision was handed down, eleven circuits had recognized aiding and abetting liability. The first case in the initial trilogy of securities law decisions,\(^{162}\) in adapting the Birnbaum rule that a plaintiff must be a purchaser or seller of securities to have standing, stated:

The longstanding acceptance by the courts, coupled with Congress’ failure to reject Birnbaum’s reasonable interpretation of the wording of § 10(b), wording which is directed toward injury suffered “in connection with the purchase or sale” of securities, argues significantly in favor of acceptance of the Birnbaum rule by this Court.\(^{163}\)

In addition, the majority rejected the argument that “Congress has amended the securities laws on various occasions since 1966, when courts first began to interpret § 10(b) to cover aiding and abetting, but has done so without providing the aiding and abetting liability is not available under § 10(b).”\(^{164}\) According to the majority, “[i]t is impossible to assert with any degree of assurance that congressional failure to act represents affirmative congressional approval of the [courts’] statutory interpretation.”\(^{165}\)

However, a few years earlier the Court, in *Herman & MacLean v. Huddleston*, determined that the existence of an express remedy under the securities laws did not preclude an action under rule 10b-5. In so doing, it relied

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159. Id. § 78t-1(c).
161. See 1984 Report, 1984 U.S.C.C.A.N. at 2283 (“The committee endorses the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws.”) The majority opinion characterized the 1984 and 1988 reports as containing only “oblique references to aiding and abetting liability.” 511 U.S. at 185. The committee statement above is hardly an oblique reference. See also 1984 U.S.C.C.A.N. at 2300.
162. See supra note 31.
163. *Blue Chip Stamps*, 421 U.S. at 733.
164. 511 U.S. at 186.
165. Id. (quoting Patterson v. McLean Credit Union, 491 U.S. 164, 175 n.1 (1989)).
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upon the fact that federal courts had consistently permitted rule 10b-5 actions in this circumstance and that Congress had comprehensively revised the securities laws in 1975 without changing the judicial precedent. The Court stated:

This cumulative construction of the remedies under the 1933 and 1934 Acts is also supported by the fact that, when Congress comprehensively revised the securities laws in 1975, a consistent line of judicial decisions had permitted plaintiffs to sue under Section 10(b) regardless of the availability of express remedies. In 1975 Congress enacted the "most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934." See Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97. When Congress acted, federal courts had consistently and routinely permitted a plaintiff to proceed under Section 10(b) even where express remedies under Section 11 or other provisions were available. In light of this well-established judicial interpretation, Congress' decision to leave Section 10(b) intact suggests that Congress ratified the cumulative nature of the Section 10(b) action. See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 384-86 (1982); Lorillard v. Pons, 434 U.S. 575, 580-81 (1978).166

This is the same situation that existed with respect to aiding and abetting liability which had been uniformly recognized at the time of the comprehensive 1975 amendments. Apparently, as Emerson stated, "a foolish consistency is the hobgoblin of little minds."167

The majority, in the process of eliminating aiding and abetting liability, again observed as it did in Chiarella and Dirks that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."168 This recurrent theme, in addition to the elimination of the accountability imposed by aiding and abetting liability, arguably led to the dereliction of responsibility by accountants and lawyers later in the decade. It is sad to observe that the accounting firm of Arthur Andersen went from a paragon of virtue at the start of the 1990s to an indicted felon at the start of the 2000s.169

B. The Elimination of a Private Rescission Remedy for Buyers in Nonregistered Offerings

While Central Bank was a poorly reasoned decision and inconsistent with prior precedents, a year later the Supreme Court handed down Gustefson v. Alloyd Co.,170 which demonstrated an abysmal ignorance of the securities laws. Were the opinion to be considered an exam question in securities regulation, the Court would have earned a grade of "F" for failing to understand the basic structure of the Act at that time.

167. JOHN BARTLETT, FAMILIAR QUOTATIONS 618 (10th ed. 1917); THE NEW DICTIONARY OF CULTURAL LITERACY 51 (3rd ed. 2002).
168. 511 U.S. at 174.
169. See infra text accompanying notes 296-297.
The plaintiffs in *Gustafson* were not sympathetic figures, which may explain the unusual alliances on the court in this case. Justices Thomas and Scalia joined Justices Breyer and Ginsburg in the dissent. Plaintiffs had agreed to buy the stock owned by defendant Alloyd and, pursuant to the contract, were entitled to a set off against the purchase price as a result of fiscal year earnings that were lower than the parties had estimated. Plaintiffs instead wanted to rescind the contract for the sale of stock, and alleged that there were material misstatements in the contract, which constituted a prospectus under the 1933 act, and thereby entitled them to rescission under section 12(a)(2) of the Act.\(^{171}\)

Section 2(a)(10) of the 1933 Act defines a prospectus to mean:

> [A]ny prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except...\(^{172}\)

Had the majority started with this definition of a prospectus found in the definitional section of the 1933 Act (which is where the dissent began), the contract in question was clearly a prospectus since it offered securities for sale. Unfortunately, however, the majority started with Section 10 of the Act which, in pertinent part, provides as follows:

> Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) (1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of Schedule A.\(^{173}\)

The court then asserted that all prospectuses must contain the information contained in a registration statement and that "a prospectus under § 10 is confined to documents related to public offerings by an issuer or its controlling shareholders."\(^{174}\) The court also could not "accept the conclusion that this

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172. Id. § 77b(a)(10).

173. 15 U.S.C.A. § 77j(j) (West 1954). Other provisions of section 10 give the SEC the authority to omit material required by Schedule A or to require that other information be included in the registration statement. Thus, Schedule A today is not where one would look to determine the information that must be included in a registration statement; rather, you would look to the forms, such as Form S-1, which the SEC has promulgated. See United States Securities and Exchange Commission, Form S-1, available at http://www.sec.gov/about/forms/forms-1.pdf.

174. 513 U.S. at 569. The full analysis of the majority is set forth below:

Section 10 does not provide that some prospectuses must contain the information contained in the registration statement. Save for the explicit and well-defined exemptions for securities listed under § 3, ... its mandate is unqualified: "[A] prospectus ... shall contain the information contained in the registration statement." Although § 10 does not define what a prospectus is, it does instruct us what a prospectus cannot be if the Act is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout. There is no dispute that the contract in this case was not required to contain the information contained in a registration statement and that no statutory exemption was required to take the document out of § 10's coverage. It follows that the contract is not a prospectus under § 10. That does not mean that a document ceases to be a prospectus whenever it omits a required piece of information. It does
single operative word [prospectus] means one thing in one section of the Act and something quite different in another."

It thus rejected the reasoning of the Seventh Circuit that "the 1933 Act contemplates many definitions of a prospectus. Section 2(10) gives a single, broad definition; section 10(a) involves an isolated, distinct document—a prospectus within a prospectus; section 10(d) gives the Commission authority to classify many." In point of fact, the Seventh Circuit was on the right track, whereas the majority opinion missed the boat.

In the 60 years of securities practice preceding the Gustafson decision, it was universally understood that the definition in Section 2(a)(10) was a very broad one and encompassed what was then referred to as "free writing." As the majority recognized, Section 5 of the act was the key provision. Section 5(c) prohibits offers to sell or buy a security until a registration statement was filed; Section 5(a) prohibits selling or transporting a security until a registration statement is effective; and Section 5(b) has two requirements: (1) no prospectus may be sent through interstate facilities unless it meets the requirements of section 10, and (2) no security may be carried through interstate facilities unless the delivery of such security is preceded or accompanied by a section 10(a) prospectus.

mean that a document is not a prospectus within the meaning of that section if, absent an exemption, it need not comply with § 10's requirements in the first place. An examination of § 10 reveals that, whatever else "prospectus" may mean, the term is confined to a document that, absent an overriding exemption, must include the "information contained in the registration statement." By and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements. It follows, we conclude, that a prospectus under § 10 is confined to documents related to public offerings by an issuer or its controlling shareholders.

Id. at 573.
176. Pacific Dunlop Holdings Inc. v. Allen & Co., 993 F.2d 578, 584 (7th Cir. 1993).
177. Section 5(c) provides as follows:
   It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under Section 77h.

178. Section 5(a) provides:
   Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

179. Section 5(b) provides:
   It shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration
Thus, from section 5(b), you can glean that there are three types of prospectuses: a section 10(a) prospectus, a section 10 prospectus that does not meet section 10(a) [generally a section 10(b), or preliminary, prospectus], and a prospectus that does not meet the requirements of section 10 at all [a "free writing" prospectus or a confirmation sent prior to the effectiveness of the registration statement].

The concept of the act as drafted was that there would be no communication until a registration statement was filed. Since there was the necessity of SEC review prior to it becoming effective, pricing information could not be included in the registration statement at the outset. During the interim between filing and effectiveness, written information normally would be disseminated only through the preliminary, or section 10(b), prospectus. Thus, brochures or letters extolling the merits of the security were forbidden during this interim period, since they were within the definition of prospectus in section 2(a)(10) of the act, but did not comply with section 10 of the act.

Moreover, a binding contract was usually consummated by the broker sending a confirmation of sale. However, this confirmation would also be considered a prospectus and, since it did not contain the information required by section 10, would also be forbidden. To avoid this dilemma, an exception in the definition of a prospectus provided that, if a section 10(a) prospectus accompanied the communication, the communication would not be deemed a prospectus.

The Supreme Court tried to focus upon text and structure in accordance with its developing pattern, but failed to understand the text and structure of the 1933 Act. The majority sought to justify its interpretation by the doctrine of noscitur a sociis, a word is known by the company it keeps. Since plaintiff focused on the word “communication” in the definition, the Court opined that the preceding words “notice, circular, advertisement, [and] letter” would be

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statement has been filed under this title, unless such prospectus meets the requirements of section 10; or (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10. 15 U.S.C.A. § 77e(b) (West 1954).

180. As a result of rule changes in 2005, the SEC now recognizes a free writing prospectus that meets the requirements of section 10(b), if certain conditions are met. See 17 C.F.R. §§ 230.405, 433 (2006).

181. There were a limited number of other written communications that could be sent. See, e.g., 17 CFR § 230.134 (2005).

182. The proviso is as follows: ...except that a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 77j of this title) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of such communication was sent or given to the person to whom the communication was made.... 15 U.S.C.A. § 77b(a)(10)(a) (West 2000).
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redundant since they all would be encompassed within the concept of a communication.183 The court also opined that these other terms all refer to documents of wide dissemination. But here the court is hung by its own petard: these terms also refer to documents that would not have all the information required in a registration statement. Consequently, according to the court’s reasoning, documents that are defined as a prospectus could not be a prospectus because they do not meet the requirements of Section 10.

If the majority wanted to be outcome determinative because of a perceived unworthiness of the plaintiff, it could have achieved the same result, without turning the structure of the 1933 act upside down, by simply holding that a negotiated contract, with the opportunity for due diligence, is not a communication by the seller. Using its noscitur a sociis approach,184 the list of terms in the definition of a prospectus all embody a unilateral message, as opposed to a bilateral agreement. While this approach raises its own questions, it could take negotiated transactions out of the mix, while still leaving a cause of action available to buyers who are misled by their seller’s communications.

Essentially, what the court was doing is once again restricting the scope of securities litigation. As stated previously, plaintiff in this case was not a sympathetic person because other remedies were available to him. But this will not always be the case. The effect of the decision is that misrepresentations in the sale of securities are not actionable under Section 12(a)(2) as long as they do not occur in the context of a public offering. Once again, defendants are favored over plaintiffs.

While this case does not deal with fraud in the publicly traded securities markets, it once again reflects a court that has little concern for protecting the rights of investors.

C. PLSRA – How to Encourage Deception

As previously indicated, the Republicans took control of Congress in 1994185 and one of the provisions in their “Contract with America” culminated

183. 513 U.S. at 574-75.
184. Justice Thomas did an excellent job of undercutting the majority’s noscitur a sociis approach. He wrote:
   The majority transforms § 10 into the tail that wags the 1933 Act dog. An analogy will illustrate the point. Suppose that the Act regulates cars, and that § 2(10) of the Act defines a “car” as any car, motorcycle, truck, or trailer. Section 10 of this hypothetical statute then declares that a car shall have seatbelts, and § 5 states that it is unlawful to sell cars without seatbelts. Section 12(2) of this Act then creates a cause of action for misrepresentations that occur during the sale of a car. It is reasonable to conclude that §§ 5 and 10 apply only to what we ordinarily refer to as “cars,” because it would be absurd to require motorcycles and trailers to have seatbelts. But the majority’s reasoning would lead to the further conclusion that § 12(2) does not cover sales of motorcycles, when it is clear that the Act includes such sales.
   Id. at 589.
185. See supra text accompanying notes 140-41.
in the “Private Litigation Securities Reform Act of 1995.” There are four provisions affecting Rule 10b-5 which are particularly troublesome, particularly as they interrelate with each other. These are (1) specificity with respect to misleading statements, (2) pleading with particularity facts giving rise to a strong inference of scienter, (3) staying discovery until a motion to dismiss based upon (1) and (2) has been heard, and (4) providing a safe harbor for forward-looking statements, even though they are made with knowledge that they are unrealistic.

