BASIC AT TWENTY: RETHINKING FRAUD ON THE MARKET

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In the twenty years since the Supreme Court of the United States' decision in *Basic Inc. v. Levinson*, lower court decisions have insisted on proof of market efficiency, materiality, and loss causation more stringent than the Court's presumption of reliance seemingly requires. This Paper looks closely at *Basic*'s own hesitancy about how and why the presumption is justified, and the doctrinal revisionism that has since occurred. In many ways, this revisionism resurrects the conservative thinking that once strongly influenced fraud-on-the-market theory. The irony is that that thinking counseled ignoring reliance as an issue, not building an entire analytical structure around it, and confusion abounds as a result. I offer an interpretation of *Basic* that would have sent the case law in a more sensible, investor-friendly direction. I also reconnect the Court's seemingly separate holding on assessing materiality to its presumption of reliance, showing how discomfort with the indeterminacy of issues like materiality and duty to disclose has also played a role in the erosion of the presumption.

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INTRODUCTION

The decision of the Supreme Court of the United States in *Basic Inc. v. Levinson*[1] is now twenty years old, and under a great deal of stress. In the context of Securities and Exchange Commission (SEC) Rule 10b-5 class-action lawsuit alleging that Basic had falsely denied that it was engaged in merger negotiations with Combustion Engineering before publicly announcing a deal in December 1978, the Court addressed two issues central to private securities litigation: first, the proper standard for determining the materiality of preliminary merger negotiations and similarly uncertain information; second, whether the reliance of open-market sellers on the misinformation could be presumed, thereby making common issues predominate among the victims so as to make class certification justifiable. Tens of billions of dollars have changed hands in settlements of 10b-5 lawsuits in the last twenty years as a result of *Basic*.

The materiality holding, on which the Court was unanimous, rejected an effort by some courts of appeals to draw restrictive bright lines as to what is material or not based on policy-driven factors such as businesses' need for predictability or the desire to protect corporate secrets.[2] *Basic* stands for the proposition that materiality is about what is important to investors, nothing more and nothing less, and offers a way (the so-called probability-magnitude test) for estimating when speculative information is sufficiently important or not.[3] That fact-specific, ex post emphasis on assessing importance to the reasonable investor has been followed faithfully by the lower courts, though critics still carp at its indeterminacy.[4]

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1. 485 U.S. 224 (1988). For more on *Basic* and its facts, see Donald C. Langevoort, *Investor Protection and the Perils of Corporate Publicity*: Basic Inc. v. Levinson, *in* THE ICONIC CASES IN CORPORATE LAW 257 (Jonathan R. Macey ed., 2008).

2. *See, e.g.*, *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756–57 (3d Cir. 1984).

3. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 590–92 (5th ed. 2006).

4. The recent "Paulson Committee" report calls for clarifying the definition of *materiality* to enhance U.S. competitiveness in the global capital markets. *See* COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 80–81 (Nov. 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. For discussions of the indeterminacy problem, see Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131 (2003); Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317 (2007).

The "presumption of reliance" holding—a 4-2 decision—was both more profound and more enigmatic. By the mid-1980s, all courts of appeals that had considered the question had invoked some kind of reliance presumption in order to make fraud-on-the-market class-action lawsuits certifiable.[5] In that sense, the Supreme Court simply endorsed what was by then a solid line of precedent. But business groups had joined with the defendants in a vigorous effort to make the Court see a burgeoning threat of private securities litigation that could be stopped in its tracks by rejecting the presumption.[6] The majority refused, and so kept the courtroom door wide open for investor lawsuits alleging open-market frauds. Soon after *Basic*, the number of such suits rose dramatically,[7] adding fuel to the political firestorm of securities class-action lawsuits and eventually leading Congress to enter the field with the Private Securities Litigation Reform Act of 1995 (PSLRA). Though urged to do so by politicians and lobbyists pushing an aggressive reform package,[8] Congress did not undo *Basic*'s presumption, and so the holding lives on today.

Yet Justice Harry Blackmun's majority opinion is deeply puzzling in a number of key respects, which has prompted lower courts to reinterpret it fairly freely and cut back severely on its plaintiff-friendly approach in many different ways. Predictably enough, whatever *Basic*'s original intent was has been lost to time.[9] My Paper explores

5. *See* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 440–41 (1984). The seminal case prior to *Basic* was the United States Court of Appeals for the Ninth Circuit's decision in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975).

6. *See, e.g.*, Brief for the American Corporate Counsel Association as Amicus Curiae in Support of Petitioners, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279); Brief Amici Curiae of Arthur Andersen & Co. et al. in Support of Petitioners, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279).

7. *See infra* text accompanying note 125.

8. The initial bill introduced by then-Congressman Christopher Cox, H.R. 10, would have undone *Basic*. *See Litigation Reform Proposals Hearing Before the Subcomm. on Telecommunications and Finance of the Comm. on Commerce*, 105th Cong. (1995) (statement of Arthur Levitt, Chairman, Securities and Exchange Commission) (opposing that provision, which was later deleted), *available at* www.sec.gov/testimony/1995/spch025.txt; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 664–65 (3d ed. 2003).

9. Private correspondence between Justice Blackmun and Justice Brennan while the *Basic* opinion was being drafted sheds some light on what they were thinking; *Basic*'s confusion is in part a product of trying to join the two justices' conflicting ideas while trying to hold onto the vote of Justice Stevens, who worried about issues of loss causation and damages. *See* Memoranda from Justice Brennan to Justice Blackmun, Jan. 14, 15, 22, 27, 1988 (on file with author). This correspondence is excerpted in STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 324–25 (2005), and I am grateful to Professor Pritchard for bringing it to my attention. For a critique of *Basic* that invokes this correspondence, see A.C. Pritchard,

the nature and cause of this revisionism by looking closely at three recent courts of appeals decisions that read *Basic* in interesting, sometimes jarring ways. Because it focuses so much on these three cases, my effort is not to try to explain what the law is currently; indeed, two of these three decisions can fairly be described as controversial, and have not been followed by other courts. The law is confused, and in flux. What makes these cases worth dwelling on is that they are beacon-like markers of the dramatic doctrinal and intellectual shift that has occurred. Through them, I want to trace the transformation of the idea (or ideas) embedded in *Basic* into something seemingly so very different twenty years later.

Part I revisits *Basic*'s presumption of reliance, its underlying analytical confusion, and the questions it left open. My claim here is that, at least partly at the urging of the SEC and Solicitor General in the government's amicus brief, the Court chose to use a conservative, law-and-economics-based tool, market efficiency, to build what it thought was a plaintiff-friendly presumption of reliance. It failed to notice, however, that the conservatives' instruction manual advised that reliance was a trivial issue and that all the important effort was elsewhere: using financial economics to demand far greater—and by no means plaintiff-friendly—rigor on questions of materiality and causation. Given the majority's instinct that plaintiffs should be entitled to rely on the integrity of the market price as undistorted by fraud, the tool turned out to be both unnecessary and dangerous. The revisionism that has followed over the last twenty years is essentially an effort to rebuild the analytical structure for fraud-on-the-market cases as per the instruction manual, rather than staying close to the Court's basic instinct.

Part II turns to this revisionism. Section A addresses how courts measure market efficiency as part of assessing the presumption of reliance, exemplified by *In re PolyMedica Corp. Securities Litigation.*[10] Section B examines the stringent methodology employed once efficiency is assumed, as illustrated by *In re Merck & Co. Securities Litigation.*[11]

Part III then deals with what plaintiffs must demonstrate besides efficiency to gain the presumption of reliance and show that common issues predominate. How much of the merits of plaintiffs' case, on such questions as whether the alleged misrepresentation or omission actually distorted the market price or produced the loss, needs to be resolved as

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Stoneridge Investment Partners v. Scientific Atlanta*: The Political Economy of Securities Class Action Reform*, 2008 CATO S. CT. REV. 217, 221–22.

10. 432 F.3d 1 (1st Cir. 2005).

11. 432 F.3d 261 (3d Cir. 2005).

part of the class-certification decision? The most striking case here is *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[12] In addressing this, I also compare *Basic* with the Supreme Court's 2005 decision in *Dura Pharmaceuticals, Inc. v. Broudo*,[13] which was about pleading and proving loss causation, but which *Oscar* turns into a class-certification issue. The conceptual and methodological contrast between *Dura* and *Basic* bears noting. I am not the first to say this,[14] but understanding cases like *Oscar* requires that we take a harder look at *Basic*'s choices twenty years ago to see exactly how and why.

Finally, Part IV reconnects *Basic*'s supposedly separate holdings on reliance and materiality. Shortly after *Basic*, the political debate over the legitimacy of private securities litigation turned mainly to the question of whether too many fraud-on-the-market lawsuits were vexatious, strike suits brought simply for their settlement value. As the noted securities law scholar Joel Seligman pointed out at the time[15] and subsequent research seems to have confirmed,[16] there probably is a stronger correlation between the merits and both the filing and settlement of these actions than critics have claimed. In all likelihood, the problem of uncertainty in plaintiffs' grounds for filing relates more to informational asymmetry (i.e., that the circumstances surrounding what was said and why are hidden from investors and their advocates) than lawyer opportunism, making circumstantial reckoning inevitable prior to discovery. Like it or not, this is largely what the PSLRA addressed.[17]

Even if we agree that a large percentage of fraud-on-the-market suits are based on at least plausible suspicions rather than imaginary factual claims, however, there is another cause for concern: the possibility that issuer damage liability may be disproportionate to the underlying conduct, particularly in a setting in which liability standards are severely indeterminate.[18] The presumption of reliance substantially

12. 487 F.3d 261 (5th Cir. 2007).

13. 544 U.S. 336 (2005).

14. *See, e.g.*, Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 153 (2006).

15. Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplifying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 444–49 (1994).

16. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004). Of course some of this is presumably due to the PSLRA. Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J. L. ECON. & ORG. 627 (2007).

17. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

18. For a very perceptive but infrequently cited article saying this about *Basic*, see Dennis S. Karjala, *A Coherent Approach to Misleading Corporate Announcements, Fraud, and Rule 10b-5*, 52 ALB. L. REV. 957, 967 (1989).

expands, if not creates, what is often staggering dollar exposure for the issuer and its shareholders, which is acceptable only if we believe that the merits of the case warrant that level of liability to a particular class of investors in addition to the expenses of litigation.

My final aim in this Paper is to take a fresh look at *Basic*'s materiality holding, which—though amply justifiable as a resolution to the narrow question posed to the Court—obscures a joint risk of indeterminacy and disproportionality, creating doubts about its fairness and efficacy as a compensatory mechanism. My sense is that the demonstrable judicial discomfort with class certification in recent years is driven more by these doubts than lingering concerns about vexatiousness (on which, after all, Congress spoke forcefully in 1995). There may be no easy solutions, but assessing *Basic* at age twenty depends at least on seeing the connection.

I. REVISITING *BASIC*

Some facts about *Basic* might be surprising to the contemporary reader. First, we tend to think of the case as dealing with whether companies have the freedom to hide preliminary merger negotiations from public scrutiny in order to make them more likely to come to fruition. That is certainly how academic commentators have viewed it, and a lively debate ensued as to whether and when securities law should permit issuers to lie in order to serve their shareholders.[19] But nowhere in the litigation was this confidentiality interest ever raised by Basic's lawyers. To the contrary, Basic said that it never lied in the first place and had nothing it wanted or needed to conceal. The district judge agreed after a thorough review of the record developed during extensive discovery. Finding that Basic was not at the time engaged in any merger negotiations as that term could reasonably be understood, he granted summary judgment for the defendants.[20]

Second, the defendants had a horrifying run of bad luck on appeal. The United States Court of Appeals for the Sixth Circuit's recitation of the facts was a nightmare for Basic, ignoring without explanation the

19. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market-Theory*, 42 STAN. L. REV. 1059, 1069–70 (1990) (explaining that the lie was an effort to protect Combustion's investment in identifying Basic as a good acquisition candidate). This debate in the law reviews is about whether and when lying to investors should be permitted because some lies, at least, can increase or protect shareholder value. *See* Ian Ayres, *Back to* Basic*s: Regulating How Corporations Speak to the Market*, 77 Va. L. REV. 945 (1991); Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750 (1992).

20. *Levinson v. Basic Inc.*, No. C79-1220, 1984 WL 1152 (N.D. Ohio Aug. 3, 1984).

district court judge's reasons for finding that there had been no lie at all, much less a material lie. Crediting what was in the plaintiffs' complaint (as opposed to the factual record), it summarily reversed the district court.[21] And when the case went up to the Supreme Court, the line-up of justices was remarkably skewed. Justice Lewis Powell—the Court's long-time corporate-securities-law specialist, for whom arguments stressing predictability and proportionality in business litigation were tailor-made[22]—retired just a few months after certiorari was granted, and his successor, Justice Anthony Kennedy, was not sworn in until a few months after the oral argument. Two other key conservatives, Chief Justice William Rehnquist and Justice Antonin Scalia, recused themselves. *Basic* was decided by only six, mostly liberal, justices.