The next section will review the foregoing legislative provisions and selected judicial decisions which have carried these provisions to the extreme.

1. Pleading Misstatements with Particularity

The first provision, pleading misleading statements with particularity, is, on its face, a reasonable one. The problem, however, is how much particularity need be pleaded without the benefit of discovery. For example, in In re Spectrum Brands, Inc. Securities Litigation, plaintiffs alleged that the company had engaged in channel stuffing so as to accelerate sales recognition. They claimed that customers such as Wal-Mart were given deep discounts, flexible payment terms, and other incentives to purchase inventory even when the buyers were already overstocked with batteries, and were permitted to return any product they did not sell in contravention of Spectrum’s announced policy.

Consider some of plaintiffs’ allegations and the court’s response. Paragraph 20 of the complaint alleged:

To induce SPC’s customers, including Best Buy, Menards, Wal-Mart, Kmart, Shopco, and Toys R Us, to order unwanted product and to pull sales forward into earlier quarters, SPC gave its customers deeper discounts, longer payment terms, and credits towards future purchases. The highest levels of management at SPC engaged in this channel-stuffing.

The court responded:

Missing here, for example, is any particular fact allegation regarding which of Spectrum Brands’s clients ordered additional batteries in response to the alleged incentives, when ordered, when delivered, what quantities, and in response to which

187. 15 U.S.C.A. § 78u-4(b)(1) (West 1998) provides as follows:
In any private action arising under this chapter in which the plaintiff alleges that the defendant--made an untrue statement of a material fact; or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall 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.
189. Id. at 1309.
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incentives. 190

Another allegation, paragraph 34, contained considerable detail:

According to a former national account manager, K-mart stores had on average between 52 to 100 weeks of Rayovac batteries, with some stores holding 250 weeks of C and D batteries. This same witness stated that Wal-Mart had 30-50 weeks of product in inventory and even though everyone knew in January 2005 that Wal-Mart’s inventory levels and weeks on hand were way up, SPC continued to offer Wal-Mart incentives to take additional product because “we needed to make the numbers.” Wal-Mart’s inflated inventory was confirmed by a former sales analyst, employed at SPC during the Class Period, who recalled at least “30 weeks on hand” and stated, “We all knew what was going on, we front loaded the stores in August and September 2004 for the Christmas holiday.” This witness reiterated that executive-level management handled every aspect of the Wal-Mart account because the Company was so dependent on this relationship. 191

These allegations also were insufficient to satisfy the court’s notion of particularity:

Plaintiffs’ allegations as to Wal-Mart and K-Mart state that those stores had multiple weeks of battery inventory their shelves, but Plaintiffs fail to allege facts to show that this level of inventory was unusually high for that time of year, what special incentives, if any, were offered to the customers, that Wal-Mart or K-Mart accepted the incentives or bought additional batteries in response thereto, or to show any of the other circumstances of the transaction. 192

But wouldn’t 250 weeks of inventory—about five years—be presumptively “unusually high?”

In assessing whether the court is being realistic in its expectations as to particularity, it is critical to recall that plaintiff’s pleading burden must be shouldered without any benefit of discovery.

During the last quarter of 2004 and the first quarter of 2005, plaintiff set forth numerous public statements by corporate officials as to how well business was doing. During the first quarter of 2005 the stock of Spectrum rose to over $40 per share. It then steadily declined, and by August of 2007 was trading at about $5 per share. The graph below reflects the impact of management’s misrepresentations upon the investing public: 193

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190. Id.
191. Id. at 1309-10.
192. Id. at 1310.
What is clear is that investors, who purchased in the first quarter of 2005, based upon Spectrum's sales and the optimistic statements of management, suffered substantial losses. However, as the Supreme Court told the world, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."\textsuperscript{194}

2. Pleading a Strong Inference of Scienter with Particularity

Section 21D provides, with respect to the state of mind necessary to support liability, as follows:

In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

a. Silicon Graphics: Using the Strong Inference Test to Protect Wrongdoers

What does it mean to plead facts giving rise to a strong inference? The Ninth Circuit's decision in \textit{In re Silicon Graphics Inc. Sec. Litig.},\textsuperscript{196} which was one of the first to deal with this issue, demonstrates how a court can adopt an absurd interpretation of what constitutes a "strong" inference of scienter and of the "particularity" necessary to demonstrate such strong inference. It also illustrates the cold indifference to fraud reflected in many federal opinions. Let

\textsuperscript{194} 511 U.S. at 174 (quoting \textit{Chiarella}, 445 U.S. at 232).


\textsuperscript{196} 183 F.3d 970 (9th Cir. 1999). The Third Circuit's decision in \textit{In re Advanta Corp. Sec. Litig.}, 180 F.3d 525 (3d Cir. 1999), was decided a couple of weeks before the Ninth Circuit's opinion was filed.
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us first examine the allegations of the complaint and then the court’s analysis.

(i) Misrepresentations of Management

Silicon Graphics’ revenue grew just 33% in the first quarter of fiscal year 1996, as opposed to the 40% that had been anticipated, with the result that the stock dropped to below $30 per share. Plaintiff Brody’s complaint alleged that the company’s officers made numerous false and misleading public representations in an attempt to enhance the price of the stock.

In particular, in October, 1995, CEO McCracken and other officers attributed the shortcoming in first quarter growth to a “temporary pause” in OEM sales, and assured investors that (1) there were no manufacturing problems with or supply constraints on the Indigo2; (2) demand was strong for the workstation, and it was being shipped in volume; (3) the Indigo2 upgrade was on schedule and would be introduced in January 1996 as planned; and (4) the goal of 40% revenue growth for FY96 would be achieved. 197

According to the complaint, these representations were repeated several times in November and December, and the officers added that European sales were likely to improve and that there was no problem in obtaining ASIC chips from Toshiba. 198

(ii) Complaint Allegations Allegedly Showing Defendants’ Knowledge

Even if there were misrepresentations, as alleged above, the defendant officers would not be liable unless plaintiff could allege facts that would create a strong inference that the officers either knew what they were saying publicly was false or that that were reckless in not realizing that they were making false statements. The complaint described three types of internal reports that notified management of serious problems:

SGI routinely produces at least three types of internal status reports: (1) daily reports; (2) monthly financial reports; and (3) “Stop Ship” reports. The daily reports include manufacturing, sales, and financial data. Monthly reports are broken down into “Flash Reports,” which are prepared immediately at the end of the month and which summarize the company’s performance, and “Monthly Financial Statements/Packages,” which are more detailed reports that SGI distributes within ten days of the close of the month. “Stop Ship” reports notify upper management of manufacturing problems and their likely effect on volume shipments. 199

With respect to these internal reports, plaintiff Brody alleged the following:

Brody alleges that SGI’s internal reports alerted the officers to serious production and sales problems. According to Brody, the Flash reports, Financial Statements/Packages and Stop Ship reports announced that: (1) SGI was not shipping the Indigo2 workstation in volume; (2) North American and European sales remained slow; and (3) SGI would not meet its revenue and growth targets for

197. 183 F.3d at 981.
198. Id. at 981-82.
199. Id. at 985 n.15.
Berkeley Business Law Journal

FY96. Brody contends that the reports notified the officers that SGI was suffering "weak North American sales due to continuing problems with its North American direct sales force" and "a very poor Oct., with revenues, net income and earnings per share well below forecasted and budgeted levels."²⁰⁰

(iii) Was Management Lying?

So, was management telling the truth? And would not telling a lie be an example of deliberate recklessness? Let's see what really happened:

Soon thereafter [December, 1995], SGI began to publicly confirm the negative rumors about its performance. On January 2, 1996, the company announced its disappointing second quarter results and acknowledged that revenue growth for the year would be much lower than expected. The next day, SGI's stock fell to $21 1/8.

On January 17, 1996, SGI's officers admitted to securities analysts that SGI had been unable to fill Indigo2 orders because of a shortage of ASIC chips and other primary components. They also acknowledged that OEM, North American, and European sales had all been down.

At this point, it is clear that the statements made by management were false. It is also clear that there were several sources of information available to management that would have informed them of the true state of affairs. Would not this give rise to a strong presumption that management either knew the truth and lied, or that management was reckless in disregarding critical information?

(iv) The Court's Expectation of Particularity

Analyzing the allegations of the complaint, developed without the benefit of discovery, a reasonable person would arguably conclude that the complaint established that management had been lying to the public from late September into December? However, the Ninth Circuit did not think so:

Although Brody's complaint suggests an inference of deliberate recklessness, it lacks sufficient detail and foundation necessary to meet either the particularity or strong inference requirements of the PSLRA. For example, Brody fails to state facts relating to the internal reports, including their contents, who prepared them, which officers reviewed them and from whom she obtained the information. In short, Brody's complaint is not sufficiently specific to raise a strong inference of deliberate recklessness. As the district court recognized, mere boilerplate pleadings will rarely, if ever, raise a strong inference of deliberate recklessness or otherwise satisfy the PSLRA's particularity requirement.²⁰²

Did the allegations discussed above appear to be mere boilerplate? What would it take to satisfy the court?

[Plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief. It is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim. In this case, Brody's complaint does not include adequate

²⁰⁰. ld. at 984-85.
²⁰¹. ld. at 982.
²⁰². ld. at 984.
corroborating details. She does not mention, for instance, the sources of her information with respect to the reports, how she learned of the reports, who drafted them, or which officers received them. Nor does she include an adequate description of their contents which we believe—if they did exist—would include countless specifics regarding ASIC chip shortages, volume shortages, negative financial projections, and so on. We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability.  

How, without the benefit of discovery, and without the company going into bankruptcy or incurring other extraordinary circumstances that would lead to the appointment of a special examiner, is a plaintiff likely to be able to obtain a type of detail demanded by the Ninth Circuit? The Ninth Circuit even opined that particularity required that the identity of the mole, who provided the information, be set forth in the complaint. This is a great way to discourage whistleblowing. Moreover, it is one thing to find a whistleblower who will provide oral information; it is another thing to expect a whistleblower to steal documents that would provide the detailed information demanded by the Ninth Circuit.  

(v) Does Insider Trading Create a Strong Inference of Scienter?

Plaintiff Brody also sought to establish a strong inference of scienter by bringing to the attention of the court substantial stock sales by insiders after their public representations in September and October that stopped the downward spiral of the stock. Let’s look at the price movements of the stock during this period:

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 21, 1995</td>
<td>44 7/8</td>
<td>205</td>
</tr>
<tr>
<td>October 9, 1995</td>
<td>29 7/8</td>
<td>206</td>
</tr>
<tr>
<td>November 3, 1995</td>
<td>36 1/4</td>
<td>207</td>
</tr>
<tr>
<td>December 5, 1995</td>
<td>38 3/4</td>
<td>208</td>
</tr>
<tr>
<td>January 3, 2006</td>
<td>21 1/8</td>
<td>209</td>
</tr>
</tbody>
</table>

203. Id. at 985.
204. If the situation is sufficiently egregious, as in Enron or Hollinger, independent directors on the board might appoint a special master to examine the situation, but there is no assurance that such a report would be made public. If the company goes into bankruptcy, the bankruptcy court might appoint a special examiner and this report likely would be public. The complaint in Enron relied heavily on the facts in a report of the special master.
205. In July 1995, Silicon Graphics reported 45% revenue growth for FY1995 (June 30, 1995) and projected similar growth for FY 1996. These projections drove the stock to its all-time high of 44 7/8. 183 F.3d at 980.
206. Revenues for the first quarter had only grown 33%, below expectations of 40%. Id. at 981.
207. After the October and November public statements, the Company's stock gained five points. Id. at 982.
208. During the month of November, the individually named SGI officers allegedly took advantage of SGI's inflated stock value by selling 388,188 shares of SGI stock at prices as high as $37 7/8. Id.
The above price movements, which the Ninth Circuit recognized, would seem to provide motivation to make false statements in order to stop the downward slide of the stock and have it rise again so that the insiders could bail out. Not according to the Ninth Circuit. "[I]nsider trading is suspicious only when it is 'dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information.'"\(^{210}\) In order to determine whether the sales are dramatically out of line, the court would consider "(1) the amount and percentage of shares sold by insiders; (2) the timing of the sales; and (3) whether the sales were consistent with the insider's prior trading history."\(^{211}\)

This is the trading picture upon which the Ninth Circuit based its decision:\(^{212}\)

<table>
<thead>
<tr>
<th>Name</th>
<th>Holding Per Court</th>
<th>Shares Sold</th>
<th>% Sold Per Court</th>
<th>Proceeds from Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>McCracken</td>
<td>2,305,382</td>
<td>60,000</td>
<td>2.6</td>
<td>$2,186,000</td>
</tr>
<tr>
<td>Kelly</td>
<td>45,790</td>
<td>20,000</td>
<td>43.6</td>
<td>$743,000</td>
</tr>
<tr>
<td>Sekimoto</td>
<td>110,811</td>
<td>7,600</td>
<td>6.9</td>
<td>$266,988</td>
</tr>
<tr>
<td>Baskett</td>
<td>390,577</td>
<td>30,000</td>
<td>7.7</td>
<td>$1,097,500</td>
</tr>
<tr>
<td>Ramsay</td>
<td>489,978</td>
<td>20,000</td>
<td>4.1</td>
<td>$746,071</td>
</tr>
<tr>
<td>Burgess</td>
<td>332,746</td>
<td>250,588</td>
<td>75.3</td>
<td>$8,761,294</td>
</tr>
</tbody>
</table>

This is how the court viewed the above picture:

All but two of the officers in this case sold a relatively small portion of their total holdings and traded in a manner consistent with prior practice. Collectively, the officers—even including the two who sold the greatest percentage of their holdings—retained 90 percent of their available holdings. President McCracken sold just 2.6 percent of his holdings and options. Vice President Baskett sold 7.7 percent. Senior Vice Presidents Ramsay and Sekimoto sold 4.1 and 6.9 percent, respectively. Senior Vice President Kelly's and Burgess's sales appear somewhat suspicious—they sold 43.6 and 75.3 percent of their respective holdings.\(^{213}\)

According to the court, even though Kelly sold 43.6% of the shares, such sales were not suspicious because his shares represented only an insignificant portion of the shares sold by management. And, while Burgess sold over 60% of his shares, his sales were not suspicious because this was the first time he had the opportunity to sell his shares, which previously were restricted.\(^{214}\)

209. The price to which the stock fell after the disappointing second-quarter results were announced. \(\textit{id.}\)
210. \(\textit{id.}\) at 986 (quoting \textit{In re Apple Computer Sec. Litig.}, 886 F.2d 1109, 1117 (9th Cir. 1989)).
211. \(\textit{id.}\)
213. 183 F.3d at 987.
214. \(\textit{id.}\)
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Now let us look at the real picture. Only by taking into account, not just stock owned by management in which management had a sunk investment, but also stock with respect to which they had options (in which there was no present cash investment), was the court able to come up with what it considered insignificant percentages. Let us look at another picture:

<table>
<thead>
<tr>
<th>Name</th>
<th>Holding Per Court</th>
<th>Purchased Shares</th>
<th>Shares Sold</th>
<th>Actual % Sold</th>
<th>Proceeds</th>
<th>12/31/96 Residual Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>McCracken</td>
<td>2,305,382</td>
<td>358,000</td>
<td>60,000</td>
<td>16.8</td>
<td>2,186,000</td>
<td>298,716</td>
</tr>
<tr>
<td>Kelly</td>
<td>45,790</td>
<td>20,815</td>
<td>20,000</td>
<td>96.1</td>
<td>743,000</td>
<td>815</td>
</tr>
<tr>
<td>Sekimoto</td>
<td>110,811</td>
<td>10,667</td>
<td>7,600</td>
<td>71.2</td>
<td>266,988</td>
<td>3,067</td>
</tr>
<tr>
<td>Baskett</td>
<td>390,577</td>
<td>37,620</td>
<td>30,000</td>
<td>79.7</td>
<td>1,097,500</td>
<td>7,620</td>
</tr>
<tr>
<td>Ramsay</td>
<td>489,978</td>
<td>50,309</td>
<td>20,000</td>
<td>39.8</td>
<td>746,071</td>
<td>30,309</td>
</tr>
<tr>
<td>Burgess</td>
<td>332,746</td>
<td>250,588</td>
<td>75.3</td>
<td>8,761,294</td>
<td>82,158</td>
<td></td>
</tr>
</tbody>
</table>

The three additional columns show the number of shares that the members of management had actually purchased, the percentage of the purchased shares sold, and the residual holdings of shares which management had actually paid for. This presents a much different picture. However, according to the court:

When evaluating stock sales, we have held that the proportion of shares actually sold by an insider to the volume of shares he could have sold is probative of whether the sale was unusual or suspicious. In this case, we see no reason to distinguish vested stock options from shares because vested stock options can be converted easily to shares and sold immediately. Actual stock shares plus exercisable stock options represent the owner’s trading potential more accurately than the stock shares alone. Therefore, a sale involving a significant portion of an insider’s actual shares, but only a small portion of his shares and options combined, is less suspicious than were the insider to hold no options. The district court did not err in treating the officers’ stock options as shares of stock for purposes of evaluating the suspiciousness of their stock sales.

But is this true? In the case of McCracken, for example, would he exercise options for almost 2 million shares if he knew the price of the shares was about to plummet. Moreover, if he held the shares, he would have millions of dollars invested in securities, which would precipitously decline in value once the true situation of Silicon Graphics came out. If he exercised the options and immediately sold, he would send up a red flag to the market and trading in the stock likely would be suspended, assuming it would be possible for an insider to liquidate 2 million shares in a short period of time.

The reality is that the insider has no direct monetary stake at risk in the options. On the other hand, the insider has expended cash to acquire the shares of stock actually owned. If the price of the stock declines, and the options go underwater, the options are valueless, but the insider has not risked a cash position. On the other hand, with stock actually owned, the insider has a cash

215. Id. at 986-87 (citations and footnotes omitted).
investment which is at risk, which can be saved by selling the stock. In this situation, the Silicon Graphics insiders recouped about $3 million by selling before disclosing the actual state of the company's affairs to the public.

Let us take a look at the earnings of the company over a five year period, and anticipate what message this picture potentially would send to an insider.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Earnings Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>$0.98</td>
</tr>
<tr>
<td>1995</td>
<td>$1.44</td>
</tr>
<tr>
<td>1996</td>
<td>$0.70</td>
</tr>
<tr>
<td>1997</td>
<td>$0.44</td>
</tr>
<tr>
<td>1998</td>
<td>($2.47)</td>
</tr>
</tbody>
</table>

The roughly 50% increase in earnings in fiscal year 1995, led by a 45% growth in revenue, drove the price to its all-time high of 44 7/8 on August 21, 1995. But in the fiscal year encompassing the class action, earnings were halved. The downward trend continued in subsequent years and, in fiscal year 1998, the company lost a substantial amount of money.

While insiders do not have impeccable foresight, it is likely that the problems that were disclosed in January 1996 would not lead management to exercise additional options, but rather to cut their losses by selling a substantial amount of their existing shareholdings.

When stock sells at a high price/earnings ratio, the value of the stock is heavily dependent upon the anticipated growth rate. The capital asset pricing model posits that the discount rate is equal to the risk-free rate plus beta times the spread between the market return and the risk-free rate:

\[ DR = RFR + B (MR - RFR) \]

The capitalization rate is the discount rate minus the growth rate:

\[ CR = DR - G. \]

Therefore, the larger the growth rate, the lower the capitalization rate. The capitalization rate is inversely proportional to the price-earnings multiple. Thus, the larger the growth rate, the higher the price-earnings multiple. As a rudimentary approach to the value of a company is earnings times the price-earnings multiple, a decrease in earnings [and, consequently, growth] is a double whammy: it reduces the earnings and increases the capitalization rate, thereby reducing the price-earnings ratio.²¹⁷

While this may appear complicated, management of a company is very aware that a decrease in earnings growth is going to have a substantial impact on the value of the company's stock.

²¹⁶ Silicon Graphics, Annual Report (Form 10-K) (June 27, 2008).
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How did management respond with respect to their cash investment which actually was at risk? McCracken sold 17%, Kelly sold 96%, Sekimoto sold 71%, Baskett sold 80%, Ramsay sold 40%, and Burgess sold 75%. Together they realized about $13.8 million in proceeds, over $5 million more than they would have realized had they sold in January instead of November. Is $5 million sufficient motivation to mislead investors? While McCracken only sold 17% of his holdings, he realized over $2 million in proceeds, about $900,000 more than he would have realized had he sold in January.

The chart below shows the history of Silicon Graphics stock prices from 1993 to 2002:

![Stock Price vs. EPS Chart]

Basically, the Ninth Circuit gave crooks a free pass. Martha Stewart went to

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219. McCracken was removed by the Board of Directors in November, 1997 because of continuing losses. See Cynthia Bournellis, *SGI's CEO McCracken tumbles*, ELECTRONIC NEWS, Nov 3, 1997:

Stumbling on the road to transforming itself from a high-end computer graphics company to one that can deliver servers to run businesses, Silicon Graphics Inc. has dropped its long term CEO, Ed McCracken. At the board of directors' insistence, Mr. McCracken resigned so a search could begin for a new CEO.

The trigger was the fact that SGI has lost money four out of five quarters. The company's net loss was $37 million on revenues of $768 million, for the first quarter ended September 30, 1997 of fiscal year 1998. Mr. McCracken's resignation is a clear sign that SGI had not met its numbers, said Jim Garden, a workstation analyst at Technology Business Research, Inc., in New Hampshire.

The company ultimately went into bankruptcy and came out of reorganization in October, 2006. Press
b. The Supreme Court on Pleading Strong Inference

The Supreme Court, in *Tellabs Inc. v. Makor Issues & Rights, LTD.*, 221 dealt with the issue of pleading the requisite state of mind. The Court observed that “[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required,” but noted that whether and when recklessness satisfies the scienter requirement is not presented in this case. 222 It then observed that:

The “strong inference” standard “unequivocally raise[d] the bar for pleading scienter,” and signaled Congress’ purpose to promote greater uniformity among the Circuits. But “Congress did not . . . throw much light on what facts . . . suffice to create [a strong] inference,” or on what “degree of imagination courts can use in divining whether” the requisite inference exists. While adopting the Second Circuit’s “strong inference” standard, Congress did not codify that Circuit’s case law interpreting the standard.223

In the case below, the Seventh Circuit had reviewed the approaches of the other circuits with respect to what was necessary to plead a strong inference of scienter. The Second and Third Circuits have continued the Second Circuit’s standard of pleading either motive and opportunity or strong circumstantial evidence of recklessness or consciousness behavior. The Ninth and Eleventh Circuits have basically rejected motive and opportunity and required the pleading a particular facts showing deliberate recklessness. The other seven circuits, including now the Seventh Circuit, have taken a middle ground that does not adopt or reject particular methods of pleading but instead require plaintiffs to plead facts that together establish a strong inference of scienter.224

In *Tellabs*, 225 the Supreme Court established the pleading standard for the “strong inference” requirement for scienter. The Seventh Circuit had rejected the standard adopted by the Sixth Circuit that “plaintiffs are entitled only to the

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220. See The Martha Stewart Verdict: The Overview, Stewart Found Guilty of Lying in Sale of Stock, N.Y. TIMES, March 6, 2004:

Martha Stewart, who used her image of domestic perfection to build a multimillion-dollar company, was found guilty by a Manhattan jury yesterday of lying about the reasons she sold shares of a biotechnology company more than two years ago.... While those suspected crimes resulted in some of the largest bankruptcies and investor losses in history, it was Ms. Stewart's trial in a downtown Manhattan courtroom, focused on a stock sale that netted her about $45,000, that grabbed much of the spotlight.

221. 127 S. Ct. 2499 (2007).

222. Id. at 2507 n.3.

223. Id. at 2509.


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most plausible of competing inferences” and held:

Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. . . . If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal.