Finally, the *Basic* opinion was for all practical purposes drafted by the SEC and the Office of the Solicitor General. Most all of the key arguments, analyses, quotes and citations that one finds in the Court's holdings on both materiality and reliance come directly out of the amicus curiae brief filed on behalf of the SEC.[23] The fact that the government intervened on behalf of the plaintiffs on both these issues is important: after all, this was late in the Reagan years and the business community would have had natural allies inside the SEC and the Department of Justice to press the government to come in on the other side, or at least stay on the sidelines.

The key move on the reliance issue comes at the outset, when Justice Blackmun's majority opinion insists that reliance is an essential element of a cause of action under rule 10b-5.[24] That was not inevitable: the Court could have said that causation was the only requirement, with reliance as one (but not necessarily the only) way of demonstrating a causal link between the lie and harm to the plaintiff. Had the Court taken this route, the rest of the opinion would have been fairly simple and straightforward. This appears to be how Justice William Brennan wanted the opinion to read.[25] But Blackmun

21. *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986).

22. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr. and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841 (2003); E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571, 1573 (2004) (noting that Justice Powell was influential in determining which securities-law cases were taken and how they came out). Powell voted to grant certiorari in *Basic*, though only on the materiality issue. *See* Pritchard, *supra*, at 897 n.343.

23. *See* Brief for the Securities and Exchange Commission as Amicus Curiae, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279).

24. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

25. Correspondence between the two justices shows that Justice Brennan wanted a conception of the "price" theory of reliance that would allow recovery simply

disagreed, perhaps because this was now a time (a decade after cases like *Ernst & Ernst v. Hochfelder*[26] and *Santa Fe Industries, Inc. v. Green*[27]) by which rule 10b-5's roots in the common law of deceit were fairly deep, and fraud orthodoxy demands proof of reliance. Once the majority kept reliance as an essential element for each claimant, however, it had to explain how the typical investor relies on a corporate misrepresentation or omission and why that kind of reliance is so pervasive that it can be deemed "common" among all purchasers or sellers of issuer securities during the time in question so as to justify class certification.

Basic cannot be understood except by appreciating that the Court's response is far more a lesson in civil procedure than financial economics.[28] Starting with its references to classic texts like Louisell & Muller's *Federal Evidence* and *McCormick on Evidence*, the first part of the opinion is an essay on the law of presumptions, how and when they are justified. The analysis is pragmatic: presumptions make judges' work manageable, are useful responses to uncertainty, and help pursue sound public policy. We do not always need to know for sure, at least at pretrial stages of a lawsuit; an educated guess will do, especially when it assists parties (here, investors) favored within the statutory regime.[29] Though largely ignored in subsequent case law, this is probably the pivotal point in the entire opinion.[30]

So how does the Court justify a presumption of reliance? Certainly not by presuming that all investors actually read, heard or were otherwise aware of the alleged misrepresentation; that would be wildly unrealistic even under the most liberal justification for a presumption. A tempting solution was to borrow from the efficient-market hypothesis—an intellectual innovation that was profoundly influencing scholarship in both law and economics in the mid-1980s, and beginning to affect policy making as well[31]—and presume that investors consider

because the trader had to accept a price distorted by fraud. *See* Memoranda from Justice Brennan to Justice Blackmun, *supra* note 9. Justice Blackmun, by contrast, was insistent on some kind of reliance on market integrity. *Id.*

26. 425 U.S. 185, 214–15 (1976) (requiring scienter in rule 10b-5 cases).

27. 430 U.S. 462 (1977) (requiring deception in rule 10b-5 cases).

28. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 892 (1992).

29. The majority was substantially aided by two earlier Supreme Court decisions that had used presumptions of reliance to obviate the need for difficult factual determinations in other private contexts. *See Basic*, 485 U.S. at 243 (citing *Mills v. Electric Auto-Lite*, 396 U.S. 375 (1970); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1972)).

30. One recent case has so noted. *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 482–84 (2d Cir. 2008).

31. *See* Langevoort, *supra* note 28, at 854–55.

stocks accurately priced, so that there is no sense in spending time and money trying to outguess the market. That would be a good reason for any given investor not to read Form 10-Ks or do other research: for investors so inclined, and there are many, this presumption might make a great deal of sense. There are strong hints of this in the opinion, as when the majority refers to the market "as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is *worth* the market price."[32]

That vision of efficiency is how many courts and commentators have since come to understand *Basic*'s presumption.[33] But if so, it is hardly much more realistic than the first way of thinking about reliance. For all the passive index investors, there are millions of others who fervently believe in their (or their broker's or adviser's) ability to beat the market—billions of dollars are certainly spent trying.[34] If passivity is the basis for the presumption of reliance in an effort to find that common issues predominate, it is a hopeless fiction. The decision would then rest on very fragile grounds as a matter of civil procedure because there really is no such commonality to reliance. More troubling, and crucial to what follows, the class of investors invited to seek recovery, and thus the amount of recovery, would be grossly inflated.[35]

Midway through his discussion of presuming reliance, however, Justice Blackmun suggests a different and much more capacious idea: that investors rely not so much on the accuracy of the stock price as its "integrity."[36] In other words, most all investors implicitly assume that the stock price has not been distorted by fraud. Even if they are hunting bargains and trying to outguess the market, they are using the current market price as an unbiased reference point to decide whether to buy, sell, sell short, engage in options trading, etc. Put more concretely, a seller of Basic Inc. stock may well have been assuming that the company had not misled the market even in the course of deciding that

32. *Basic*, 485 U.S. at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)) (emphasis added).

33. *E.g.*, *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 77 (2d Cir. 2004) (stating that *Basic*'s efficiency theory is a rebuttable presumption that "investors rely on the market price as an accurate measure of their intrinsic value").

34. *See, e.g.*, Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611 (1995).

35. *See* Langevoort, *supra* note 28, at 895–96. Other articles on *Basic* have also noted this muddle. *See, e.g.*, Barbara Black, *The Strange Case of Fraud on the Market: A Label in Search of a Theory*, 52 ALB. L. REV. 923 (1988); Nicholas L. Georgakopoulos, *Fraud, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671 (1995).

36. *Basic*, 485 U.S. at 246–47.

the market had overvalued Basic's stock, so that it was a good time to sell. This version of the reliance story is what likely prompted the Court, for example, to make its often-quoted gambling reference—"Who would knowingly roll the dice in a crooked crap game?"[37]

This would more plausibly justify a class-wide presumption of reliance and, hence, is a better reading of *Basic*.[38] But it, too, is problematic because no reasonable investor would ever make such an assumption. Fraud and manipulation are predictable enough that it would be foolish for anyone simply to *assume* that a stock price has integrity.[39] In an efficient market, the inevitable risk of fraud is priced and investors are compensated for taking on the risk—the market is not assuming its absence.

This soft spot can easily be filled, however, by making the presumption of reliance a normative exercise, not a descriptive one. That is to say, the presumption may not be a description of commonplace reliance, but rather a declaration that investors *should* be able to rely on stock-price integrity. Under this reading, *Basic* creates an entitlement for investors to rely on stock-price integrity because that is consonant with congressional intent behind the securities laws,[40] and then presumes that actual reliance reasonably follows the entitlement.[41] This relates back to the view expressed earlier in the opinion on why

37. *Id.* (quoting *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

38. The correspondence between Justices Blackmun and Brennan shows that they were well aware of the likelihood that many investors buy or sell because they think the price is wrongly valued. *See* Memoranda from Justice Brennan to Justice Blackmun, *supra* note 9. Nothing in the correspondence suggests that such an investor is not entitled to the presumption of reliance. *See id.*

39. Of course reasonable investors do assess the credibility of management in making decisions and an investor's willingness to rely no doubt varies from issuer to issuer depending on its reputation for candor. The stock-price drop that ensues upon discovery of fraud is partly the product of learning the truth about the company's situation and partly the product of loss of credibility.

40. *See Basic*, 485 U.S. at 245–46 (citing H.R. REP. No. 73-1383, at 11 (1934)). For a recent endorsement of this approach to fraud-on-the-market litigation, see Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 771–80 (2006).

41. A very clear statement of this is in *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), where the court stated, "The theory . . . actually facilitates Congress's intent . . . by *enabling* a purchaser to rely on an expectation that the securities markets are free from fraud." *Id.* at 748 (emphasis added). This explanation from *Lipton* is cited in *Basic* (with the specific page reference) but not quoted. *Basic*, 485 U.S. at 246. It was quoted in the SEC's amicus brief, which presumably led to the citation. *See* Brief for the Securities and Exchange Commission as Amicus Curiae, *supra* note 23, at *47. The correspondence between Justice Blackmun and Justice Brennan suggests that this was Brennan's preferred approach. *See* Memoranda from Justice Brennan to Justice Blackmun, *supra* note 9.

presumptions are justified, and is hardly a radical move: the common law of fraud is the judicial creation of an entitlement to rely on representations of fact by strangers whether or not there is any reason to trust them, because doing so facilitates economic exchange.[42] It is an act of juristic grace. But Justice Blackmun never articulates this explicitly, perhaps because such policy-making style of justification dates from an earlier interpretive era rather than the more contemporary strict constructionism, where the Court is supposed to be following the legislative word, as opposed to promoting the legislative philosophy. Whether or not it is what he was thinking, this really is the only persuasive, coherent interpretation of *Basic*'s presumption.

The way the majority opinion is written, however, leaves us thoroughly confused as to the "common" reliance on which the presumption is based. Justice Blackmun then compounds the confusion by making so much of market efficiency. The references to stock-price integrity come in the midst of a discussion of efficiency, so there must be some connection intended (as it was in the SEC's amicus brief from which the "crooked crap game" quote comes). But market efficiency is a hypothesis about one or both of two things: the fundamental rationality of market valuation, and the speed of adjustment to new information. The latter (informational efficiency) is what finance studies had largely shown, that is, that stock prices react very quickly to new information and show no bias or drift thereafter. To be sure, if prices adjust rapidly to impound new information, then fraud will quickly distort prices if market professionals are deceived. So market efficiency could be a sufficient reason why an investor relying on market-price integrity would be harmed.

But market efficiency is not a necessary reason because fraud can and does distort prevailing prices even when adjustment is delayed or incomplete. All we need is reason to believe that there is *some* causal linkage between the misrepresentation and prevailing prices that investors are using as reference points for their trading decisions.[43] That is hardly a rigorous standard and could be justified without any reference to sophisticated financial economics. In a footnote, the opinion says precisely this: "For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about

42. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007). The point, of course, is that transactional efficiency is enhanced by creating a right to rely on the factual representations of the maker in the absence of affirmative reasons, rather than force the other party to investigate its accuracy.

43. *See* Goshen & Parchomovsky, *supra* note 40, at 768–70; Jonathan R. Macey et al., *Lessons From Financial Economics: Materiality, Reliance and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1021 (1991).

companies, thereby affecting stock market prices."[44] It could have gone even further, because there are ways even in the absence of professional analysts that information can affect posted prices.

The final portion of the Court's reliance discussion is about rebutting the presumption.[45] Justice Blackmun gives three examples where traders might be disqualified. The first is where the market has in fact not been deceived, for example, because market professionals knew the truth or considered the statements noncredible. Plainly, showing market impact is the plaintiff's burden on the merits, but it is unclear why this should be a class-certification issue: marketplace impact is an issue common to the class rather than anything having to do with individualized reliance or nonreliance. We will see in Part III how this has nonetheless come back into the case law with a vengeance. The second is closely related; if the market was fooled but learned the truth before a particular investor bought or sold, that investor cannot be said to rely. True, but the point just made applies again: this is a question of defining the class, but still not individualized proof. The third is the only plausible example—the investor who had to buy or sell during the time period in question and would have done regardless of what was known or not known about the issuer or its stock (for instance, a shareholder forced by an antitrust decree to divest the stock within a certain amount of time).[46] These three examples shed relatively little light on the Court's thinking and have led to the widespread impression that once the class is certified, it will include all purchasers or sellers during the class period without any serious attempt by the defendants at rebuttal.[47]

In the next three Parts, we will look at how this confusion about presumption of reliance has played out in subsequent case law. Before turning to these questions, a word about Justice Byron White's lengthy dissent, which was joined by Justice Sandra Day O'Connor. That dissent is best remembered today for its sarcastic expressions about stock-market efficiency, accusing the plurality of writing a vision of

44. *Basic*, 485 U.S. at 247 n.24.

45. *Id.* at 248–49. This was the main source of disagreement between Justices Blackmun and Brennan. Justice Brennan advocated an approach in which all persons trading at a distorted price were entitled to the presumption, and found little reason to create grounds for rebuttal. *See* Memoranda from Justice Brennan to Justice Blackmun, *supra* note 9.

46. One interesting question is how strict application of this would affect an index fund that was required to buy or sell stock in the index to stay consistent with its investment characterization.

47. Justice Brennan's willingness to join Justice Blackmun's opinion notwithstanding his conceptual problems with it was based on his prediction that rebuttal would rarely even be attempted.

financial economics into law worthy of the medieval scholastics—that price always equals fair value—well before the mechanics of market efficiency are adequately understood, and for the point that Congress wanted investors to rely on disclosure, not lazily assume that others are doing the work.[48] But the dissent goes much beyond that. Justice White questions why there should ever be any recovery under rule 10b-5 for open-market fraud when the defendant was not a purchaser or seller—hinting at a rejection of *SEC v. Texas Gulf Sulphur*,[49] wherein the United States Court of Appeals for the Second Circuit famously abandoned privity as a rule 10b-5 requirement and thereby laid the doctrinal groundwork for the fraud-on-the-market lawsuit.[50] Justices White and O'Connor were inclined to follow the business groups' insistence on simply shutting the door to expansive private securities litigation. We will have more to say about the dissent in the discussion that follows.

This last point brings us back to the surprising position of the SEC and the Solicitor General in *Basic*. Their amicus brief filed in the spring of 1987 staunchly defended the presumption of reliance in the face of businesses' challenge and put forth many of the efficient-market–hypothesis-based arguments that found their way almost verbatim into the majority opinion. As Justice White noticed, there was some irony in the SEC's embrace of market efficiency given that famous financial economists were at the time arguing that efficiency also proves that SEC-mandated disclosure is both unnecessary and counterproductive.[51] Whether the SEC's appreciated this provocative threat to its historic legislative mission is not clear. Whatever the bureaucratic thinking, it bears emphasis that the fraud-on-the-market theory was at the time a free-market-driven idea, from which conservative SEC commissioners and Reagan-administration lawyers might well have found reason to ignore businesses' plea for protection. By all accounts, the most important intellectual justification for the fraud-on-the-market theory came from Daniel Fischel, who wrote about it in *The Business Lawyer*

48. This provoked a number of law-and-economics-oriented scholars who considered Justice White's dissent to be a misunderstanding of (and perhaps an attack on) modern finance theory. *See, e.g.*, William J. Carney, *The Limits of the Fraud on the Market Doctrine*, 44 BUS. LAW. 1259, 1277–78 (1989); Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907 (1989).

49. 401 F.2d 833 (2d Cir. 1968).

50. *See Basic*, 485 U.S. at 261 (citing Brief for the American Corporate Counsel Association as Amicus Curiae in Support of Petitioners, *supra* note 6).

51. *Id.* at 259.

in 1982,[52] just before he joined the University of Chicago law-school faculty. And his intellectual partner, Professor Frank Easterbrook (who handled securities cases in the Solicitor General's office before going to the University of Chicago in the early 1980s)[53] joined him in the applause, both in writings and, after his appointment to the United States Court of Appeals for the Seventh Circuit, from the bench.[54] In this light, the government's position was not a liberal outlier in 1987. Instead, it was very much in the mainstream of conservative law-and-economics thinking, which had not yet assumed the more critical stance on the value of private litigation that emerged shortly after *Basic* in the writings of influential scholars such as Jonathan Macey and Geoffrey Miller,[55] Paul Mahoney,[56] and Roberta Romano.[57]

This is an important part of our story because, to Fischel and Easterbrook at least, market efficiency was the sine qua non of the fraud-on-the-market theory.[58] They elide the reliance requirement

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52. *See* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982). Professor Fischel later applauded the result in *Basic*, even though he did not necessarily concur in the Court's reasoning. *See* Fischel, *supra* note 48, at 917–18, 922.

53. Easterbrook was a principal author of the Department of Justice's brief in *Chiarella v. United States*, 445 U.S. 222 (1980), and the creator of what later came to be known as the misappropriation theory for insider-trading liability. *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1335 n. 114 (2008).

54. *See Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987). Also influential was Judge Patrick Higginbotham, who as a district court judge gave a strong conservative endorsement to the fraud-on-the-market theory in the *LTV* case, which was cited and quoted by the Supreme Court in *Basic*. *See Basic Inc. v. Levinson*, 485 U.S. 224, 244 (1988) (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)). In *LTV*, Judge Higginbotham justified the presumption of reliance almost entirely by reference to modern financial economics. He was later appointed by President Reagan to the United States Court of Appeals for the Fifth Circuit, and wrote the Fifth Circuit's opinion in *Oscar Private Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), which is analyzed later in Part III.B.

55. *See* Macey & Miller, *supra* note 19, at 1060, 1062.

56. Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 624–25 (1992).

57. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 56 (1991). Other critical perspectives quickly came as well. *E.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 499–501 (1991); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 967–68 (1994); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928 (1999).

58. *See* Fischel, *supra* note 52, at 9–10.

because they think individualized reliance is trivial in the context of market efficiency.[59] The law should protect markets: markets will then protect investors. That approach requires causation only.[60] The heavy lifting to which Easterbrook and Fischel put modern finance theory goes to assessing materiality and measuring damages.[61] This is the ultimate source of *Basic*'s analytical confusion. Urged on by the SEC and the Solicitor General, Justice Blackmun enlists the conservatives' vision of market efficiency as an organizing principle without realizing that that vision counsels ignoring reliance, not building an entire analytical structure around it.

Of the many consequences of the confusion about reliance, one should be stressed at the outset. Treating reliance as a presumed fact rather than either a fiction or an act of juristic grace strongly implies that each investor has a *right* to individualized compensation for the fraud, which, given the large-scale class certification contemplated by *Basic*, guarantees massive liability exposure in such cases. That indeed came to be. This troubled Fischel and Easterbrook as a conceptual matter; they concluded that such aggregate out-of-pocket damages will probably exceed the net social harm from the fraud because they ignore all the windfall gains by innocent marketplace traders who happen to be on the right side of buying or selling at a distorted price.[62] Ultimately, however, Fischel and Easterbrook decided that the aggregate-damages approach was nonetheless acceptable.[63] The next round of critical scholars was not at all persuaded by this view,[64] however, and today, concerns that the tort-style approach to damages in open-market fraud cases systematically overcompensates are common in the legal literature. When this point was joined with the recognition that investors largely self-fund this mechanism (i.e., that it really is an

59. *Flamm*, 814 F.2d at 1180; Fischel, *supra* note 52, at 10–11.

60. Professor Fischel is clear about this in his first article, where he says: "The concept of a presumption of reliance, therefore, is best abandoned. The logic of the fraud on the market theory dictates that the reliance requirement as conventionally interpreted be discarded altogether." Fischel, *supra* note 52, at 11; *see also Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1129 (7th Cir. 1993) (demonstrating that Judge Easterbrook reads *Basic* as if it does just that).

61. Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. Rev. 611, 651–52 (1985).

62. *Id.* at 622–25.

63. *See id.* They rightly note that damages include a variety of externalities (misallocation of economic resources, etc.) so that the right level is not simply the net of losses and windfalls or the benefit to the defendants. *Id.*

64. *See, e.g.*, Mahoney, *supra* note 56, at 637, 663.

expensive form of investor insurance), the distaste for fraud-on-the-market theory as a compensatory device grew stronger.[65]

Had *Basic* abandoned or softened the insistence on reliance-in-fact, other possible directions would more clearly have opened up; recognizing that the goal of full class compensation might be excessive or unnecessary, for instance, could lead to different ways of thinking about damages.[66] An alternative might be to somehow limit out-of-pocket damages and/or seek more recovery from individual wrongdoers rather than the issuer itself.[67] That, in turn, leads us to see that class recovery makes more sense as a deterrence mechanism than a compensatory device, which would bolster the intuition that a stringent approach to reliance, causation, or class certification is entirely unnecessary. Instead, as we are about to see, the law headed in precisely the opposite direction.

II. *BASIC* AND MARKET EFFICIENCY

Basic says that plaintiffs must show some degree of market efficiency in order to gain the presumption of reliance, but it says little about how to demonstrate this or how much efficiency is required apart from a footnote reference to "some" following by market professionals, which suggests a fairly easily met efficiency threshold.[68] A commentator who had surveyed the fraud-on-the-market cases before *Basic* noted that market efficiency was often mentioned but rarely strictly applied, so it included trading on nearly any well-organized marketplace.[69]

But once defendants had failed to persuade the Supreme Court to reject the presumption of reliance generally, their tactics shifted to

65. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1496–99 (1996); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1535–37 (2006); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 648–50 (1996).

66. Professor Fox points out that the kind of reliance described in *Basic* is so far removed from traditional "fraud in the inducement" that it does not properly deserve the label "transaction causation." Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507, 516 (2005); *see also* Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297. Once the Court kept to the reliance approach, it sowed seeds of further confusion, including inviting loss causation. *See infra* Part III.

67. *See* Arlen & Carney, *supra* note 57, at 694–95; Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 630 (2007).

68. *Basic Inc. v. Levinson*, 485 U.S. 224, 246 n.24, 247 n.26 (1988).

69. *See* Black, *supra* note 35, at 937.

arguing, with respect to non-blue-chip issuers, that the market for that particular issuer was not sufficiently efficient. This forced the lower courts to confront that question explicitly and look for objective markers on which certification decisions could be made. After all, *Basic* had made a big deal of efficiency (and Justice White's dissent insisted that it was fundamental to the majority's conclusion).[70] *Basic*'s obfuscation about the role of efficiency sent the courts off on a long journey without a particularly good compass.

Predictably, courts began collecting a list of factors that they might use in making efficiency decisions; the best-known list still comes from a district-court decision decided shortly after *Basic*, *Cammer v. Bloom*.[71] *Cammer* lists five factors: weekly trading volume, number of analysts following the company, number of market makers and arbitrageurs, status as a Form S-3 filer for SEC disclosure purposes, and responsiveness of the market price to new information.[72] The jumble is evident. The last factor, usually measured by reference to speed of adjustment, is the standard test for informational efficiency, and would seem to be sufficient to address the issue. The first three are plausible predictors for relatively high speed of adjustment (and probably correlate highly with each other, producing some redundancy). Filer status is based on the idea that Form S-3 status reflects the SEC's judgment about efficiency, which is only loosely true.[73] As with most multifactor lists, *Cammer* is unclear what is to be done except examine the factors in order. It invited an ad hoc approach informed by expert testimony, but in fact largely unconstrained.[74]

The judicial muddle should hardly be surprising, because informational efficiency is not a binary, yes or no question. Perfect efficiency is just a theoretical ideal; measurement tools compare actual adjustment of a particular piece of information to the ideal. One can

70. *Basic*, 485 U.S. at 248, 252–53 (White, J., dissenting).

71. 711 F. Supp. 1264, 1286–87 (D.N.J. 1989). Some courts add additional factors. *See, e.g.*, *Unger v. Amedisys Inc.*, 401 F.3d 316, 324 (5th Cir. 2005) (adding references to bid-ask spread, market capitalization and total float).

72. *Cammer*, 711 F. Supp. at 1286–87.

73. *See* Langevoort, *supra* note 28, at 886–89; *see also* Randall S. Thomas & James F. Cotter, *Measuring Securities Market Efficiency in the Regulatory Setting*, 63 LAW & CONTEMP. PROBS. 105 (2000) (questioning measures used in SEC standard setting).

74. For useful discussions of the inconsistencies in the way district courts applied the efficiency standards in the years after *Basic*, see Paul A. Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 83 (2004); Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in* Cammer v. Bloom *and Its Progeny*, 10 U. MIAMI BUS. L. REV. 303 (2002).

generalize about different markets and different issuers to find support for the common-sense intuition that the larger the trading volume, the larger the number of shareholders, the larger the professional following, etc., the quicker the adjustment one is likely to observe[75]—hence the appeal of *Cammer*'s first three factors. But wading into the mind-numbing data defendants (and thus plaintiffs as well) often put forward in their expert reports creates the illusion that there is a bright-line distinction among different issuers to be discovered, forgetting that we are still not sure how or why that distinction matters.

A. PolyMedica

The most thorough appellate-court discussion of how to approach efficiency at the class-certification stage is *In re PolyMedica Corp. Securities Litigation.*[76] PolyMedica was a Nasdaq-traded company but not a blue-chip stock. In certifying the class, the district judge—Robert Keeton, hardly an amateur at thinking through tort-type cases—refused to consider the defendants' detailed analysis of potential inefficiencies in PolyMedica's market because, relying on *Basic*'s footnote dictum, he did not think the efficiency analysis at the class-certification stage should be overly demanding. Rather, he only needed to be reasonably confident of a likely causal connection between public information and the issuer's stock price.[77] He thus rejected the defendants' claim that market efficiency, as financial economists understand that term, had to be established.[78]

The United States Court of Appeals for the First Circuit reversed, starting its lengthy inquiry by acknowledging that the case law had not yet clearly explained the role of efficiency in class-certification

75. One of the earliest empirical studies to address the definition of efficiency in fraud-on-the-market cases, still often cited, concluded that only two of the factors (number of analysts and volume of trading) are particularly probative. *See* Brad M. Barber et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, 19 J. CORP. L. 285, 290 (1994); *see also* Victor L. Bernard et al., *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of the Fraud-on-the-Market Theory*, 73 NEB. L. REV. 781 (1994).