The Supreme Court, with two concurring and one dissenting opinion, concluded that “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.” Since the Seventh Circuit expressly declined to engage in such a comparative inquiry, its decision was reversed. The court reasoned as follows:

The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite “strong inference” of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, i.e., of the “smoking-gun” genre, or even the “most plausible of competing inferences.”

The court held that a complaint would survive “only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”

It was the notion that the inference from plaintiff’s pleadings need only be as compelling as any opposing inference that drew the ire of Justices Scalia and Alito in their concurring opinions. Justice Scalia opined that the inference of scienter pleaded by plaintiffs must be more plausible than the other inferences. He modestly suggested that, of the various wordsmithing found in the different opinions, “only . . . mine is the natural reading of the statute.” Justice Scalia apparently does not understand that there are three degrees of adjectives: positive, comparative, and superlative. In the present context, this would translate into strong, stronger, and strongest. Justice Scalia would rewrite the statute from requiring a “strong” inference of scienter to requiring the “strongest” inference. Isn’t this judicial activism?

While the majority is correct in arguing that a word like strong involves some degree of comparison, it is in the context of “strong” versus “weak.” Justice Scalia argues that the normal rule is that the tie goes to the defendant; in other words, a plaintiff must prevail by a preponderance of the evidence. But he

227. Tellabs, 437 F.3d at 602.
228. 127 S. Ct at 2509.
229. Id. at 2510.
230. Id.
231. Id. at 2514.
is confusing the pleading stage with the trial stage. A motion on the pleadings is not a trial on the evidence. At trial, plaintiff will need to prove scienter by a preponderance of the evidence. But plaintiff will have had the benefit of discovery and the opportunity to cross-examine the defendant. Justice Scalia’s approach is another example of an outcome determinative mentality designed to impede plaintiffs and protect wrongdoing.

Of all the opinions, Justice Stevens’ dissent made the most sense. He acknowledged that “[t]oday the majority crafts a perfectly workable definition of the term, but I am persuaded that a different interpretation would be both easier to apply and more consistent with the statute.” He would have used a “probable cause” standard that, he acknowledged, is not capable of precise measurement but is a concept that is familiar to judges. He explained the benefit of this approach as follows:

In addition to the benefit of its grounding in an already familiar legal concept, using a probable-cause standard would avoid the unnecessary conclusion that “in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences.” Ante, at 2509 (emphasis added). There are times when an inference can easily be deemed strong without any need to weigh competing inferences. For example, if a known drug dealer exits a building immediately after a confirmed drug transaction, carrying a suspicious looking package, a judge could draw a strong inference that the individual was involved in the aforementioned drug transaction without debating whether the suspect might have been leaving the building at that exact time for another unrelated reason.

He then applied this approach to the facts of the Tellabs case:

If, using that same methodology, we assume (as we must, see ante, at 2509 - 2510, 2511) the truth of the detailed factual allegations attributed to 27 different confidential informants described in the complaint, App. 91-93, and view those allegations collectively, I think it clear that they establish probable cause to believe that Tellabs’ chief executive officer “acted with the required intent,” as the Seventh Circuit held.

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232. Id. at 2517.
233. Id.
234. Id. As he elaborated in a footnote:
The “channel stuffing” allegations in ¶¶ 62-72 of the amended complaint, App. 110-113, are particularly persuasive. Contrary to petitioners’ arguments that respondents’ allegations of channel stuffing “are too vague or ambiguous to contribute to a strong inference of scienter,” ante, at 2511, this portion of the complaint clearly alleges that Notebaert himself had specific knowledge of illegitimate channel stuffing during the relevant time period. See, e.g., App. 111, ¶ 67 (“Defendant Notebaert worked directly with Tellabs’ sales personnel to channel stuff SBC”); id., at 110-12 (alleging, in describing such channel stuffing, that Tellabs took “extraordinary” steps that amounted to “an abnormal practice in the industry”; that “distributors were upset and later returned the inventory” (and, in the case of Verizon’s Chairman, called Tellabs to complain); that customers “did not want” products that Tellabs sent and that Tellabs employees wrote purchase orders for; that “returns were so heavy during January and February 2001 that Tellabs had to lease extra storage space to accommodate all the returns”; and that Tellabs “backdat[ed] sales” that actually took place in 2001 to appear as having occurred in 2000). If these allegations are actually taken as true and viewed in the collective, it is hard to imagine what competing inference could effectively counteract the
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Justice Stevens' analysis and insight are a refreshing contrast to the wordsmithing in which so many federal courts engage in order to let culpable management off the hook. It is also interesting to observe the pattern of stock prices in December of 2000 and January of 2001, which indicates that management's commentary supported the price of the Tellabs' shares. As is so often the case, when the true facts were disclosed, the price of the stock plummeted. See graph below:

After the Tellabs decision in the Supreme Court, the Seventh Circuit revisited the strong inference standard from the perspective of whether the facts alleged created an inference "cogent and at least as compelling" as an opposing inference that could be drawn from the facts alleged. In an opinion written by Judge Easterbrook, the court gratuitously and, I would assert, erroneously concluded that information supplied by confidential sources must be "discounted," usually "steep[ly]." He acknowledged that it was "unnecessary to say more today," because all that he said was gratuitous and

inference that Notebaert and Tellabs "acted with the required state of mind."

Id, at n.2.


237. Consider Judge Easterbrook's opinion in Amanda Acquisition Corp. v. Univ. Food Corp., 877 F.2d 496 (7th Cir. 1989), where he reluctantly upheld the Wisconsin takeover defense statute, which did not square with his own economic thinking. A substantial part of the opinion was devoted to his analysis as to why the statute was unwise. But he was constrained by the Supreme Court's opinion in CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987).

238. Higginbotham, 495 F.3d at 757.
unnecessary for the decision of the case at bar.

The basis for Judge Easterbrook’s assertion that testimony of confidential witnesses must be deeply discounted is his assumption that “[i]t is hard to see how information from anonymous sources could be deemed ‘compelling’ or how we could take account of plausible opposing inferences. Perhaps those confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t even exist.”

Judge Easterbrook confuses facts with assumptions and finds assumptions more compelling than facts. Inferences are really nothing more than conjecture or assumptions, and which assumption you find more plausible is a function of your bias. For example, if an executive sells stock in February, and quits in March, and if the market price of the stock of his company later drops because the company reported that the optimistic statements in January were unfounded, a “liberal” judge could infer that the sale was made on the basis of inside information that the optimistic statements were not true and thus evidence of scienter, whereas a “conservative” judge could infer that the executive sold because he was leaving and wanted to diversify his portfolio.

On the other hand, the statements of a confidential informant are facts. If the informant stated that the executive was regularly informed about the cancellation of significant orders or the misstatements of Brazilian income, this is a fact, not conjecture, and would be probative that the executive had scienter in April when he made the misleading projections. These facts would create an inference that a sale a month later was predicated upon knowledge that the optimistic statements were designed to support the price of the stock and that he sold to avoid a loss when the true facts were disclosed. This is at least as compelling an inference as one that asserts that the sale was made to diversify his portfolio in contemplation of his retirement. But the inference is predicated upon the fact of his knowledge, which in turn is based upon the informant’s testimony.

If, after discovery or trial, it was found that the informant did not exist, plaintiff’s attorney would be subject to sanctions. It is highly unlikely that an attorney would fabricate the existence of a witness and thereby run the risk of

239. Id.
240. See generally supra text at notes 21-24.
241. Cf. Cent. Laborers' Pension Fund v. Integrated Elec. Supply, 497 F.3d 546, 553-54 (5th Cir. 2007) (“Reynolds resigned from IES in March 2004, near the end of the period when his relevant stock sales occurred. IES asserts that it is not unusual for a corporate officer to sell his stock shortly before resigning.”).
242. Id. at 554 (taking a neutral position as to what inferences should be drawn).
243. Cf. Tellabs, 437 F.3d at 597 (“By January 2001, the complaint asserts, demand for Tellabs’s "best seller"—the TITAN 5500—was drying up. Verizon, Tellabs's largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001.”).
244. Cf. Higginbotham, 495 F.3d at 758.
sanctions, if not disbarment. Judge Easterbrook relies upon a parade of horribles to justify an unreasonable position.

3. Staying Discovery during Dependency of a Motion to Dismiss

PLSRA provides that, if the misstatements and allegations of scienter are not pleaded with sufficient particularity, the complaint shall be dismissed. However, the allegations in the complaint must be prepared without the benefit of discovery:

In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Moreover, the stay of discovery cannot be circumvented by initiating a proceeding in state courts. The rule provides that "[u]pon a proper showing, the court may stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this paragraph."

The legislative history of PLSRA took a dim view of discovery. The Senate report stated:

Thus, plaintiffs sometimes file frivolous lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint. Accordingly, the Committee has determined that discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint.

The legislative history also took a very narrow view of what might constitute "undue prejudice:"

Courts should stay all discovery pending a ruling on a motion to dismiss a securities class action, except in the exceptional circumstance where particularized discovery is necessary to preserve evidence or to prevent undue prejudice to a party. The Committee recognizes, for example, that a motion to dismiss may remain pending for a period of time, and that the terminal illness of an important witness may necessitate the deposition of the witness prior to ruling on the motion to dismiss.

The basic philosophy is that "discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint" and that discovery should not aid a plaintiff to find a "sustainable claim." Federal courts have basically enforced this policy. As one court stated:

Manifest in the 1995 Reform Act is the mandate that courts assess the legal

246. Id. § 78u-4(b)(3)(B).
247. Id. § 78u-4(b)(3)(B).
249. Id.
250. Id.
251. Id.
sufficiency of plaintiffs' securities fraud allegations according to what plaintiffs know at the time the complaint is filed, rather than what they wish to learn through discovery and recover from defendants merely by reason of commencing an action charging fraud.\textsuperscript{252}

Courts are wary that information gleaned from discovery could be used to supplement the complaint before the motion to dismiss is decided or could be used in aid of being able to file an amended complaint which would surmount a subsequent motion to dismiss.\textsuperscript{253}

Congress and the federal courts are operating in a fairyland world. Unless the accountants decide to recast the financial statements, or the board of directors or a bankruptcy court initiates an investigation which is made public, or whistleblowers are found, requiring specificity in pleading without discovery is an almost insurmountable hurdle, particularly considering the degree of specificity which many federal courts have required. Review the cases discussed thus far in Part III and, in particular, consider the court’s expectation regarding particularity in \textit{Spectrum Brands}, where it stated that “[m]issing here, for example, is any particular fact allegation regarding which of Spectrum Brands’s clients ordered additional batteries in response to the alleged incentives, when ordered, when delivered, what quantities, and in response to which incentives.”\textsuperscript{254}

This degree of detail is not publicly available. Requiring this degree of detail simply means that federal courts are insulating wrongdoers from any accountability.

4. The Safe Harbor for Forward-Looking Statements

a. The Statute

One of the more pernicious provisions of PLSRA is that dealing with the safe harbor for forward-looking statements. It covertly and dramatically

\textsuperscript{252} \textit{In re} Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 423 (S.D.N.Y.2001). One of the few situations in which discovery has been allowed involves situations in which the defendant has already made the information available to the government or a self-regulatory organization. As the court in \textit{In re} LaBranche Sec. Litig., 333 F. Supp. 2d 178, 183 (S.D.N.Y. 2004), stated: In Firstenergy, the court lifted the discovery stay when the defendant could not allege any burden from producing the requested information because the defendant had already reviewed, compiled and produced the requested information to the government. Likewise, in the Nicor securities litigation, the court lifted the stay and noted that “since these documents have already been found and compiled and plaintiffs will pay production costs, defendants will not be unduly burdened by producing them to plaintiffs now.” (citations omitted).

\textsuperscript{253} See \textit{In re} Lantronix, Inc. Securities Litigation, 2003 WL 22462393 (C.D. Cal.) (“It cannot be concluded that ‘evidence from discovery might not be the subject of controversy as to a claim in the complaint if leave to replead were granted.’ Nor can it be assured that plaintiffs will not attempt to use the discovery materials in opposition to the recently filed motion.”) (quoting \textit{In re} AOL Time Warner, Inc. Sec. & ERISA Litig., 2003 WL 21729842, 1 (S.D.N.Y. July 25, 2003) and \textit{In re} Vivendi Univ. S.A., Sec. Litig., 2003 WL 21035383, at 1 (S.D.N.Y. May 6, 2003)).

changed prior law, which required that management and the company have a reasonable basis for projections. For example, rule 175 under the 1933 act provides as follows:

A statement within the coverage of paragraph (b) of this section which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement (as defined in paragraph (d) of this section), unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.  