76. 432 F.3d 1 (1st Cir. 2005). At roughly the same time, a number of other circuit courts similarly came to the conclusion that there should be rigorous district-court scrutiny of efficiency claims and rigorous appellate-court review of class certifications where efficiency is in question. *See, e.g.*, *Unger v. Amedisys Inc.*, 401 F.3d 316 (5th Cir. 2005); *Gariety v. Grant Thornton*, 368 F.3d 356 (4th Cir. 2004). *See generally* Douglas C. Conroy & Johanna S. Wilson, *Class Actions—Evening the Playing Field: Stress-Testing the Efficient Market Hypothesis*, 4 CORP. ACCOUNTABILITY REP. 26 (2006).

77. *In re PolyMedica Sec. Litig.*, 224 F.R.D. 27, 43 (D. Mass. 2004).

78. *Id.*

decisions and hence went back to *Basic* to find the right answer.[79] What the court decided, however, was that *Basic* was incoherent.[80] It took note of the footnote language and conceded that it fully supported Judge Keeton's minimalist approach.[81] However, the court decided that the footnote was inconsistent with much of the rest of the opinion, as well as statements in pre-*Basic* case law suggesting that efficiency was a serious and important inquiry. Thus, it dug more deeply to find the link. The court's conclusion is stated clearly enough: to certify the class, the district judge must make a reasoned determination that the market for the issuer's stock "is one in which the market price of the stock *fully reflects all* publicly available information."[82] Not *partly* reflects, nor fully reflects *some*, but fully reflects *all*. The First Circuit said that this does require a detailed look at all measures of informational efficiency, as financial economists use the term, which the district court had refused to do.[83]

At this point, the court tries to explain why, but never really succeeds because it gets caught up in the same confusion as *Basic*. Early on in the analysis, it seems inclined to invoke fundamental-value efficiency as crucial, but quickly backs off of that (although it says that district courts might want to consider evidence on accuracy of adjustment, even though it will not necessarily be determinative).[84] Informational efficiency is what is important.[85] But what does speed of adjustment have to do with reliance on stock-price integrity? The court's answer is that speed of adjustment creates the confidence that the particular piece of misinformation on which plaintiffs have based their lawsuit has in fact been impounded into, and thus distorted, the market price.

The logical flaw here should be obvious. High speed of adjustment does indeed bolster that confidence, and thus can be highly probative. But what would less-than-high speed of adjustment prove? Tests for adjustment seek to determine that time at which the stock price has *ceased* responding to the new information in a biased fashion. A few hours or a day would presumably show high speed, but suppose it took

79. *PolyMedica*, 432 F.3d at 13–14, 17–18.

80. *Id.* at 11–12.

81. *Id.* at 10.

82. *Id.* at 14.

83. *Id.* at 14–15.

84. In a companion case, *In re Xcelera.com Sec. Litig.*, the court expressly rejected the requirement that a court find that the market "accurately" prices the stock—that is, is devoid of noise—in order to certify. 430 F.3d 503, 510–11 (1st Cir. 2005); *see also infra* note 94.

85. *See PolyMedica*, 432 F.3d. at 14–17.

a few days or even weeks? The price is still distorted, even if it drifts for a while.

PolyMedica never explains why, if the question is simply whether the price was distorted in the first place, the class-certification decision should be anything more than an educated guess whether the fairly basic market conditions for information to influence prices are met. Judge Keeton had done just that. And the First Circuit left open many questions, not the least of which is how fast is fast, given that no adjustment is magically instantaneous. Nor is it clear how close the court's inquiry comes to assessing the speed of adjustment of the *particular* piece of information at issue in the lawsuit as part of the class-certification decision, which is the question considered in Part III. One of the points about market efficiency the *PolyMedica* court never thought much about is the finding that different kinds of information are likely impounded at different rates of speed, even for the same issuer. Not surprisingly, dramatic, easy-to-understand information takes less time to impound than more subtle or confusing information about which there may be heterogeneous expectations. One of the most common types of material disclosures—an earnings surprise—actually takes a while to be fully impounded, even for large-cap stocks, and even varies depending on whether it is good news or bad.[86] The inquiry the court demands can turn out to be a morass.

Perhaps a better way to pose the question is in terms of "justifiable" reliance. Here, some pre-*Basic* case law is instructive. Shortly after lower courts started adopting a presumption of indirect reliance based on market-price distortion in the 1970s, they started considering how far the idea could be stretched in the absence of an organized market. In a series of cases, of which *Shores v. Sklar*[87] is the best known, a few courts of appeals took the logic fairly far. For instance, why not permit a presumption of reliance in the unregistered public-offering setting (e.g., municipal bonds, as in *Shores*) because the issuer may have deceived its investment bankers, who then set the offering price too high, thereby harming buyers who took that price? Or, permit a presumption on lies to the SEC, which may have caused it to permit a transaction to go forward that would not have otherwise?[88]

86. *See* A. Craig MacKinlay, *Event Studies in Economics and Finance*, 35 J. ECON. LIT. 13, 25 (1997).

87. 647 F.2d 462 (5th Cir. 1981). The essence of this approach is that the fraud created the market, that is, allowed unmarketable securities to nonetheless come to market. For a discussion and criticism based heavily on justifiable reliance, see Carney, *supra* note 48, at 1260.

88. *See T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir. 1983).

If but-for causation of mispricing is the question, then this logic might work. But shortly after these cases took root, there was a counterreaction that imposed severe limits and smothered their growth. For the most part, this reversal did not contest the logic of causation or indirect reliance so much as doubt that any investor who so relied in these settings was reasonable in doing so. These cases distinguish organized markets, where the forces of arbitrage and informed trading justify investors who forego diligence and research, from settings like public offerings, where there are no such unbiased forces, just underwriters and dealers with incentives to make deals happen.[89] This tied into a line of authority under rule 10b-5 that denied recovery to investors whose reliance was overly gullible.[90]

PolyMedica invokes this kind of reasoning. The court says, for instance, that investors are "justified" in assuming that informationally efficient markets have integrity.[91] To this we have to ask the same question as in Part I: what is it about speed of adjustment that could justify anyone in *assuming* no fraud? There is no good answer, which is what led us to see that *Basic* is creating an entitlement to such reliance even though it is unearned, rather than just describing it as a fact. Once we accept the normative dimension to this exercise, we should ask questions of the sort that provoked the counterattack to *Shores* and its progeny: why should anyone be relying on market-price integrity in the absence of fairly compelling protective features built into the market, for which speed of adjustment might be a rough proxy? This taps into one of Justice White's dissenting points in *Basic.* We want investors to act with some diligence, and blind reliance should not be rewarded. Investors who buy or sell thinly traded stocks should not be assuming much of anything.

That vision of reliance has *some* connection to market efficiency, and so I suspect that this idea motivates *PolyMedica*—that is, there are limits to how far we would want to go in creating an entitlement to rely

89. The key case was *Ross v. Bank South*, 885 F.2d 723 (11th Cir. 1989), decided shortly after *Basic.* The court did not overrule *Shores*, but did limit it severely. In a concurring opinion emphasizing the reasonableness point, Judge Tjoflat said flatly that *Shores* was wrongly decided. *Id.* at 739; *see also In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006) (determining that IPO market inefficiency was one reason not to certify); *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir. 1993).

90. *See* Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

91. *In re PolyMedica Sec. Litig.*, 432 F.3d 1, 16 (1st Cir. 2005).

on price in settings of palpable inefficiency.[92] But it is hard to see why the detailed ex-post inquiry into informational efficiency that the First Circuit insists on is a particularly good way to draw this line. Note how disconnected the *Cammer* factors are from what a typical investor actually might (or even could) think about ex ante in deciding whether a stock's price has integrity. Again, we come back to what speed of adjustment can tell us. Even if we believe that some markets are too thin to justify any uninformed reliance, the category of markets that are "thick enough" is presumably fairly large.[93]

In sending inexperienced district judges off on mind-numbing investigations of adjustment variations often measured in minutes rather than weeks, cases like *PolyMedica* invite no-certification decisions unrelated to any meaningful assessment of justifiable reliance. And that is precisely what seems to happen when courts enter the efficiency thicket to resolve battles among the experts. On remand, the district-court judge in *PolyMedica* read the First Circuit strictly and refused to certify (even though most of the *Cammer* factors were satisfied), simply because speed of adjustment extended out more than a single day.[94] In

92. For a very thoughtful set of suggestions for reconciling the fraud-on-the-market theory with justifiable reliance, see Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25 (2007).

93. Judge Easterbrook suggested as much in *Eckstein v. Balcor Film Investors*, when he said:

> Prices of even poorly followed stocks change in response to news, including statements by the issuers, and these changes may be better indicators of causation than litigants' self-serving statements about what they read and relied on and about what they would have paid (or whether they would have bought at all) had the issuer said something different.

8 F.3d 1121, 1130 (7th Cir. 1993).

He suggested that the line is crossed when this approach to causation "peters out" sufficiently that "the litigation process offers superior information about causation," and found that to be the case at least in the IPO setting. *Id.*

94. *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260, 277–78 (D. Mass. 2006) ("What this suggests is that the same forces (i.e., reaction to news) that were affecting PolyMedica's stock price on Day D were also affecting its price on Day D+1 . . . [the First Circuit's decision, however] requires that the reaction to news be fully completed on the same trading day as its release—and perhaps even within hours or minutes."). Judge Young took over the case from Judge Keeton, and seemed uncomfortable with the implications of the court of appeals's decision. *Id.* at 272 n.10 (suggesting that the future of securities-fraud class-action lawsuits "may be in jeopardy"). Ironically, he may have been too strict in his reading. In the companion case to *PolyMedica*, *Xcelera*, the First Circuit seemed willing to accept a two–five day speed of adjustment because the district judge determined, by reference to the *Cammer* factors, that there was sufficient evidence of immediate reaction to the news, even though it took a while longer for abnormal returns to cease. *See In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 513 n.11 (1st Cir. 2005). I am grateful to Elliott Weiss for pointing this out. This inconsistency underscores the point about the law failing to explain itself at all coherently.

general, the case law is inconsistent and largely self-referential: *X* number of market makers is not enough but *Y* is, or *Z* days' speed of adjustment is too slow, largely because some other court said so.[95] The bar can be set mindlessly high. An example of what can happen is a United States Court of Appeals for the Fifth Circuit decision, *Bell v. Ascendant Solutions, Inc.*,[96] where the court affirmed a refusal to certify a Nasdaq-traded stock with some twenty or so market makers and high trading volume in the context of a case where immediately after a surprise disclosure of bad news, the stock price fell by some 30 percent. Those facts certainly suggest a market where fraud can distort price and no obvious reason why investors should not be entitled to rely. But there is no such thing as a perfectly efficient market, and so it becomes easy for a court to miss the forest for the trees by accepting too readily the defendants' statistical evidence of imperfection as reason not to certify.

B. (Im)perfect Efficiency and the Debate Over Stock-Price Rationality: Merck

For large-cap stocks, there is seldom any debate over whether the market is efficient enough: efficiency is assumed. That does not lead immediately to certification, however, because as we shall explore in Part III, there may still be issues of market impact and loss causation to address. What is worth observing here is that many courts that take up these issues then shut their eyes to any further empirical questions regarding actual informational efficiency, and simply assume near-perfect efficiency. This is the flip side of what *PolyMedica* does—efficiency remains a binary question, and just as a no answer takes away the reliance interest entirely, a yes answer removes all doubt.

A case decided by the United States Court of Appeals for the Third Circuit, *In re Merck & Co., Inc. Securities Litigation*,[97] is particularly instructive here. Merck allegedly misstated the revenues associated with a major subsidiary, Medco.[98] It eventually corrected this in an obscure way in a Form S-1 registration statement filed for review by the SEC.[99]

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95. *See PolyMedica*, 453 F. Supp. 2d at 268–70, 277–78.

96. 422 F.3d 307 (5th Cir. 2005). To be fair, *Ascendant*'s main grounds for affirmation is that the plaintiffs' expert report was unpersuasive in its methodology, and the plaintiffs left out key pieces of information from their argument. But given the prima facie case for efficiency, the rigor of what it demands is still worth noting.

97. 432 F.3d 261 (3d Cir. 2005). For a critique of *Merck*, see Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 PEPPERDINE L. REV. 927 (2007).

98. *Merck*, 432 F.3d at 263–64.

99. *Id.* at 265.

But the presentation left the calculation of the impact to the reader, who would have to parse through various bits of data elsewhere in the filing to even make an estimate of the bottom-line effects.[100] There was no demonstrable market impact around the time of this filing.[101] A few weeks later, however, *The Wall Street Journal* ran a story about it, with the reporter doing a rough calculation, and Merck's market price dropped significantly when that story appeared. The Third Circuit found that the market's initial lack of reaction established immateriality as a matter of law (a subject we will come back to in Part IV).