Isn’t this what a reasonable investor would expect, namely, that when a company makes a projection, it has a reasonable basis for such projection? But that is not what PLSRA provides. Management can make a projection with full knowledge that there is no basis for it, so long as cautionary language accompanies the projection.

Let’s take a look at how the safe harbor provisions actually work. A person is not liable with respect to a forward-looking statement to the extent that:

(A) the forward-looking statement is—
  (i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
  (ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement—
  (i) if made by a business entity; was—
     (I) made by or with the approval of an executive officer of that entity; and
     (II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.  

The key word in section 21E is the phrase “or.” In other words, even if an executive knows that the projections are false or misleading, there is no liability if they are identified as a forward-looking statement, which management typically is careful to do, and accompanied by a meaningful cautionary statement. We will explore later what is a meaningful cautionary statement but, assuming that a court buys the argument that the statement is meaningful, the court will not entertain evidence that the executive knew the statement was false or misleading.

It might appear, by parsing the way the statute was drafted, that I am engaging in abstract wordsmithing, because a court would not let an executive

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who knows the statement is false off the hook. Or would it? Let's look at the cases.

b. Knowledge of Fraud Immaterial If Cautionary Language Used

In *Harris v. Ivax Corp.*, the court determined that the safe harbor provisions require the court first to examine whether the statement was accompanied by cautionary language. If so, the state of mind of the person making the statement is irrelevant:

All of the statements that the plaintiffs claim to be false or misleading are forward-looking. They were accompanied, moreover, by "meaningful cautionary language."

Because we reach this conclusion, we need not in this case enter the thicket of the PSLRA's new pleading requirements for scienter; if a statement is accompanied by "meaningful cautionary language," the defendants' state of mind is irrelevant. 258

The IVAX decision was relied upon in *Sandmire v. Alliant Energy Corp.*:

Plaintiffs contend that dismissal is inappropriate because at the time of the forward-looking statements defendants knew of the Mexican loan devaluation and therefore had knowledge that the projections were without a reasonable basis. Assuming the complaint sufficiently alleged this it would not avoid dismissal of the claims based on the forward looking statements. Proof of knowledge that a forward-looking statement was false relates to a separate and distinct safe harbor provision, § 78u-5(c)(1)(B). Such knowledge and the state of mind of the defendants at the time the statement was made are irrelevant to a safe harbor defense based on cautionary language. 259

Since, under the safe harbor provisions of PLSRA, cautionary statements bar inquiry into the state of mind of the person making the statements, let's briefly examine some of the disclaimers deemed adequate by the courts to foreclose inquiry into whether the executive intended to deceive the public. Consider the IVAX case. The basic facts are as follows:

On August 2, 1996 Ivax issued a press release that, while acknowledging business problems, also showed some optimism. Ivax stock rose. On September 30, the last day of the quarter, Ivax announced in another press release that it anticipated a $43 million loss. On November 11, Ivax announced a $179 million loss for the third quarter, $104 million of which was a reduction in the carrying value of the goodwill ascribed to certain of Ivax's businesses. Neither of the earlier press releases had mentioned the possibility of this goodwill writedown based on third-quarter results.

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257. 182 F.3d 799, 803 (11th Cir. 1999).
258. Id. at 803. See H.R. Conf. Rep. 104-369, at 44 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 743 ("The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement."). In a footnote, the court added:

The plaintiffs do make a wholly unpersuasive argument that the defendants' knowledge of the need to reduce goodwill robs the projections of their forward-looking status. The statutory definition of "forward-looking statement" does not refer at all to the defendants' knowledge of the truth or falsity of the statement, however; such knowledge is relevant only to liability in the safe harbor, and even there only when there is inadequate cautionary language.

Id. at 808 n.10.
259. 296 F. Supp. 2d 950, 958 (W.D. Wis. 2003).
The price of Ivax stock plummeted. 260

The September 30th press release went into extensive detail about the proposed restructuring of the company, basically involving closing and relocating facilities to become more efficient. The restructuring charge was estimated to be $13 million in the third quarter. This figure was embodied in an anticipated loss of $43 million. But a write-down of $104 million of goodwill is a horse of a different color. The goodwill charge was probably predicated on the acquisition of intangibles which were anticipated to produce income in the future. However, if history indicates that assets are not going to generate income, GAAP requires that they be written down. 261 A write-down of $104 million is not just a substantial dollar amount, but also suggests concern about the earning power of the underlying assets.

The market’s reaction to the foregoing information is reflected in the chart below: 262

<table>
<thead>
<tr>
<th>Date</th>
<th>Price per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1996</td>
<td>$35.00</td>
</tr>
<tr>
<td>26/1996</td>
<td>$30.00</td>
</tr>
<tr>
<td>1/1997</td>
<td>$25.00</td>
</tr>
<tr>
<td>2/1997</td>
<td>$20.00</td>
</tr>
<tr>
<td>5/1997</td>
<td>$15.00</td>
</tr>
<tr>
<td>6/1997</td>
<td>$10.00</td>
</tr>
<tr>
<td>9/1997</td>
<td>$5.00</td>
</tr>
<tr>
<td>11/1997</td>
<td>$0.00</td>
</tr>
</tbody>
</table>

The court engaged in some questionable logic. Plaintiffs asserted that the press releases were misleading as a whole because they omitted mention of the anticipated write-down in goodwill. Even though the list of problems in the releases contained both factual and forward-looking material, the court determined to treat the list of factors as a unitary forward-looking statement. 263

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260. *IVAX*, 182 F.3d at 802.
263. The court in *IVAX* stated:
The court then phrased the question as follows:

That leaves, however, another question: the plaintiffs here allege fraud by material omission. Neither of the statements mentions the possibility of a large goodwill writedown. To be "meaningful," must the cautionary language explicitly mention the factor that ultimately belies a forward-looking statement?264

The court answered this question in the negative:

We think not. The statute requires the warning only to mention "important factors that could cause actual results to differ materially from those in the forward-looking statement." It does not require a listing of all factors. The conference report, moreover, that accompanied the PSLRA specified that "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." In short, when an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward. This statement satisfies Ivax's burden to warn under the statute, and it excuses Ivax from liability.265

This statement is absurd. The risks that were listed were only remotely, if at all, related to the failure to disclose any massive goodwill write-down. The cautionary language did talk about the problem of competition, and competition undoubtedly was a factor in the determination that the income producing capability of the assets did not support their valuation. But is a generic statement "competition may affect our business" a meaningful statement? What ever happened to the old ethic of the securities laws that it is a sin, not just to lie, but to tell half-truths?266 Once again, the court engages in tortuous reasoning in order to throw a plaintiff out of court.267 A loss of $179 million is certainly significant when compared to an announced anticipated loss of $43 million. Management may, or may not, have been aware of the necessity of a write-down at the time the public announcements were made, but we will never know. But if they were, isn't the underlying policy of the securities laws to promote full disclosure?

The mixed nature of this statement raises the question whether the safe harbor benefits the entire statement or only parts of it. Of course, if any of the individual sentences describing known facts (such as the customer's bankruptcy) were allegedly false, we could easily conclude that that smaller, non-forward-looking statement falls outside the safe harbor. But the allegation here is that the list as a whole misleads anyone reading it for an explanation of Ivax's projections, because the list omits the expectation of a goodwill writedown. If the allegation is that the whole list is misleading, then it makes no sense to slice the list into separate sentences. Rather, the list becomes a "statement" in the statutory sense, and a basis of liability, as a unit. It must therefore be either forward-looking or not forward-looking in its entirety.

182 F.3d at 806.
264. Id. at 807 (citation omitted) (emphasis in original).
265. Id. (citations omitted) (emphasis in original) (alteration in original).
266. See 17 C.F.R. §240.10b-5(b) (stating that it is unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.") (emphasis added).
267. See, e.g., IVAX, 182 F.3d at 807-08 (deciding not to give plaintiffs leave to amend the complaint).
c. The Conflict between Rule 175 and PLSRA

The facts in *In re Midway Games, Inc. Sec. Litig.*,268 illustrate the potential conflict between Rule 175 of the 1933 Securities Act269 and the safe harbor provisions of PLSRA for forward looking statements. In *Midway*, the cautionary statements accompanying various forward-looking statements clearly covered the relevant risks. For example, one statement found in the December, 2001 registration statement, which was apparently repeated in connection with other statements, provided:

> From time to time, we have experienced delays in product introductions. The timing of a creative process is difficult to predict. Unanticipated delays could cause us to miss an important selling season. A delay in introducing products could also affect our development schedule for other products. In either case, we may not achieve our anticipated revenues.270

Plaintiff complained that the release schedules for the games were misleading because Midway was experiencing production delays, and the games that it was producing were riddled with bugs,271 that Midway had inadequate reserves is for price protection, returns and discounts,272 and that Midway attempted to conceal the deterioration of its business by failing to write-down its capitalized product development costs in a timely manner.273

Let’s look, first, at a statement in the press releases of April 30, 2002 and June 31, 2002. The company stated that “Midway believes these products comprise the strongest home videogame lineup in the Company’s history and that these products will produce record home videogame results in 2002.”274 With respect to these statements, the court treated them, not as forward-looking statements, but as “puffing” which was immaterial as a matter of law.275

According to the court, “[n]o reasonable investor, much less ‘the market’ itself, would rely on such general statements of optimism.”276 The court observed that “[t]he market is not so easily duped, even granted that individual investors sometimes are.”277 One problem with this reasoning is that it is the aggregate of individual investors that comprise the market. Thus, we can hardly say that individual investors may be misled, but not the market. Moreover, the market lives on rumors, not just hard, verifiable data.278

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269. See 17 C.F.R. § 230.175.
270. 332 F. Supp. 2d at 1156.
271. Id. at 1157-58.
272. Id. at 1159.
273. Id. at 1160.
274. Id. at 1165.
275. Id.
276. Id.
Next, let’s look at the issue of the failure to meet production schedules. According to the complaint, the public announcements as to release dates for games were highly unrealistic:

A former website producer, W-2, employed with Midway from 2000 to October 2003, stated that Midway’s management issued projections based on unrealistic release dates for video games. W-2 stated that the release dates slipped in 2002 because project teams “did not have enough time” to create and develop the games.” (Id. ¶ 39.) A former Quality Assurance Manager, W-3, employed by Midway from 1998 through 2003, also stated that Midway’s management issued projections based on unrealistic release dates for video games. He explained that the average game title production cycle at Midway was two years. However, “what marketing usually did is cut production times in half. So basically what happened to the product team is that they had about two years of work that they had to complete in about a year, and that’s generally why” release dates were not met throughout the class period. (Id. ¶ 40.) Finally, a former Vice President of Quality and Market Support, W-4, employed with Midway from 1998 to 2001, stated that Nicastro would ask how long it would take to develop a title and then mandate that it be done quicker. W-4 stated that Nicastro “did have a tendency to be unrealistic.” (Id. ¶ 41).

Is it a misrepresentation to the market and individual investors to promulgate information, such as the release dates for the games, if the company’s history and the present circumstances demonstrate that such targets would not be met? Under PLSRA, the cautionary statement referenced above warned investors that delays had occurred in the past and might well occur in the future. Thus there is no liability.

On the other hand, Rule 175 would impose liability if a statement were made without a reasonable basis or not in good faith. Conceivably, the release schedules in Midway Games were made without a reasonable basis or in bad faith.

Another piece of forward-looking information involved the statement that “[w]e expect revenue for the December quarter will grow to $105-$155 million.” In point of fact, the fourth-quarter revenue was just over $80 million. The case does not specify when the foregoing statement was made but, depending upon the proximity to the fourth-quarter, once again an issue could be raised as to whether the projection was made in good faith and whether there was a reasonable basis for it.

Turning now to the allegation that the financial statements were misleading because Midway had manipulated reserves to conceal the plight of the company, the court agreed that these were not forward-looking statements. Plaintiff alleged:

Midway “set reserves that were not reasonable or based on any supportable methodologies.” (Id. ¶¶ 43-46 and 124-27.) When asked about the propriety of

278. 332 F. Supp. 2d. at 1158.
279. Id. at 1165-66.
280. Midway Games, Annual Report (Form 10-K), at F-23 (Dec. 31, 2002).
Midway's reserves, W-5, a former Midway employee who was hired specifically to establish Midway's reserves, stated "reserves for the sales returns were out of whack" and compared the process of computing reserves to "throwing a dart at a board." (Id. ¶ 43.) W-5 stated that Midway's senior management often ignored W-5's recommended reserves because they were too high or set reserves for the company without waiting for W-5's recommendation. W-5 also claimed that Midway's senior management purposely understated sales return reserves so that Midway could overstate its projections and sales revenue, stating "Midway was kind of throwing out any kind of [reserve] number out there to get the kind of [revenue] number they wanted it to be for that quarter or year." W-5 also recalled that "the decisions in establishing the reserve went to the CFO level," and he thought Nicastro was also involved in establishing the company's reserves. (Id. ¶ 44.) Specifically, W-5 recalled that Midway inadequately funded the Marketing Development Fund reserve, which was used to subsidize in-store promotions of Midway products. W-5 stated that Midway established a reserve at 2% of sales to fund the promotions, but the company spent much more. (Id. ¶ 45.)

The court disposed of this issue on the basis that the above allegations failed to meet the heightened pleading standard for particularity. According to the court:

Plaintiffs have alleged neither the amount of the alleged overstatement of revenues due to defendants reserve accounting or the net effect it had on the company's earnings. In fact, they have pled no specific facts that would show that defendants reserve estimates were so unreasonable when they were made that they constituted fraud. 282

The use of reserves to manipulate earnings has been a problem over the years. The SEC does not have the resources to monitor the accounting manipulations of slightly more than 13,000 public corporations. 283 Private litigation is one way of doing it but, at the pleading stage, a plaintiff does not have the degree of detail which the court here once again expects.

What is clear is that a substantial number of investors lost a substantial amount of money. During the period in question, the price of the company's stock dropped from $15, when it was in part supported by the April 30 press release and a conference call of the same date, to about $2 a share in mid-2003. Before the stock completed its precipitous drop, the company had a private placement to raise $35 million, which was announced just prior to the conference call. 284 But, as a result of the court's reasoning, investors were left without a remedy under the securities laws. See chart below.285

281. 332 F. Supp. 2d at 1159.
282. Id. at 1169.
284. 332 F. Supp. 2d at 1161.
IV. STONERIDGE INVESTMENT PARTNERS, LLC v. SCIENTIFIC-ATLANTA, INC.: A LOW POINT IN SUPREME COURT JURISPRUDENCE

As previously observed, the defendant, in Central Bank, was not a very sympathetic figure.\textsuperscript{286} However, the conduct of the defendants in Stoneridge\textsuperscript{287} was unconscionable. The Supreme Court accepted as true the following set of facts:

Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers. Respondents agreed to the arrangement.

\textsuperscript{286} See supra text accompanying note 148.
\textsuperscript{287} 128 S. Ct. 761.
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So that Arthur Andersen would not discover the link between Charter's increased payments for the boxes and the advertising purchases, the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business. Following a request from Charter, Scientific-Atlanta sent documents to Charter stating falsely that it had increased production costs. It raised the price for set top boxes for the rest of 2000 by $20 per box. As for Motorola, in a written contract Charter agreed to purchase from Motorola a specific number of set top boxes and pay liquidated damages of $20 for each unit it did not take. The contract was made with the expectation Charter would fail to purchase all the units and pay Motorola the liquidated damages.288

Thus, the Supreme Court was well aware that the effect of its decision was to exculpate from liability under the securities laws scurrilous defendants who knowingly participated in a fraud designed to mislead investors in the securities markets. The court observed that it was not clear whether Arthur Andersen was "complicit"289 in the fraud because Arthur Andersen may have been misled. What is clear is the complicity of the Supreme Court because it was well aware of the fraudulent activity and nonetheless insulated defendants from liability.

It is strong language to suggest that the Supreme Court is complicit in furthering fraud. Perhaps the court, jurisprudentially, had no other course. Or perhaps the Supreme Court is naïve and is not aware of the pervasiveness of corporate corruption, so that it did not appreciate the risk to investors imposed by corporate corruption. As the ensuing discussion will demonstrate, neither excuse for the Supreme Court holds water. Let us examine the latter point first and then analyze the judicial craftsmanship, or lack thereof, embodied in the majority's opinion.

A. The Pervasiveness of Corporate Corruption.

When the Supreme Court decided Central Bank, it did so with the history of the 1980s in mind. Insider trading was a widespread problem.290 But insider trading frequently occurs in a rising market and that is what we generally experienced in the two decades preceding Central Bank. Other than the 1987 market break, which was triggered by computer programming, and the drop in late 1990, which was triggered by the first Gulf War, the market rose about 3000 points in an orderly manner. See the chart below:291

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288. Id. at 766-67.
289. Id. at 766.
290. See supra text accompanying notes 74, 120-124.
While investors can be deceived by management in a steadily rising market, generally when investors make money, there is less litigation. Arguably, sudden price drops fuel litigation. But be the scene the Supreme Court sees today is a far different scene than that which existed in 1994. For the past decade, there has been a volatile market, the volatility of which has been in part caused by the corporate corruption scandals which came to light in the early 2000s. See chart below:

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292. See e.g., Interim Report of the Committee on Capital Markets Regulation, Committee on Capital Markets Regulation, at 77, www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. The committee is an independent, bipartisan committee composed of 20 corporate and financial leaders. It was announced on September 12, 2006.

The Supreme Court could hardly have been unaware of the corporate fraud that was uncovered in the early 2000s. The publicity which attended the Enron and WorldCom scandals was pervasive and led to the enactment of the Sarbanes-Oxley act.

Moreover, the Supreme Court, in 2005, reversed the conviction of Arthur Andersen, one of the more notorious participants in the corporate corruption of this period. Arthur Andersen was involved in scandals involving Waste...

294. See HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE App'x D (West 2006-2007) (listing over twenty of the more spectacular examples of corporate corruption during this period).

295. See supra note 3.


[w]hoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to... cause or induce any person to... withhold testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object’s integrity or availability for use in an official proceeding....

Id. at 703 (citing 18 U.S.C. §1512).

In reversing the decision, Chief Justice Rehnquist opined that the jury instructions failed to convey the proper meaning of the statutory text, specifically the terms “knowingly...corruptly persuade.” Id. at 704-05. He found the lack of culpability required in the instructions “striking.” Id. at 707. The Court also found error in the instructions failure to include any nexus requirement. Id. By lacking a nexus element, the jury was wrongly led to believe “that it did not have to find any nexus between the ‘persuasion’ to destroy documents and any particular proceeding.” Id. at 697. According to the Court, the statutory text mandates that the “official proceeding,” in the very least, has to be foreseeable. Id.

Despite the apparent malfeasance of Anderson in the Enron collapse, the Supreme Court’s decision
Management, Sunbeam, the Baptist Foundation of Arizona, Global Crossing, Qwest Communications and, of course, Enron and WorldCom.\textsuperscript{297}

Were the events at these highly visible companies isolated instances or merely the tip of the iceberg? In this regard, it is illuminating to examine the pattern of restatements of income by companies subsequent to Sarbanes-Oxley. Between 2002 and 2006, the number of restatements rose from just over 300 to approximately 1400. See graph below:\textsuperscript{298}

(RE)STATING THE CASE

The rapid rise in filings by U.S. public companies

\begin{center}
\includegraphics{chart.jpg}
\end{center}

The number of "repeat filers" and companies reporting errors in multiple annual reports also rose.\textsuperscript{299} Thus, hundreds of companies have been responsible for the flawed information and inaccurate and misleading financial statements disseminated into the marketplace.

Even before the scandals were uncovered, the former chairman of the SEC, Arthur Levitt, stated that "we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion."\textsuperscript{300} He repeated the same theme about a dozen times.\textsuperscript{301} Consequently, the problem of

\begin{itemize}
\item to reverse and remand was sound. The jury instructions securing the conviction were a veritable distortion of the statutory text.
\item \textsuperscript{297} SUSAN E. SQUIRES, ET AL., INSIDE ARTHUR ANDERSEN: SHIFTING VALUES, UNEXPECTED CONSEQUENCES, 113-22 (Jim Boyd ed., Financial Times Prentice Hall 2003).
\item \textsuperscript{299} Id.
\end{itemize}
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earnings management should hardly have been a surprise to anyone paying attention.

In 2006, CFO Magazine reported that financial executives can use “allowable discretion” to boost or lower earnings by a few percentage points. The chart below illustrates the scope of “earnings management.”

The pressure on executives to meet earnings estimates is also well known. As former Chairman Levitt observed, “missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization.”

There is also no question that the so-called “gatekeepers,” whose responsibility it was to monitor corporate management, abysmally failed to meet their responsibilities and, in point of fact, were often participants in defrauding the market. As Professor Coffee, a widely respected expert in securities regulation, succinctly stated with respect to Enron:


303. Id.
304. See supra note 300.
None of the watchdogs that should have detected Enron's collapse—auditors, analysts or debt rating agencies—did so before the penultimate moment. This is the true common denominator in the Enron debacle: the collective failure of gatekeepers.\textsuperscript{306}

This past year we witnessed the trial of Conrad Black,\textsuperscript{307} who looted Hollinger International of hundreds of millions of dollars through phony covenants not to compete and other contrivances.\textsuperscript{308} Former Governor Thompson of Illinois\textsuperscript{309} was the chair of the Hollinger audit committee and the other members of the audit committee, as well as the board itself, deferred to Governor Thompson as the chair of the committee. Thompson stated that, when he reviewed corporate documents, he only “skimmed” them and acknowledged that his pre-audit committee meetings with corporate management were brief, and usually held over lunch or coffee. He acknowledged that he never asked for any analysis supporting the payments he approved.\textsuperscript{310} Surely, the Supreme Court did not expect that the board of directors would be a sufficient check on the fraud of corporate management!

It is unfathomable that the Supreme Court was not aware of the serious problem of misleading information being imported into the securities markets by unscrupulous persons.

B. The Unnecessary and Unwarranted Extension of Central Bank.

The action of the Supreme Court, in extending the boundaries of \textit{Central Bank}, was elective, unnecessary, and, for many innocent investors, a tragic event. The impact on the investing public is demonstrated by the stock chart below:\textsuperscript{311} When the fraud came to light, the bottom fell out of the stock-price.

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\textsuperscript{306} \textsc{Nancy B. Rapaport & Bala G. Dharan}, \textit{Enron: Corporate Fiascos and Their Implications} 131 (2004).

\textsuperscript{307} Lord Black was convicted of fraud and obstruction of justice, and sentenced to six and a half years in prison. \textit{Black Is Sentenced to 6 ½ Years in Prison}, \textsc{N.Y. Times}, Dec. 10, 2007.

\textsuperscript{308} Report of Investigation by the Special Committee of the Board of Directors of Hollinger International, Inc., Aug. 30, 2004, at 106, Table 3, available at http://everything2.com/title/Report%2520of%2520Investigation%2520by%2520the%2520Special%2520Committee%2520of%2520the%2520Board%2520of%2520Directors%2520of%2520Hollinger%2520International%2520Inc. [hereinafter Hollinger report].

\textsuperscript{309} After being governor, Mr. Thompson was a managing partner at the law firm of Winston Strawn in Chicago and a member of the 9/11 Commission. See Winston & Strawn, James R. Thompson bio, http://www.winston.com/index.cfm?contentID=24&itemID=10873.

\textsuperscript{310} Hollinger report, supra note 308, at 134.

Let us now examine why this decision was such a poor example of judicial craftsmanship, but an excellent example of outcome determinative type reasoning. At the outset, recall that, in Central Bank, the Supreme Court, on its own motion, determined that aiding and abetting liability did not exist under rule 10b-5, even though that was not the issue the parties had presented to the court.312 Moreover, all eleven courts of appeal that had considered the issue had recognized aiding and abetting liability.313 Finally, it was ludicrous for the Supreme Court to try to glean whether Congress “intended” to create aiding and abetting liability under rule 10b-5 when liability under the rule itself is not a legislative creation, but rather one by the judiciary.314

Nevertheless, even accepting the viability of Central Bank, Stoneridge is poor judicial craftsmanship. The court began in its analysis by focusing upon the language of section 10(b), the duty to disclose, and the necessity of reliance. First of all, it should be observed that the language of section 10(b)315 says nothing about a duty of disclosure, the source of such duty, or that only a person who makes a representation can be liable under this section. Rather, it forbids the use, in connection with the purchase or sale of any security, of “any

312. See supra text accompanying notes 144-45.
313. See supra text accompanying note 146.
314. See supra text accompanying notes 152-57.
315. Section 10(b) provides in pertinent part that it shall be unlawful to "use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (2000).
manipulative or deceptive device or contrivance” in violation of SEC rules. Thus, the statutory language is actually very broad.