Naturally, plaintiffs wanted to fight this by arguing that the market had simply been slow in discovering the buried facts, but the Third Circuit wanted no part of such an argument.[102] After vowing its faithful "commitment" to the efficient-market hypothesis in fraud-on-the-market cases, it said that once efficiency is established, speed of adjustment is presumed as a matter of law; the plaintiffs' claim, it said, "overlooks that our court has [already] resolved how 'quickly and completely' public information is absorbed into a firm's stock price. We have decided that this absorption occurs 'in the period immediately following disclosure.'"[103] It then put plaintiffs in a tight bind. Were they to successfully challenge that determination on grounds that the market was slow in responding to the news because of its obscurity, the court said, it would simply demonstrate the inefficiency of the market for Merck stock and be grounds for denial of certification under *Basic*.[104]

Because it is hard to imagine any stock more likely traded in an efficient market than Merck, this threat is rather striking. The questions here are two-fold: first, whether under our current state of knowledge of finance it is at all plausible that such a delayed reaction could occur in a relatively efficient market; second, what follows if it is?[105] This

100. *Id.* at 270.

101. *Id.*

102. *Id.* at 269–71.

103. *Id.* at 269 (quoting *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000)). The court also said, "An efficient market for good news is an efficient market for bad news," paying no attention to evidence that there may be precisely such an asymmetry. *Id.* at 271. *See generally* Harrison Hong et al., *Bad News Travels Slowly: Size, Analyst Coverage, and the Profitability of Momentum Strategies*, 55 J. FIN. 265 (2000).

104. *Merck*, 432 F.3d at 269–70.

105. For thorough studies of this question, see Fredrick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 509–10 (2006); Ferrillo et al., *supra* note 74, at 84; William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843 (2005); *see also* Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. CORP. L. 517, 535–36 (2003); Ribstein, *supra* note 14, at 156–57. For some policy recommendations based in part on this literature, see Karmel, *supra* note 92, at 49–54.

bears on Justice White's prophecy when he warned against adopting a theory based on not-yet-proven financial economics.

Doubts about the strength and pervasiveness of market efficiency are much greater today than they were in the mid-1980s.[106] I have written at length about the legal implications of this,[107] as have many others.[108] As a technical matter, to be sure, these doubts are easy to misconstrue. Because perfect market efficiency is just a theoretical ideal, even statistically significant deviations from its predictions that mean much to financial economists would mean much less to a layman. Although researchers debate whether some observed anomalies are such that profitable trading strategies can be devised from them, any such strategies are usually only marginally profitable, short-lived, or both.[109] The growth of hedge funds is evidence that there is profit to be made in exploiting inefficiencies, but only for those with immense sophistication and resources, and perhaps with diminishing returns and greater risk as more entrants make the required effort.

Nonetheless, the contemporary literature suggests that even for widely traded stocks, substantial deviations from the efficiency ideal are quite possible.[110] There is plenty of evidence, for example, of momentum and drift—that is, abnormal returns that persist for relatively long periods of time, even for larger issuers. When sentiment or noise causes an overreaction to some kinds of news (or pseudonews),

106. For two very recent surveys summarizing much of this research, see Malcolm Baker & Jeffrey Wurgler, *Investor Sentiment and the Stock Market*, 21 J. ECON. PERSP. 129 (2007); Harrison Hong & Jeremy C. Stein, *Disagreement and the Stock Market*, 21 J. ECON. PERSP. 109 (2007). On the degree of doubt and disagreement about efficiency among finance and economics professors, see Ivo Welch, *Views of Financial Economists on the Equity Premium and on Professional Controversies*, 73 J. BUS. 501 (2000); James S. Doran et al., Market Efficiency and Its Importance to Individual Investors—Surveying the Experts (Aug. 10, 2007) (unpublished Ph.D. dissertation, Florida State University), *available at* http://ssrn.com/abstract=1006237 (noting that not only are economists in disagreement about the degree of efficiency, but more strongly, do not act as if the market is efficient in their own investment activities).

107. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002); Langevoort, *supra* note 28.

108. Strangely, *PolyMedica* used an article by Professor Stout that is mainly about market inefficiency as one of its main sources on market efficiency. *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 636–39 (2003).

109. *See* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003). Professor Fischel emphasized this in arguing that doubts about efficiency should not undermine the *Basic* presumption. *See* Fischel, *supra* note 52, at 9–12.

110. *See, e.g.*, Bradford Cornell & James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 TUL. L. REV. 443, 450 (2006).

or an underreaction to other news (perhaps because pseudoinformation crowds out what is fundamentally important because of limited attention capacity),[111] we see evidence of both fundamental and informational inefficiency. There is evidence that even professional investors and analysts sometimes pay insufficient attention to buried facts, and react only, albeit swiftly, when issues are made more salient.[112] A recent study of corrective disclosures of financial information, for example, demonstrated dramatic differences in marketplace reaction depending on how prominently the issuer publicized the correction.[113] For this reason, while we still should be skeptical of the plaintiffs' claim in *Merck* that the market simply missed the significance of the corrective disclosure in the filed Form S-1, contemporary financial economics would not rule out this possibility entirely. Given the abnormally large drop in Merck's price when the *Journal* published its report, it probably was worth a harder look at what actually happened and why.[114]

Suppose, then, that plaintiffs were able to put forth a sufficiently persuasive case (e.g., through analyst testimony) that the market had simply missed the importance of what was buried in the Form S-1 filing. I think *Merck* is wrong in suggesting that this would defeat a plaintiff's entitlement to the presumption of reliance. As discussed earlier with respect to *PolyMedica*, the question simply goes back to what use we are actually making of market efficiency. If *Basic*'s presumption is essentially an entitlement to rely on the market price as undistorted by fraud, it is hard to see why investors should lose that entitlement simply because of some market imperfection. To the contrary, these kinds of imperfections would seem to strengthen, not weaken, the need for additional investor protection.[115] If one cannot

111. *See* David Hirshleifer & Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 J. ACCT'G & ECON. 337 (2003).

112. *See, e.g.*, Bradford Cornell, *Is the Response of Analysts to Information Consistent with Fundamental Valuation? The Case of Intel*, 30 FIN. MGT. 113, 131–35 (2001); Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 J. FIN. 387 (2001). Enron is often put forward as an example of delayed reaction to palpable warning signs inconsistent with market efficiency. *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Langevoort, *supra* note 107.

113. *See* Edward Swanson et al., *Stealth Disclosures of Accounting Irregularities: Is Silence Golden?* (Social Science Research Network Working Paper Series, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1004299; *see also* Ron Kasznik & Baruch Lev, *To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise*, 70 ACCT'G REV. 113 (1995).

114. For a discussion, see Padfield, *supra* note 97, at 954–57.

115. *See* Goshen & Parchomovsky, *supra* note 40, at 770–71 ("[O]ur model shows that when markets are effective but inefficient it is especially desirable to provide optimal conditions to information traders, because information traders constitute the

rely on the integrity of the market for Merck stock, then no stock price is reliable.

PolyMedica refers to these contemporary doubts about efficiency,[116] but concludes that they mainly challenge fundamental but not informational efficiency, and the court makes clear that all it is insisting on is the latter. A companion case, *In re Xcelera.com Securities Litigation*,[117] confirms this, rejecting the defendants' effort to invoke the inefficiency literature to argue that Xcelera.com's market was too noisy and moody.[118] This is a bit too facile, however. As economists Fred Dunbar and Dana Heller have emphasized,[119] this literature shows that material information is sometimes ignored, and immaterial information sometimes weighted heavily. What is impounded into price, at whatever speed, can be a mix of real factors and pseudofactors, with no obvious way of knowing when reality will come to dominate. To the extent that cases like *PolyMedica* are looking for evidence that the issuer's market price reflects *only* value-relevant information,[120] one cannot so easily ignore the doubts about informational efficiency that are now well established in the finance literature. But again—if we were right earlier in our reading of *Basic*—so what?[121]

best mechanism for correcting market inefficiencies."); Langevoort, *supra* note 107, at 183–86; Macey et al., *supra* note 43, at 1049 ("The legal system should not withhold redress from an injured plaintiff simply because he owns the security of a corporation traded in a market considered by some court to be 'inefficient.'").

116. *See In re PolyMedica Sec. Litig.*, 432 F.3d 1, 10 n.15 (1st Cir. 2005).

117. 430 F.3d 503 (1st Cir. 2005).

118. *Id.* at 516–17.

119. *See* Dunbar & Heller, *supra* note 105, at 509–10. For an expression of doubt that the distinction between informational and fundamental efficiency holds the weight it is often asked to bear, see Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 716 n.4 (2003).

120. *See PolyMedica*, 432 F.3d at 8 ("[W]hen a market lacks efficiency, there is no assurance that the market price was affected by the defendant's alleged misstatement at all. Instead, the price may reflect information wholly unrelated to the misstatement.").

121. A rare judicial acceptance of the inefficiency concern is found in *Bell v. Ascendant Solutions, Inc.*, 422 F.3d 307, 315 n.17 (5th Cir. 2005). As noted earlier, a number of commentators have called for a complete reexamination of *Basic* in light of this literature. This was rejected in *Unger v. Amedisys Inc.*, 401 F.3d 316, 322 n.4 (5th Cir. 2005), as a job for the Supreme Court, not the lower courts. And it is worth noting that Congress spoke to this at least indirectly in the PSLRA, acting in response to concerns about marketplace overreaction to corrective disclosure without altering *Basic*'s presumption in any way. *See* Langevoort, *supra* note 107, at 182–86; Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879 (1998); Jeffrey L. Oldham, Comment, *Taking "Efficient Markets" Out of the Fraud-*

C. Restatement

Basic is surely to blame for its own confusion about the role of efficiency in the presumption of reliance. The Court's opinion makes sense only if we see it as creating an entitlement to rely on market-price integrity, even though there is no good reason for any investor simply to assume the absence of fraud. This, as said earlier, is an act of juristic grace rather than recognition of any preexisting right. If so, the fraud-on-the-market presumption should permit recovery without a showing of actual reliance on the fraud that is justifiable so long as the market is sufficiently well organized that we have reason to believe that fraud is likely to distort the price. The limit on this should come only in situations (like *Shores v. Sklar*) where the institutional price-setting mechanism is so weak that reliance on price integrity is manifestly unreasonable. It takes a high level of inefficiency for that to be the case. And if this is so, then Judge Keeton got the approach exactly right in his district-court opinion in *PolyMedica,* and the First Circuit was wrong to reverse him.[122] For the same reason, cases like *Merck* are completely off base in suggesting that finding any significant market imperfection—of the sort that might be found with respect to any company's stock—would automatically defeat the presumption.

While this interpretation sounds extremely plaintiff friendly, remember that there is still much more to come. Eventually, whether on the merits or as a matter of class certification, plaintiffs will have to show that the fraud did in fact distort the market price. As we are about to see, differing visions of market efficiency are very much at work here as well, and the plaintiffs' burden can still be very heavy. We are not yet out of the thicket.

III. *BASIC*, MARKET IMPACT AND LOSS CAUSATION

As we have seen, a crucial part of the intellectual history behind *Basic* and the fraud-on-the-market presumption was the embrace that the presumption received early on from conservative academics and

on-the-Market Doctrine After the Private Securities Litigation Reform Act, 97 NW. U. L. REV. 995 (2003). In the lower courts, then, the more likely response is to continue to narrow the definition of *efficiency* in class-certification decisions. Thus, for instance, Dunbar and Heller suggest adding to the *Cammer* factors inquiry into the level of short-selling ability for the stock in question, because short-sale restrictions are one common reason to doubt the ability of arbitrage to cleanse the market of behavioral biases. *See* Dunbar & Heller, *supra* note 105, at 517–19.

122. *Accord* Recent Cases, *First Circuit Defines an Efficient Market for Fraud-on-the-Market Purposes*—In re PolyMedica Corp. Securities Litigation, *432 F.3d 1 (1st Cir. 2005)*, 119 HARV. L. REV. 2284 (2006).

judges, particularly Professor Fischel and Judge Easterbrook. This was not an impulsive love affair with aggressive private securities litigation. Instead, it was part of a larger agenda, designed to substitute a market test for the subjective (and often too plaintiff-friendly, in their view) evaluation of materiality. True believers in market efficiency, they were sure that the number of lawsuits would go down, rather than up, if courts also insisted on a rigorous showing of market impact, because markets are extremely hard to fool.[123] They acknowledged, however, that *if* such an impact can be demonstrated, then plaintiffs have a good claim to recovery with damages measured and limited by reference to the impact. The assumption was that scientific expert testimony in the form of an event study would reliably establish impact or not, and Fischel later cofounded Lexicon to assure that the requisite expertise was available.

To the extent that they believed that the science was determinate, they were wrong: famously, econometric studies on both materiality and damages can produce wildly divergent estimates and bona fide factual disputes.[124] In this sense, Fischel's predictions notwithstanding, *Basic* was a boon to plaintiffs, leading to a rapid increase in the number of fraud-on-the-market suits after 1988—the number of filings had already tripled by 1991,[125] and continued to rise dramatically over the next fifteen years.