However, the Stoneridge court relied upon the “limitation” in Santa Fe that “‘manipulative’ is a term of art.” While Santa Fe did use restrictive language in dealing with what constitutes manipulation, essentially the Santa Fe court declined to find a breach of fiduciary duty by those in control to be a violation of the securities laws when those in control had made full disclosure. The Santa Fe situation is a far cry from the Stoneridge situation in the case at bar, in which vendors schemed with management to inflate earnings which the vendors knew would be disclosed to the public. If this were not manipulative or deceptive conduct, it would be hard to contemplate what would be.

According to the Supreme Court, the Court of Appeals had concluded that only misstatements or omissions “by one who has a duty to disclose . . . are deceptive within the meaning of the rule.” The Supreme Court rejected the notion that “there must be a specific oral or written statement before there could be liability under section 10(b) or Rule 10b-5.” Rather, the court concluded that “[c]onduct itself can be deceptive” and then pointed out that “respondents’ course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.”

The court then examined another interpretation of the Court of Appeals opinion to the effect that “any deceptive statement or an act respondents made was not actionable because it did not have the requisite proximate relation to the investors harm.” On this point, the Supreme Court agreed with the Eighth Circuit since such a position “is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents.”

In rejecting the possibility of a presumption of reliance, the court stated: Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents’ actions except in an indirect chain that we find too remote for liability.

In effect, the court falls back on its misguided decision in Chiarella. As discussed earlier, the Chiarella court, in the context of insider trading,

316. See Santa Fe, 430 U.S. at 463-64 (deception, and not mere corporate mismanagement, is necessary for fraud under rule 10b-5).
317. Stoneridge, 128 S. Ct. at 769.
318. Id.
319. Id.
320. Id.
321. Id.
322. Id.
323. Id.
324. See supra text accompanying notes 75-84.
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required that there must be a common law fiduciary duty obligation in order to
give rise to a duty to disclose. In so doing, the court relied upon Cady, Roberts,
which held just the opposite.\footnote{See supra text accompanying notes 77-80.} It is nonsensical to constrain the application of
the securities laws by common law notions of “duty,” when the securities laws
were enacted because inadequacies in the scope of responsibility under the
common law.

It is also nonsensical, when dealing with secondary liability, to require that
the defrauded purchaser or seller relied upon a specific statement of the
defendant. If the purchaser or seller relied upon a specific representation of the
defendant, then the defendant would be primarily liable, not secondarily. This
was a fatal flaw in logic in the Central Bank reasoning, an error the Supreme
Court perpetuates by its holding in Stoneridge.

The Supreme Court phrased plaintiff’s argument as follows:
Liability is appropriate, petitioner contends, because respondents engaged in
conduct with the purpose and effect of creating a false appearance of material fact
to further a scheme to misrepresent Charter’s revenue. The argument is that the
financial statement Charter released to the public was a natural and expected
consequence of respondents’ deceptive acts; had respondents not assisted Charter,
Charter’s auditor would not have been fooled, and the financial statement would
have been a more accurate reflection of Charter’s financial condition. That causal
link is sufficient, petitioner argues, to apply Basic’s presumption of reliance to
respondents’ acts.\footnote{Stoneridge, 128 S. Ct. at 770.}

In dealing with this argument, the court observed that the “in connection
with” requirement and the “causation” requirement are related to each other.\footnote{Id. (emphasis added).}
This is obviously true. All would accept that rule 10b-5 does not cover all fraud—only fraud that is in connection with the purchase or sale of a security.
But the court concluded that “respondents’ deceptive acts, which were not
disclosed to the investing public, are too remote to satisfy the requirement of
reliance.”\footnote{Id.}

The rationale for this conclusion was that the petitioner had sought to
extend the reach of rule 10b-5 “beyond the securities markets—the realm of
financing business—to purchase and supply contracts—the realm of ordinary
business operations.”\footnote{See Blue Chip, 421 U.S. at 754-55 (requiring purchaser or seller status in order to have standing, based in part on speculation as to all the unwarranted lawsuits that might otherwise be brought). However, this was not the case in Blue Chips Stamps, where the plaintiffs who did not buy were a select group of persons to whom the defendants were ordered by court to make an offer. Id. The policy announced by the court was a sound one; unfortunately, it did not fit the facts of the case. This is}

\footnote{See supra text accompanying notes 77-80.}
The *Stoneridge* court was not dealing with an “ordinary business operation.” The respondents were acting in concert with Charter management to inflate Charter’s earnings, the necessary and proximate result of which would be to mislead investors in the marketplace. Rather than dealing with the factual situation before the court, the court instead justified its result by avoiding “a cause of action . . . to the world at large” or providing “a private cause of action against the entire marketplace in which the issuing company operates.” This is judicial legislation.

The court observed that petitioner had contended that, “in an efficient market investors relied not only upon the public statements relating to a security but also upon the transactions those statements reflect.” Once again, this is exactly the information upon which the market relies. Financial statements are not some abstraction, of value in and of themselves. Financial statements only have value to the extent they accurately reflect the underlying transactions.

But this truism was rejected by the court which stated that “[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business.” The court went on to observe that securities fraud “does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.” In its conclusion, the court added:

Here respondents were acting in concert with Charter in the ordinary course as suppliers and, as matters then evolved in the not so ordinary course, as customers. Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere.

It is only bias that can account for the refusal of the court to recognize that concerted action aimed at creating earnings does not bear an attenuated relationship to the price at which the stock trades and upon which the market relies, but rather such concerted action goes to the essence of the price at which the stock trades.

The mischief of the Republican-controlled 105th Congress, which gave us PLSRA, also played a part in the majority’s decision. After *Central Bank*, the Senate quickly held hearings on the case and the issue of aiding and abetting liability was considered over the next year. However, despite the efforts of Democrats, only the SEC, and not private parties, was authorized by PLSRA to bring a cause of action predicated upon aiding and abetting. The Supreme

judicial activism.

332. *Id.* at 770.
333. *Id.*
334. *Id.* at 771.
335. *Id.* at 774.
Court found such congressional action to be significant: “we give weight to Congress’ amendment to the Act restoring aiding and abetting liability in certain cases but not others. The amendment, in our view, supports the conclusion there is no liability.”

However, since the petitioner’s theory of scheme liability was based upon the respondents being primary violators, the legislation with respect to aiding and abetting liability is not applicable. As Justice Stevens observed in his dissent, “[t]hat Congress chose not to restore the aiding and abetting liability removed by Central Bank does not mean that Congress wanted to exempt from liability the broader range of conduct that today’s opinion excludes.”

In his dissent, Justice Stevens took the majority to task. He first criticized the majority’s failure to recognize that the facts and issues in Central Bank were fundamentally different than those raised in Stoneridge:

What the Court fails to recognize is that this case is critically different from Cent. Bank because the bank in that case did not engage in any deceptive act and, therefore, did not itself violate § 10(b). The Court sweeps aside any distinction, remarking that holding respondents liable would “reviv[e] the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud.” Ante, at 771. But the fact that Central Bank engaged in no deceptive conduct whatsoever-in other words, that it was at most an aider and abettor-sharply distinguishes Central Bank from cases that do involve allegations of such conduct.

Justice Stevens also sharply criticized the court’s view of reliance as “unduly stringent and unmoored from authority.” He noted that the restatement of torts provides that:

The maker of a fraudulent misrepresentation is subject to liability . . . if the misrepresentation, although not made directly to the other, is made to a third person and the maker intends or has reason to expect that its terms will be repeated or its substance communicated to the other.

Applying this to the facts in Stoneridge, he concluded that:

The sham transactions described in the complaint in this case had the same effect on Charter’s profit and loss statement as a false entry directly on its books that included $17 million of gross revenues that had not been received. And respondents are alleged to have known that the outcome of their fraudulent transactions would be communicated to investors.

Justice Stevens dissent concluded with the charge that the Court has engaged in a “continuing campaign to render the private cause of action under § 10(b) toothless.” He pointed out that, with respect to the Court’s current

337. Stoneridge, 128 S. Ct. at 772.
338. Id. at 778-79.
339. Id. at 775.
340. Id. at 777.
341. Id. (quoting RESTATEMENT (SECOND) OF TORTS §533, 72-73 (1977)).
342. Id.
343. Id. at 779.
view that implied causes of action are a "relic" of the Court's prior "heady
days," that such heady days persisted for 200 years: "Fashioning appropriate
remedies for the violation of rules of law designed to protect a class of citizens
was a routine business of judges." 344

It is clear that the majority opinion in Stoneridge was based upon "faulty
premise[s],"345 was "unduly stringent,"346 and was "unmoored from
authority."347 It is also clear that the decision destroyed a remedy for many
innocent investors who were left with stock that was basically worthless.

V. CONCLUSION: CONGRESS MUST ACT IF WE WANT MANAGEMENT AND
GATEKEEPERS TO UNDERSTAND THEIR OBLIGATION TO TELL THE TRUTH

With all the handwringing over securities litigation, why not go to the heart
of the matter and inquire why corporate management has so much difficulty
telling the truth?

There is a widespread belief in the business community that reform
legislation such as Sarbanes-Oxley is making management risk-averse: "[A]
 staggering 72% of responding directors in the Americas believe that the
regulations have made them too cautious; not taking unnecessary risks to drive
growth."348 Similarly, the CEO of an investment firm anticipated the following
effect on boards of directors: "We're going to have people who are much more
bureaucratic . . . and who are frightened and will react in always the most
conservative course and will rely on process dictated by lawyers rather than
good business judgment."349 This seems to be the concern of the Supreme
Court as well.

This is sheer nonsense. As developed earlier,350 the likelihood of a director
being sued for a breach of the duty of care, in which a director is protected, not
only by the business judgment rule, but also statutory provisions exculpating
duty of care liability, is highly remote. Directors are not sued for taking risks,
or for making poor operating business decisions. Rather they are sued when
they play Monopoly with the stock of their company or when they fail to

344. Id. at 779-80. Justice Stevens referenced Marbury v. Madison, 1 Cranch 137, 166, 2 L.Ed. 60
(1803), and stated: "While it is true that in the early days state law was the source of most of those rules,
throughout our history-until 1975-the same practice prevailed in federal courts with regard to federal
statutes that left questions of remedy open for judges to answer." Id. at 780.
345. Id. at 775.
346. Id. at 777.
347. Id.
at http://www.vnunet.com/accountancyage/news/2150885/sarbanes-story (analyzing a recent study by
Korn/Ferry Intl.).
349. John Berlau, A Tremendously Costly Law: Sarbanes-Oxley, three years after its unfortunate
passage, NAT'L REV., April 11, 2005 (quoting Alfred C. Eckert III, CEO of the GSC Partners
investment firm).
350. See supra text accompanying notes 59-70.
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provide honest information to the securities markets.

Rather than worrying about being sued because of Sarbanes-Oxley or rule 10b-5, directors should focus their energy toward ensuring that management has integrity and that honest disclosure is made when the company communicates to the public.

Consider some of the cases previously discussed. In Spectrum Brands, the company allegedly engaged in channel stuffing to accelerate sales recognition and hype the price of the stock. In Silicon Graphics, the company repeatedly made public pronouncements that everything was on target and that it would meet its 40% growth rate target, even though a disaster was unfolding.

In Tellabs, channel stuffing was again involved, as well as numerous reports that the product was being shipped when that was not in fact the case. The case essentially involved a series of positive and specific statements by the CEO of Tellabs, and the chairman of the board, with respect to two of Tellabs key products, the Titan 5500 and the Titan 6500. They reported the continuing growth of the 5500 and that the 6500 was ready to ship. In point of fact, according to the complaint, demand for the 5500 was precipitously declining and the 6500 was not yet being produced.

In Ivax Corp., the company issued a press release which, while acknowledging business problems, also was optimistic. Ivax stock rose. A month later, Ivax announced in another press release that it anticipated a $43 million loss. Five weeks later, Ivax announced a $179 million loss for the third quarter.

In Midway Games, the company issued press releases stating that its products “will produce record home video game results in 2002” and stated that revenue for the December quarter would grow to $105-155 million. The revenue came in $80 million and the price of the stock dropped from $15 to $2 a share.

Had the truth been told, these cases never would have been brought.

The theme of this article is that courts and legislatures, particularly Congress and the federal courts, led by the Supreme Court, have been complicit by creating an environment in which management is not called to account. Moreover, as a result of the Central Bank decision, which eliminated aiding and abetting liability, the gatekeepers have fallen asleep as well.

351. See supra, text accompanying notes 188-94.
352. See supra text accompanying notes 196-218.
353. See supra text accompanying notes 221-235.
355. See supra text accompanying notes 257-267.
356. See supra text accompanying notes 268-285.
357. See supra text accompanying notes 142-169.
Central Bank did, however, leave open a window. At the conclusion of its opinion, the court stated:

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.\(^{358}\)

Relying upon this qualification, the District Court in the Enron case\(^{359}\) found that attorneys and others who participated in the drafting of misleading documents could be held liable as a creator or maker of the misstatements, even though they did not sign the statements and were not otherwise identified in the communication of the statements to the public. However, the court did not hold liable attorneys for the special purpose entities who, arguably, participated in the fraud but did not make a statement.\(^{360}\)

The plaintiffs in Stoneridge also hoped to take advantage of this open window by charging vendors who conspired with the issuer to inflate the earnings of the company with primary liability as participants in a common scheme. But any hope that the general trend toward protecting wrongdoers at the expense of public shareholders would be reversed was dissipated when the Supreme Court announced its decision in Stoneridge. While the Supreme Court acknowledged that the conduct of defendants was clearly fraudulent, the court once again exculpated conduct that ought to shock our collective consciences.

Because of the entrenched conservative philosophy in the federal courts, it will take years to reverse the protectionist attitude of federal judges toward management and the courts’ disregard of investor interests. One modest way to begin the process of restoring integrity to the securities markets, shake up management, and wake up gatekeepers would be for the new Congress to reinstate aiding and abetting liability in private actions. This is an action that Democrats had previously favored.

But this will not stem the actions of the federal courts in protecting management itself. The only effective way to do this would be to repeal the provision in PLSRA that precludes discovery until after a motion to dismiss is decided. So long as courts persist in taking an extreme view of what constitutes particularity, the only effective way that Congress can reverse this uncalled for approach is to provide plaintiffs with the opportunity to obtain the requisite


\(^{359}\) In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 610 (S.D. Tex. 2002). One of the earliest commentaries on this case is Charles W. Murdock, The Attorney as 'Creator' or 'Author': Attorney Liability Under Enron, CHI. BAR REC., Apr. 2003, at 34.

\(^{360}\) In re Enron, 235 F. Supp. 2d at 706.
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distinguishability through the discovery process.
APPENDIX I


Majority by: Alito, Joined by: Roberts, Kennedy
Concurrence by: Kennedy
Concurrence by: Scalia, Joined by: Thomas
Dissent by: Souter, Joined by: Stevens, Ginsburg, Breyer

**Majority opinion by Chief Justice Alito:**
The majority in *Hein* gives us a glimpse of the Court’s view on stare decisis near the end of its opinion, “[i]t is a necessary concomitant of the doctrine of stare decisis that a precedent is not always expanded to the limit of its logic. That. . . is the approach we take here. We do not extend *Flast*, but we also do not overrule it. We leave *Flast* as we found it.” *Id.* at 2571-72.

**Concurring opinion by Justice Scalia joined by Thomas:**
Justice Scalia concurs with the majority but shows less deference to precedent:

Either *Flast v. Cohen*, 392 U. S. 83 (1968), should be applied to (at a minimum) all challenges to the governmental expenditure of general tax revenues in a manner alleged to violate a constitutional provision specifically limiting the taxing and spending power, or *Flast* should be repudiated. For me, the choice is easy. *Flast* is wholly irreconcilable with the Article III restrictions on federal-court jurisdiction that this Court has repeatedly confirmed are embodied in the doctrine of standing.” *Id.* at 2573-74.

. . . .

We had an opportunity today to erase this blot on our jurisprudence [*Flast*], but instead have simply smudged it.” *Id.* at 2584.

**Dissenting opinion by Justice Souter joined by Stevens, Ginsberg and Breyer:**
The united dissenters take exception with the majority’s analysis and application, or lack there of, of stare decisis:

[The majority] declares that *Flast* does not apply, but a search of that opinion for a suggestion that these taxpayers have any less stake in the outcome than the taxpayers in *Flast* will come up empty: the plurality makes no such finding, nor could it. Instead, the controlling opinion closes the door on these taxpayers because the Executive Branch, and not the Legislative Branch, caused their injury. I see no basis for this distinction in either logic or precedent, and respectfully dissent.

. . . .

[T]here is no dispute that taxpayer money in identifiable amounts is funding conferences, and these are alleged to have the purpose of promoting religion. Cf. *Doremus v. Board of Ed. of Hawthorne*, 342 U. S. 429, 434 (1952). The taxpayers therefore seek not to "extend" *Flast* . . . but merely to apply it.” *Id.* at 2584-85.

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Majority by: Roberts (Parts I, II, III-A, III-C), Joined by: Scalia, Kennedy, Thomas, Alito
Plurality by: Roberts (III-B, IV), Joined by: Scalia, Thomas, Alito
Concurrence by: Thomas
Concurrence by: Kennedy
Dissent by: Stevens
Dissent by: Breyer, Joined by: Stevens, Souter, Ginsburg

Plurality opinion by Chief Justice Roberts joined by Scalia, Thomas and Alito:
Roberts reverses the holding of the Appellate courts by limiting the scope of Grutter to higher-education only:
The Court in Grutter expressly articulated key limitations on its holding-defining a specific type of broad-based diversity and noting the unique context of higher education-but these limitations were largely disregarded by the lower courts in extending Grutter to uphold race-based assignments in elementary and secondary schools. The present cases are not governed by Grutter.
Id. at 2754.

Dissenting opinion by Justice Stevens:
Justice Stevens dissents accusing the plurality of failing to follow appropriate Supreme Court precedent including Brown v. Bd. of Educ.: The Court has changed significantly since it decided Sch. Comm. of Boston in 1968. It was then more faithful to Brown and more respectful of our precedent than it is today. It is my firm conviction that no Member of the Court that I joined in 1975 would have agreed with today’s decision.
Id. at 2800.

Dissenting opinion by Justice Breyer joined by Stevens, Souter and Ginsberg:
In the principal dissenting opinion Justice Breyer challenges the Courts holding, questions the soundness of its reasoning and warns of the impact that the decision can have focusing on the use of precedent:
Indeed, the consequences of the approach the Court takes today are serious. Yesterday, the plans under review were lawful. Today, they are not. Yesterday, the citizens of this Nation could look for guidance to this Court’s unanimous pronouncements concerning desegregation. Today, they cannot. Yesterday, school boards had available to them a full range of means to combat segregated schools. Today, they do not.

The Court’s decision undermines other basic institutional principles as well. What has happened to stare decisis? The history of the plans before us, their educational importance, their highly limited use of race-all these and more-make clear that the compelling interest here is stronger than in Grutter. The plans here are more narrowly tailored than the law school admissions program there at issue. Hence, applying Grutter’s strict test, their lawfulness follows a fortiori. To hold to the contrary is to transform that test from “strict” to “fatal in fact”-the very opposite of what Grutter said. And what has happened to Swann? To McDaniel? To Crawford? To Harris? To School Committee of Boston? To Seattle School Dist. No. 1? After
decades of vibrant life, they would all, under the plurality’s logic, be written out of the law.

... And what of law’s concern to diminish and peacefully settle conflict among the Nation’s people? Instead of accommodating different good-faith visions of our country and our Constitution, today’s holding upsets settled expectations, creates legal uncertainty, and threatens to produce considerable further litigation, aggravating race-related conflict.

... Finally, what of the hope and promise of Brown? ... Today, almost 50 years later, attitudes toward race in this Nation have changed dramatically. Many parents, white and black alike, want their children to attend schools with children of different races. Indeed, the very school districts that once spurned integration now strive for it. The long history of their efforts reveals the complexities and difficulties they have faced. And in light of those challenges, they have asked us not to take from their hands the instruments they have used to rid their schools of racial segregation, instruments that they believe are needed to overcome the problems of cities divided by race and poverty. The plurality would decline their modest request.

The plurality is wrong to do so. The last half-century has witnessed great strides toward racial equality, but we have not yet realized the promise of Brown. To invalidate the plans under review is to threaten the promise of Brown. The plurality’s position, I fear, would break that promise. This is a decision that the Court and the Nation will come to regret.

I must dissent.

Id. at 2835-37.


Majority by: Roberts (Parts I and II), Joined by: Scalia, Kennedy, Thomas, Alito

Concurrence by: Scalia, Joined by: Kennedy, Thomas

Dissent by: Souter, Joined by: Stevens, Ginsburg, Breyer

The Court in Fed. Election Comm’n v. Wisc. Right to Life, Inc. found it unconstitutional to ban campaign “issue ads” through Section 203 of the Bipartisan Campaign Reform Act of 2002 (BCRA), despite a previous ruling in McConnell v. Fed. Election Comm’n, where the Court upheld § 203 against a First Amendment facial challenge.

Majority by Roberts, Joined by Alito:
Justice Robert’s opinion deals carefully with the McConnell precedent distinguishing the facts and limiting its effect:

When the McConnell Court considered the possible facial overbreadth of § 203, it looked to the studies in the record analyzing ads broadcast during the blackout periods, and those studies had classified the ads in terms of intent and effect. The Court’s assessment was accordingly phrased in the same terms, which the Court regarded as sufficient to conclude, on the record before it, that the plaintiffs had not “carried their heavy burden of proving” that § 203 was facially overbroad and could
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not be enforced in any circumstances. 540 U.S., at 207. The Court did not explain that it was adopting a particular test for determining what constituted the “functional equivalent” of express advocacy. The fact that the student coders who helped develop the evidentiary record before the Court in *McConnell* looked to intent and effect in doing so, and that the Court dealt with the record on that basis in deciding the facial overbreadth claim, neither compels nor warrants accepting that same standard as the constitutional test for separating, in an as-applied challenge, political speech protected under the First Amendment from that which may be banned.  

*Id.* at 2665.

Justice Roberts finds support in a prior Supreme Court case, *Buckley v. Valeo,* which rejected the test that *McConnell* appeared to establish and is relied upon by the Federal Election Commission, “[m]ore importantly, *Buckley v. Valeo,* rejected an intent-and-effect test for distinguishing between discussions of issues and candidates, and *McConnell* did not purport to overrule *Buckley* on this point-or even address what *Buckley* had to say on the subject.  

*Id.* at 2655.

**Scalia, joined by Kennedy and Thomas concurring in part and in judgment:**

Justice Scalia joins in the Court’s judgment, but indicates that he would simply overrule *McConnell,* “We could render the regime workable only by effectively overruling *McConnell* without saying so-adopting a clear as-applied rule protective of speech in the “heartland” of what Congress prohibited.” *Id.* at 2685.

On the matter of stare decisis, Justice Scalia writes, ““*stare decisis* is not an inexorable command or a mechanical formula of adherence to the latest decision. It is instead ‘a principle of policy,’” and this Court has a “considered practice” not to apply that principle of policy “as rigidly in constitutional as in nonconstitutional cases.” *Id.* at 2684 (quoting *Payne v. Tennessee,* 501 U.S. 808, 828 (1991)).

**Souter, joined by Stevens, Ginsberg, and Breyer Dissenting:**

In a dissenting opinion, four justices express their dissatisfaction with the majority’s decision and treatment of the *McConnell* precedent:

The significance and effect of today’s judgment, from which I respectfully dissent, turn on three things: the demand for campaign money in huge amounts from large contributors, whose power has produced a cynical electorate; the congressional recognition of the ensuing threat to democratic integrity as reflected in a century of legislation restricting the electoral leverage of concentrations of money in corporate and union treasuries; and *McConnell v. Federal Election Comm’n,* 540 U.S. 93, 491 (2003), declaring the facial validity of the most recent Act of Congress in that tradition, a decision that is effectively, and unjustifiably, overruled today.  

*Id.* at 2687.