Two comments on the connection between this and what was just discussed in Part II are in order. First, as Professors Macey, Miller, Mitchell, and Netter rightly pointed out shortly after *Basic*,[126] rigorous insistence on a showing of market impact would seem to obviate the need to also show market efficiency if what we care about is simply stock-price integrity. Event-study-methodology works acceptably well even for thinly traded stocks, although the higher volatility associated with such stocks does require a larger abnormal return in order to be confident that the observed impact of the alleged misrepresentation was not simply by chance. Contrary to *PolyMedica*, courts can be fairly

123. Here again, Professor Fischel is clear: "Because the focal issue of every case will be whether there has been any effect on the market price of the firm's securities, the increased certainty resulting from this objective determination will reduce the amount of litigation." Fischel, *supra* note 52, at 16. A classic expression of this approach, cited in *Basic*, is Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373 (1984).

124. *See, e.g.*, Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1424–26 (1994); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990).

125. *See* Mahoney, *supra* note 56, at 662–63.

126. *See* Macey et al., *supra* note 43, at 1018.

relaxed about efficiency in class-certification decisions without losing control over this aspect of the case.

On the other hand, the behavioral-finance and market-inefficiency literature plainly becomes more troubling here. If we assume that markets often over- or under-react to news (and pseudonews) and sometimes develop troublesome bubbles where price strays from intrinsic value, then the simple statistical showing of an impact cannot so easily be treated as a precise *measure* of either the omitted information or the defendant's responsibility. In other words, the event study no longer offers a clean assessment of the intrinsic value of the fraud because noise and sentiment can influence price as well, hence the econometrician's ability to discipline the litigation process diminishes.[127]

The connection between *Basic*'s teachings and inquiries into market impact thus deserves careful thought. Market-impact analysis takes two related forms: first, the showing that the market was distorted by the fraud; second, that the emergence of the truth, corrective disclosure, caused a loss to some or all investors. The former, as just noted, is what *Basic* focused on as a predicate for the presumption of reliance. The latter, loss causation, is conceptually distinct.[128] Typically, however, litigants have used measures of market decline after corrective disclosure as the best available evidence of the extent of the original fraud-induced price distortion, and hence these two issues are often treated as if the same.[129]

Well after *Basic*, the Supreme Court took on the separate question of loss causation in *Dura Pharmaceuticals v. Broudo*,[130] a case dealing with issues of pleading and proof, not class certification. Other courts, however—most notably, the Fifth Circuit in *Oscar Private Equity*

127. *See* Cornell & Rutten, *supra* note 110; Dunbar & Heller, *supra* note 105, at 509–10. Dunbar's contribution to this issue explores this problem in depth. *See* Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199. To some extent at least, doubts about efficiency also call into question the precision of the event study itself, which often makes efficiency-driven assumptions in drawing the baseline against which observed returns are measured. *See* Brav & Heaton, *supra* note 105, at 536–37.

128. For a cogent discussion of loss causation, see Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Law*, 94 IOWA L. REV. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1234021.

129. *E.g.*, Cornell & Morgan, *supra* note 124; Robert B. Thompson, *"Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5*, 51 BUS. LAW. 1177, 1181–85 (1996). This is particularly apt when what plaintiffs allege is an omission rather than an affirmative lie: the omission will not necessarily lead to an identifiable market move; rather, the plaintiffs' claim is that the market would have adjusted had the truth been told.

130. 544 U.S. 336 (2005).

Investments v. Allegiance Telecom, Inc.[131]—have turned loss causation into a class-certification question, finding implicit permission to do so in both *Basic* and *Dura*. I find *Oscar* unpersuasive for reasons we will come to shortly. However, first we need to take a closer look at *Dura*.[132]

A. Dura Pharmaceuticals

Dura deals with what plaintiffs need to plead and prove regarding whether there was a subsequent loss in value of the stock that is attributable to the fraud. It is easy to become confused by loss causation, wherein securities litigation confronts many of the same "proximate cause" problems that have vexed generations of judges, lawyers and law students in torts and criminal law generally. Here, in many ways, rule 10b-5 meets *Palsgraf v. Long Island R.R.*[133] For example, suppose a pharmaceutical company knowingly misrepresents its estimates of revenues and earnings from sales of a particular drug. A few months later, a safety defect is unexpectedly discovered and the drug is pulled from the market, which causes an immediate and severe stock-price drop. Somehow, the lie is also uncovered and revealed. To the extent that the stock-price drop was caused by the safety defect (and assuming that it had nothing to do with the lie), it is easy to see the argument that the lie caused no loss—the intervening event caused the entire injury, which would have occurred whether or not there was a lie. Thus, there is nothing for investors to recover, even if all the other elements of a cause of action under rule 10b-5 are satisfied.

The standard measure of damages in securities-fraud cases has long been the so-called out-of-pocket-loss measure.[134] It is the difference for each purchaser or seller between the transaction price and the hypothetical value the security would have had that same day had the truth been told. This approach ignores all posttransaction events

131. 487 F.3d 261 (5th Cir. 2007).

132. Others have analyzed *Dura* in more depth. *See e.g.*, Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348 (2007); Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implication of* Dura Pharmaceuticals, Inc. v. Broudo, 63 BUS. LAW. 163 (2007); Merritt B. Fox, *Understanding* Dura, 60 BUS. LAW. 1547 (2005); James C. Spindler, *Why Shareholders Want Their CEOs To Lie More After* Dura Pharmaceuticals, 95 GEO. L.J. 653 (2007); Madge S. Thorsen et al., *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93 (2006). My purpose here is simply to underscore the conceptual tensions between *Dura* and *Basic* as they relate to the presumption of reliance.

133. *See AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 210 (2d Cir. 2000) (citing *Palsgraf v. Long Island R. Co.*, 62 N.E. 99, 103 (1928)).

134. *See* Thompson, *supra* note 129, at 1181–82.

(although as noted earlier, plaintiffs have typically sought to construct the hypothetical value by reference to what later happened to the stock price when the truth came out). All that is measured is price distortion, *Basic*'s focal point. At first glance, loss causation would seem irrelevant under this approach,[135] at least as long as the trial judge prevents plaintiffs from sneaking in unrelated stock-price declines as evidence of the price distortion.

In *Dura*, the United States Court of Appeals for the Ninth Circuit followed this out-of-pocket reasoning closely in holding that plaintiffs satisfy their pleading burden simply by alleging price distortion.[136] A unanimous Supreme Court reversed, however, with Justice Stephen Breyer writing the opinion. The Court's "logical" starting point is that there is nothing automatic about loss simply as a result of inflated price because "the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value."[137] In other words, if the stock is resold before the truth comes out, there is no injury. That is certainly right, but is easily dealt with for those particular "in and out" traders by offsetting the hypothetical loss at the time of the transaction with the windfall that comes from selling at an inflated price. The Ninth Circuit had dealt with this successfully for years prior to *Dura*.[138]

The bigger issue is where there is an intervening or supervening event that also causes investor injury, to which the out-of-pocket measure pays no attention. The Court insisted that it do so. One reason for this was that Congress had imposed an explicit loss-causation requirement in rule 10b-5 lawsuits in 1995, with fraud-on-the-market suits clearly in mind. Paying no attention seems inconsistent with whatever Congress might have been thinking. But statutory intent is not what the Court stressed; instead, the reasoning was quite purposive. It twice quoted Justice White's dissent in *Basic*, emphasizing that rule 10b-5 litigation is not supposed to provide investor insurance and indicating that compensating for losses that would have happened anyway would be just that.

One has to be very careful in thinking through loss causation before playing the investor-insurance card. Determining whether there might be some foreseeable relationship between the lie and the

135. *See* COX ET AL., *supra* note 3, at 725.

136. *Broudo v. Dura Pharma., Inc.*, 339 F.3d 933 (9th Cir. 2003).

137. *Dura Pharma., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

138. *See Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1344–45 (9th Cir. 1976) (Sneed, J., concurring).

seemingly unrelated loss is often very hard.[139] But, even assuming an unrelated intervening event, can we be so sure that *none* of the stock-price drop related to the fraud?[140] If not, the issue is to disentangle the two separate causes of the price drop rather than assume there is no fraud loss at all. Moreover, as Judge Richard Posner wrote in the seminal opinion on this subject in a face-to-face case (the context in which most all the pre-*Dura* case law developed),[141] there will be some instances where it is fair to say that but for the fraud, the investor would not have purchased the stock at all—rather than simply purchased it at a distorted price—and so would not have suffered the later loss whatever its cause.[142]

Dura does little more than reject the price-inflation approach; it says nothing about how courts are to deal with uncertainty about whether losses were attributable to the fraud or not, or whether there were losses in the first place.[143] The two main proof problems are well

139. Courts here have developed a test that asks whether a reasonable person at the time of the fraud could have foreseen this kind of injury as a result of the fraud, *see AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 216–17 (2d Cir. 2000), or alternatively, whether the loss was caused by a materialization of the risk that was misrepresented or concealed. *See Suez Equity Investors, LP v. Toronto-Dominion Bank*, 250 F.3d 87, 98 (2d Cir. 2001). The test has proved notoriously difficult to apply in practice, as illustrated by *AUSA*, where the three judges on the panel had three different answers to the foreseeability question. 206 F.3d at 209, 224, 228.

140. A fascinating question, still unresolved by the courts, has to do with the stock-price decline that reflects the issuers' loss of credibility upon discovery of the fraud. To take the example given earlier, even if the drug is permanently pulled from the market, is it unlikely that the revelation said something about management's honesty so that the drop was the combination of the product recall and the revealed dirty linen? Presumably, most stock-price declines that follow a surprise revelation of fraud reflect not only the truth with respect to the specific facts misrepresented or omitted but also a readjustment in expectations regarding other matters on which management was previously thought credible. Should investors be able to recover for this downward readjustment as well? *See* Dunbar & Sen, *supra* note 127, at 237; Ferrell & Saha, *supra* note 132, at 179–80 (finding that this "collateral damage" is not recoverable). I share with Professors Dunbar and Sen the sense that this is recoverable as within the foreseeable consequences attendant to revelation of the fraud. *Cf. AUSA*, 206 F.3d at 237 (Winter, J., dissenting) (finding that had the truth been told, the plaintiffs would have realized management's lack of credibility so that consequences of the dishonesty are within the zone of proximate cause).

141. *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990).

142. One example emphasized in the behavioral-finance literature is the power of momentum: traders coming in precisely because they have observed a price rise and believe that it will continue. *E.g.*, Hong & Stein, *supra* note 106, at 120–22. Indeed, Judge Posner's emphasis on excluding market-wide trends was based on an efficient-markets point: all securities have equivalent value on a risk-adjusted basis. *Bastian*, 892 F.2d at 685–86.

143. *See* Fisch, *supra* note 128. One implication that might be drawn from *Dura* is that there can be no recoverable loss for buyers unless the price dropped below their purchase price.

known. First, what if there is no price drop at all upon corrective disclosure? That was the situation in *Dura*. Although this might well signal that the market was never fooled in the first place, it could also be explained by predisclosure leaks, independent discovery of the truth, or the mixing in of good news with the subsequent acknowledgement of the truth. The very idea that markets wait for the formality of corrective disclosure to adjust defies the teachings of market efficiency. Second, as just noted, what if there were multiple bits of bad news at the same time as the admission of the truth, so that although the stock-price drop is clear, disentangling the multiple effects is impossible?[144] Event studies do very well when there is a single event and a short time window to measure marketplace impact, but not all that well otherwise. Since *Dura*, courts have hardly been clear on the burden of uncertainty even at the pleading stage, but the case law tilts in defendants' favor.[145] In contrast to *Basic*, the Court did not make much of an effort to lighten plaintiffs' burden though presumptions or other procedural devices, even though it could easily have done so.[146] As such, *Dura*'s disinclination to move in that direction probably does say something about shifting attitudes toward private securities litigation in the last twenty years, an issue we will come back to shortly.

B. Oscar

Oscar is the most recent of a cluster of Fifth Circuit decisions dealing with what showing plaintiffs must make at the class-certification stage on whether the fraud distorted the market in the first place.[147] As

144. *See* Spindler, *supra* note 132, at 680–82. There are possible approaches to this, for instance focusing on intraday price moves. *See* Ferrell & Saha, *supra* note 132, at 170. A third issue that has gotten increasing attention is what happens if there are multiple allegedly fraudulent statements for which certain defendants (e.g., investment banks) are only responsible for some but not all? How can we know what correction was attributable to those particular misstatements as opposed to others, if the truth about everything came to light at once? A variation on this, which has generated a good bit of litigation, deals with alleged fraud by investment analysts; how much of the price deflation can be attributed to them as opposed to other factors when the particular stock bubble (or entire industry bubble) bursts? *See, e.g.*, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 (2d Cir. 2005).

145. *See* Jonathan C. Dickey & Daniel S. Floyd, *The* Dura *Debate: Recent Securities Litigation Decisions on Loss Causation*, 21 INSIGHTS 2, 8–9 (2007).

146. As Professor Fox has pointed out, this approach, though consistent with the desire not to provide investor insurance via rule 10b-5, has a poor deterrence fit. It too easily absolves defendants for conduct that was harmful to the economy as a whole and, at least at the time, to investors. *See* Fox, *supra* note 66, at 304.

147. *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 264–65 (5th Cir. 2007); *see also Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 665 (5th Cir. 2004); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 414 (5th Cir. 2001).

we have seen, *Basic* set this confusion in motion. Its dicta regarding what must be shown for purposes of creating the presumption of reliance does not require such a showing explicitly. But rule 10b-5 does require a showing of materiality, which could (although *Basic* makes no such suggestion) be read to require a demonstration of marketplace impact. That was Professor Fischel's preferred route and something we will come to in Part IV. However, the more obvious route taking us from *Basic* to the issue posed in *Oscar* comes via the Court's discussion of how the presumption of reliance can be rebutted. As we have seen, *Basic* says that a showing that the market was not fooled severs the causal link.

That suggests that defendants can challenge certification based on the absence of market impact, although *Basic* read literally would place the burden here on defendants to rebut, not on plaintiffs to prove.[148] In *Oscar*, however, the court read Fifth Circuit precedent to insist that plaintiffs prove market impact in order to gain class certification. It then bridged *Basic* and *Dura* by requiring as part of this market-impact showing a demonstration of loss causation—that the claimed losses were demonstrably attributable to the fraud. Echoing the *Merck* case, it also connected market impact to *Basic*'s requirement of a showing of market efficiency, saying that if it were determined for some reason that analysts and market makers did poorly at digesting the kind of information in question notwithstanding its apparent materiality, it would be evidence of inefficiency and hence grounds for denying certification for that reason alone.

Some preliminary responses are in order. First, as we have seen, *Basic*'s rebuttal example was probably ill chosen, or at least poorly explained, in terms of what was at issue in the case: the insistence on the predominance of common issues in rule 23(b)(3) of the Federal Rules of Civil Procedure. Reliance on a distorted price is common to all class members, which would seem to be enough to find class-action treatment appropriate. Distortion goes to the merits, not to either commonality or typicality, but *Basic* invites lower courts to think otherwise.

Second, note the immense strategic importance of this shift. A detailed resolution of market-impact and loss-causation issues at the class-certification stage substitutes fact finding by the judge on an extraordinarily complex issue at an early stage of the proceeding for

Oscar was written by Judge Higginbotham, who was influential in the early development of the fraud-on-the-market theory. *See supra* note 54.

148. *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474 (2d Cir. 2008) (accepting the importance of showing price distortion to justify class certification, but placing the burden of showing lack of distortion on defendants).

fact finding by the jury at trial and gives appellate courts far greater authority to review those findings.

Third, *Oscar*'s discussion of market efficiency illustrates the problems that arise when courts invoke efficiency without clear-cut guidance as to why. Citing Professors Macey and Miller, it rightly notes that contemporary research shows that efficiency is not a yes or no question:[149] some kinds of information are harder for market professionals (and hence the market itself) to digest. That does not mean that they are poor at digesting it, but rather that ambiguous information takes time to assess and can lead even experts to divergent views (i.e., slower speed of adjustment).[150] But as discussed in Part II, this hardly proves that the market is so inefficient that it should bar class certification. Distortion is still quite possible. It is distortion—not metrics of efficiency—that is ultimately important.[151]

Finally—and strongly emphasized by Judge James Dennis in dissent—loss causation is entirely separate from price distortion. There will be many situations where there is clear price distortion but difficult loss-causation problems, so that insisting on proof of the latter as well as the former is unnecessary to the *Basic* inquiry. Nothing in *Dura* hints that loss causation is a class-certification issue rather than one of pleading and proof. In particular, the supervening cause problem about which loss-causation doctrine worries has no bearing whatsoever on the initial distortion question.

These are all good reasons to worry about a case like *Oscar* as a doctrinal matter, and it is heartening that most courts outside the Fifth Circuit have been skeptical of its reasoning.[152] But the even more jarring aspect of the decision comes when the court applies its version of doctrine to the facts, which dealt with alleged misstatements regarding the number of line installations the company had done during the first three quarters of 2001. Line installations were the basic measure of the company's growth in bringing on new customers. There was no general issue about market efficiency here: Allegiance was a Nasdaq-traded company with more than fifty active market makers and roughly 65 percent of its stock owned by large institutional investors. In early 2002, the company revised its 2001 line count downward by some 10 percent and disclosed other adverse news, both historic and forward

149. *Oscar*, 487 F.3d at 269 n.43 (citing Macey & Miller, *supra* note 19, at 1083).

150. *See* Hong & Stein, *supra* note 106.

151. *See supra* note 43 and accompanying text.

152. *See, e.g.*, *Lapin v. Goldman Sachs & Co.*, No. 04 Civ. 2236 (RJS), 2008 WL 4222850, *22–24 (S.D.N.Y. Sep. 15, 2008) (collecting cases).

looking. The stock price fell almost 30 percent, and the company later went into bankruptcy.

In seeking class certification, plaintiffs did not produce an event study on either impact or corrective disclosure, though they said they could if necessary. They did, however, address loss causation by putting forward reports from key investment analysts covering Allegiance, who emphasized the line-count revision in their notes right after the corrective disclosure. Allegiance responded by offering different analyst reports downplaying the line-count issue, but even the Fifth Circuit conceded that the plaintiffs had the better of this particular argument.

Yet the court of appeals decided that this evidence was not enough. It insisted on expert scientific proof that would disentangle the new bad news from the correction in the February disclosure: "When multiple negative items are announced contemporaneously, mere proximity between the announcement and the stock loss is insufficient to establish loss causation."[153] Because the plaintiffs' expert said this might be possible even though it had not yet been done, we cannot say for sure how this might be shown. But there is reason to be skeptical: event studies, at least, simply do not produce clean results when there are two or more simultaneous issuer-specific events being measured over a short time horizon.[154]

Here, then, is an example of the uncertainty problem encountered earlier. Event studies sometimes produce determinate results, sometimes not. When they do not, it is often not because there was no observable effect, but because there were too many possible causes. This bundling problem is pervasive, leading commentators to note that under a strict loss-causation regime, the optimal strategy for a company is always to release corrective disclosure as part of a larger package, including more lies if necessary.[155] What *Oscar* does is takes this uncertainty problem and moves it up to the class-certification stage, inviting judges to kill the case immediately.

Here, the methodological comparison with *Basic* is striking. Assuming the truth of the plaintiffs' factual allegations, there seems to be a strong case of securities fraud. There is a very strong prima facie case of materiality (10 percent of a key performance indicator, bolstered with analyst testimony supporting the importance of the revision). There was also a palpable and large stock-price drop tied to corrective disclosure. Though there simply is no compelling way to say

153. *Oscar*, 487 F.3d at 271.

154. Perhaps a content-analysis study might be sufficiently scientific, but it is far from clear. *See* Dunbar & Sen, *supra* note 127, at 227–41.

155. *See, e.g.*, Spindler, *supra* note 132.

how much of that drop was attributable to the alleged line-count fraud or how much other bad news, it is hard to believe that the most likely answer is zero weight to the fraud. Dismissing the case on these grounds alone simply assures that the answer is zero. Obviously, this nearly irrebuttable presumption of no loss in the face of confounding events is a heavy thumb on the scale to favor the defense, and thus remarkably different from the way *Basic* articulated its plaintiff-friendly presumption. The Fifth Circuit was hardly subtle about it either, explicitly referring to the in terrorem nature of certified fraud-on-the-market class-action lawsuits as a reason for the heavy burden.

It is tempting, then, to ascribe this simply to an increased hostility to private securities litigation since *Basic* was decided. That more lower courts (courts of appeals, especially) have become more critical of private securities litigation since 1988 can be taken as a given, and if the only point here is to use *Oscar* to give an example of hostility, the point is hardly worth making. In fairness, however, there is probably more substance and coherence to what the court is doing in *Oscar*. Recall Fischel and Easterbrook's "bargain." Their intuition was that the presumption of reliance was justified within the framework of a market-test approach to reliance and causation because a rigorous approach to marketplace distortion can readily distinguish good lawsuits from bad, and thus reach more accurate results than subjective fact finding. It turns out that the methodological problems are often more difficult than they suggest, generating many ambiguous cases. Although from all indications *Basic* expected courts to deal with this ambiguity in the normal fashion—reserving the disputed factual issues for trial, by whatever evidence seems probative—Fischel and Easterbrook would likely disagree. Absent compelling, scientific evidence of marketplace distortion, they would argue, the potential for error and speculative abuse is simply too great.[156] Empirical ambiguity should be resolved against the plaintiffs early on in the case, rather than made a fact question for the jury so as nearly to guarantee a plaintiff-favorable settlement regardless of the persuasiveness of the claim. A strict market test, in other words, is the price plaintiffs pay for the liberality of the presumption of reliance.

And that is *Oscar* in a nutshell. To use the Fifth Circuit's own strange rhetoric, this approach "honors" the fraud-on-the-market theory.[157] But what it really honors is the conservative idea articulated by Fischel and Easterbrook. Instead of being faithful to *Basic* itself

156. Professor Coffee makes a very similar argument about loss causation. *See* John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 BUS. LAW. 533 (2005).

157. *Oscar*, 487 F.3d at 269.

(though once again the Supreme Court's confusion on the subject gives the revisionists ample cover), it is a deliberate effort to bring the fraud-on-the-market theory back to its fundamentalist roots, with efficiency and its metrics the source of all authority. Just as when the Third Circuit said in *Merck* that it had "one of the 'clearest *commitments*' to the efficient market hypothesis,"[158] invoking market efficiency in *Oscar* is more a profession of faith than the description of an analytical tool. This orthodoxy might explain *PolyMedica* as well, to the extent that the First Circuit's insistence on a strong empirical showing of efficiency is designed to reserve the fraud-on-the-market theory to those issuers where we have the most confidence in the power of the empirical tools.

If this is right, then there is a profound methodological tension in the contemporary fraud-on-the-market case law, and it is mainly about how to deal with factual uncertainty, scientific reasoning versus ad hoc resolution.[159] This is more than simple politics or businesses' influence over the judiciary. To explore this methodological tension further, and complete our analysis of what has happened to *Basic* in the last twenty years, we now need to reconnect the supposedly two separate issues that the Supreme Court addressed in *Basic*: materiality and reliance.

IV. RECONNECTING RELIANCE, MATERIALITY AND DUTY TO DISCLOSE

A. "Materiality as a Matter of Law"

The seemingly scientific method to approach fraud-on-the-market litigation is what Fischel and Easterbrook promoted and believed in, and which cases like *Oscar* have embraced. Questions of materiality, transaction causation (collective reliance), and loss causation are usually one and the same, measurable through event studies to gain a good sense of whether the alleged fraud really fooled the market and generated harm to contemporaneous traders. The background assumption is that if the market is efficient, it will be hard to fool, so that true cases of fraud will be relatively rare. Staying close to the scientific method thus checks unnecessary litigation.[160]

This brings us back to the first half of *Basic*, its discussion of materiality, to consider the relationship between the two holdings. Recall that *Basic* rejected the effort by at least two circuits (including one Easterbrook opinion) to hold preliminary merger negotiations

158. *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 269 (3d Cir. 2005) (quoting Carden, *supra* note 121, at 886) (emphasis added). One might point out that in the social sciences, there is little that is worse than having a commitment to a hypothesis.

159. *See* Dunbar & Sen, *supra* note 127, at 216–21.

160. *See supra* note 157 and accompanying text.

"immaterial as a matter of law," that is, grounds for dismissing a case prior to discovery or trial if that is all that the alleged misstatements or omissions addressed. Though *Basic* emphasizes that materiality is fact-intensive so that materiality would seem rarely appropriate to decide as a matter of law, courts over the last twenty years have persisted in doing so, including in a way that connects materiality directly to the presumption of reliance.

Suppose that upon release of corrective disclosure, the market price does not go down. As we have just seen, this can be a loss-causation defect that under *Oscar*, at least, means that the lawsuit can be dismissed through denial of class certification. But according to other courts, this lack of market-price reaction can also be the basis for holding the alleged misstatements immaterial as a matter of law. A trilogy of Third Circuit cases (two written by Judge Samuel Alito before his promotion) stand for the proposition that information is presumed immaterial as a matter of law when the stock price did not react significantly to corrective disclosure.[161] *Merck*, explored earlier, is one of these three.

Because this is just *Oscar* in another guise (and does not in any event represent a clear majority view in the courts),[162] we need not repeat the critique in any detail. Again, the court is invoking a questionable heuristic in a number of respects: the problem of information leakage, or professionals figuring out the problem before being told officially, or corrective disclosure bundled with positive news, all very plausible even in markets characterized by a high degree of efficiency. Event studies and similar analyses do not do well in assessing these other possibilities, so if the court is willing to look at nothing more than market reaction, plaintiffs probably lose what could be an otherwise strong case. Moreover, if we soften our assumptions

161. *See In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 269 (3d Cir. 2005); *Oran v. Stafford*, 226 F.3d 275, 283 (3d Cir. 2000); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997). This line of cases was squarely rejected by the Ninth Circuit in *No. 84 Employee-Teamster Joint Council Pension Trust Fund v. Am. West Holding Co.*, 320 F.3d 920, 934 (9th Cir. 2003), and is inconsistent with many other decisions. The approach that materiality cannot be determined by simple reference to a market test is probably the majority rule, not the Third Circuit's approach. *See Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 660–61 (4th Cir. 2004). Even the Third Circuit may not be entirely consistent in its commitment to market efficiency. *See Oran*, 226 F.3d at 285 n.5 (claiming that a delayed market reaction was the more plausible explanation for a price drop); Padfield, *supra* note 97, at 953 n.165.

162. The Fifth Circuit has taken note of these holdings but expressed a preference for treating the issue in terms of reliance rather than materiality. *See Nathenson v. Zonagen Inc.*, 267 F.3d 400, 415 (5th Cir. 2001).

about market efficiency, such conclusions become all the more doubtful, as our discussion of *Merck* showed.

B. The Indeterminacy Problem: Revisiting Basic *Itself*

To this point, I have been critical of excessive judicial insistence on market efficiency and event studies, insofar as courts have turned econometric analysis into a talisman without explaining why it should be determinative rather than just helpful. Fraud can operate powerfully in less-than-fully efficient markets, and have pernicious effects that are hard to isolate even in those that are efficient. But our discussion of *Oscar* suggested that the obsession with efficiency and its metrics is really an effort to gain control over factual ambiguity that, if left to conventional rules of civil procedure, may promote excessive litigation and settlement. So now I want to relax my criticism a bit by considering the implications of going in the opposite direction, embracing the plaintiff-friendly vision wherein we concede the limitations of economic science and resolve all significant factual uncertainty about materiality, market impact and loss causation in the usual way, through fact-finder deliberation at trial, educated by whatever relevant evidence the parties have at hand.

In order to think this through, I want to come back to *Basic* itself. As noted earlier, the actual facts are not necessarily what they seem to those who only read the Supreme Court's opinion. So assume the following over-simplified version of the main denial of merger negotiations at issue in the case, based on how the trial judge understood the story.[163] Basic Inc. had been approached in 1976 by Combustion Engineering, which expressed an interest in acquiring it. Basic's management preferred to remain independent, but feared the possibility of a hostile takeover bid by another chemical company. Combustion, at least, indicated that it wanted a friendly deal and hinted that it would leave Basic management in place with a good deal of autonomy. Seeing Combustion as a potential white knight if one should ever be needed but much preferring no deal at all, especially at the low price Combustion was suggesting, Basic did not say no, but nonetheless did nothing to invite or encourage serious merger negotiations.

In October 1978, a few months after last having heard any expressions of interest from Combustion (and with no hint that any future conversations were planned), the price of Basic stock rose for a

163. The trial judge was considering the defendants' motion for summary judgment and had before him an extensive factual record developed in the course of discovery. *See Levinson v. Basic Inc.*, No. C79-1220, 1984 WL 1152 (N.D. Ohio Aug. 3, 1984).

few days without obvious reason, and Basic was asked to comment on whether there were any "present or pending corporate developments" that could explain the rise. It said no.[164]

Was that securities fraud? There is, of course, the hindsight fact to add—a couple of months after that denial, Combustion came back with a serious offer far higher than any price previously mentioned. This did lead to the commencement of serious negotiations and Basic's consent to a friendly takeover. But as of October, was it an intentional, material misrepresentation? If Basic genuinely believed that the occasional (and theretofore unproductive) contacts at which Combustion expressed an interest were not the sort of thing that would constitute a material corporate development, much less explain the particular price move that had triggered the inquiry, then no. It was not trying to cover anything up, as commentators on *Basic* tend to assume.[165] It is just that this was not serious or specific enough to be a "pending" corporate development, and to publicly say otherwise would probably have led to its own market gyrations based on the misimpression that Basic was now actually up for sale. Both the Sixth Circuit and the Supreme Court, however, insisted that this was at least a fact question for the jury. After one more frustrating round on remand to the Sixth Circuit,[166] Basic (now a Combustion subsidiary) settled for a few million dollars, mostly in attorneys' fees.[167]

To me, *Basic* illustrates a problem with fraud-on-the-market cases that touches on many of the issues taken up in this Paper. It is not that the case is extortionate or vexatious; there were certainly colorable

164. In fact, there had been a first denial a full year before, when there had been even fewer contacts between the two companies, and in the context of market movements clearly driven by false rumors that a different company, Flintkote, had an interest in Basic. There was a third denial as well, a short time after the second, in a report circulated to shareholders that did nothing more than repeat what had been said publicly in the October 1978 denial. These two are less compelling cases for securities fraud than the one emphasized in the text; the first because it came so early and was in the context of Flintkote's supposed interest, rather than anything to do with Combustion; the third because it was nothing more than a repetition of what had recently been said in the media. *See Levinson v. Basic Inc.*, 786 F.2d 741, 744–45 (6th Cir. 1986).

165. *See supra* text accompanying note 19. I am bothered by the possibility that Basic's management might have concealed these talks deliberately so as not to put the company in play for a hostile takeover, which they clearly feared. If that is the story, however, it is a good example of selfish concealment, which would not readily justify corporate (as opposed to individual) liability. *See* Arlen & Carney, *supra* note 57, at 694; Langevoort, *supra* note 1.

166. *Levinson v. Basic Inc.*, 871 F.2d 562 (6th Cir. 1989).

167. *Basic* was settled for between $2 million and $4.5 million, depending on how many seller claims were ultimately filed. Between $1.4 million and $1.9 million of this amount was set aside for attorneys' fees. *See* Langevoort, *supra* note 1, at 267.

grounds for plaintiffs to bring it. Rather, the problem combines "law-fact" indeterminacy with the risk of disproportion. My sense is that what was going on with Combustion was almost certainly not material as of October, and that Basic probably acted in good faith in that it thought that it was responding fairly to the question about the recent stock-price moves. That is certainly what the district-court judge thought. Others might disagree, of course. Even putting aside questions of how well a jury would do at assessing materiality or scienter in hindsight,[168] however, the question is whether resolving this kind of legal ambiguity by way of fact finding at trial is worth the expenditure of heavy legal fees and the creation of massive liability exposure.

There are really three points here that, cumulatively, underlie the intuition that this may not be a good investment of investor resources. The first was noted earlier: the suspicion that the measure of damages in securities-fraud action is systematically excessive, which can lead to unnecessarily large judgments or settlements. This was first raised by Easterbrook and Fischel, who probably set the problem aside too easily.[169] The excess is compounded by the insurance-like nature of the system; putting aside the less common situation of third-party (e.g., investment bank) liability, shareholders themselves fund settlements and judgments, directly or indirectly. The high attorneys' fees are a form of tax to facilitate a redistributive system.

That by itself is not necessarily damning if the promotion of stock-price accuracy and the compensation of investors is important enough, and if fraud-on-the-market lawsuits serve these goals efficiently. Moreover, there is the reliance interest on stock-price integrity that *Basic* so stresses, which suggests that investors who buy or sell at distorted prices have a right to compensation. The second point, however, is that it is easy to misunderstand the place of stock-price accuracy and the idea of a right to recovery. Securities regulation tries to make stock prices accurate, but the effort is necessarily imperfect.[170]

168. *See* Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773 (2004). The well-researched psychological phenomenon is that people do poorly at assessing the likelihood that an event would come to pass as of some earlier date once told that in fact it did come to pass. They substantially overstate the risk compared to those not told what ultimately happened. *Id.* at 778–79.

169. *See supra* notes 63–65.

170. The best explanation of this is Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995). Disclosure is costly in terms of production, delivery, and its effects on legitimate corporate needs for confidentiality, and these factors counter the desire for full disclosure. The result is a compromise. For an argument that stock-price accuracy should be abandoned as a disclosure philosophy in favor of policing against managerial disloyalty, see Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

In fact, securities regulation tolerates a substantial amount of nondisclosure of material information, for sound policy reasons, so that even efficient markets (in the semistrong sense) are often inaccurate. As a result, the baseline is not full disclosure—the default rule is *no* duty to disclose even dramatically material information in the absence of a specific SEC or judicially created duty. *Basic* is a good example. As the Court conceded, the company had no obligation to divulge any talks with Combustion, just the duty not to lie.[171] But for the happenstance of an inquiry from the stock exchange (or in the case of the first disclosure, false rumors about a different company's potential interest in Basic), investors would have been in no significantly worse position than Basic supposedly put them through its denials, yet with no serious chance for recovery. Surprise announcements are commonplace and usually perfectly lawful, even though company managers knew of the surprise well beforehand but stayed silent. Investors necessarily assume the risk of occasional differences between what is known publicly and privately, without any expectation of compensation through litigation. This brings us back to a point made earlier—no reasonable investor could possibly *assume* that stock prices are not distorted, whether by fraud or otherwise, without appreciating the inevitable risk involved in so doing.

Were the law clear about both materiality and duty to disclose, this still would not be all that troubling; the law would simply mark the line between legitimate and illegitimate nondisclosure. That brings us to the third point. *Basic* determined that materiality as a factual matter requires going through a horribly indeterminate exercise. And as I have written about extensively elsewhere, the duty to disclose is just as much of a muddle, if not more.[172] It takes little stretching of the half-truth doctrine to find something that was said that somehow relates to something important that was not, and to challenge the company's silence at raising questions for the fact-finder about whether the market was misled. That goes back to the earlier question posed about the facts of *Basic*. I doubt that there was fraud, but others might differ. The problem is that there is no discernable baseline from which to judge whether Basic was in bounds or not. It is all open to argument, and in the glare of hindsight.

In turn, this is where concerns about expense and disproportionality arise. If the most that can be said is that there *might*

171. *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.17 (1988).

172. *See* Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87 (1999); Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639 (2004).

be materiality and a breach of duty—that is, that reasonable people could think there was no liability—it is far from clear that investors would want protection that costs millions for each lawsuit rather than adding this to the risk of mispricing, which they commonly assume and can diversify away reasonably well. It is a fortiori if we suspect a systematic risk of hindsight bias, and a liability threat of tens or hundreds of millions of dollars seems awfully big for conduct that reasonable people may see as fairly innocent, even if others might disagree. Put simply, we should not overstate the threat to investors if cases like *Basic*, where there are bona fide doubts about whether there is any fraud, are dismissed before trial. Remember, the presumption of reliance is best thought of as an act of juristic grace, in the name of both fairness and efficiency. We need not follow it slavishly if there are doubts about either, much less both.

I now may seem to have changed direction completely in this Paper, joining the hostile judges I was so critical of in Parts II and III. How can I reconcile my criticism of cases like *PolyMedica* and *Oscar* with what I have just said? As I understand it, something like this was Professor John Coffee's reason why the defendants should win in *Dura*:[173] even though the no-liability decision might rest on a weak conceptual footing, it has the virtue of taking doubtful cases off the table promptly. I am sympathetic, but ultimately disagree.

My concern about these cases is that they make ham-fisted doctrinal or procedural moves that too easily affect the best of lawsuits along with the doubtful ones. Taking *Oscar* seriously, one could imagine a truly dastardly fraud where class certification is denied simply because the company announced additional bad news along with its acknowledgement of wrongdoing. All deterrent effect is lost.

Let us return once more to *Basic*. The Court rejected the "agreement in principle" test for the materiality of merger negotiations in favor of the more generic probability-magnitude standard, fearing it would open up too much opportunity to lie (or engage in insider trading, which the SEC was worried about). I would not have accepted agreement in principle either, because it departs far too much from defining what is significant. But probability-magnitude is too hard to apply, especially in hindsight, and thus invites too much marginal fraud-on-the-market litigation. My sense is that a better case could have been made for saying that merger negotiations need not be treated as material for corporate-disclosure purposes until they have reached a point at which the parties are actively and seriously seeking a deal so that one is reasonably likely to occur.

173. *See* Coffee, *supra* note 156.

Preliminary merger negotiations, however, are but a small piece of materiality, and my concern about the ability of borderline cases to claim a disproportionate share of public and investor resources is a more general one.[174] And I doubt that one could ever address all the hard materiality questions on an item-by-item basis. The only way to respond, then, is through some kind of procedural innovation, and any approach that creates a higher standard for materiality or duty cannot wait for it to be applied at trial. There has to be an early-stage determination, either prior to discovery or with carefully restricted discovery. For this reason, I am not that averse to the idea of addressing materiality as a matter of law.

That leads me to a moderate suggestion. I have come to accept the PSLRA's heightened pleading standard on scienter (though I am still uncomfortable with the near impenetrable discovery bar) because it generates a reasonable balance; if there is not enough circumstantial or direct evidence to support a cogent inference of scienter in the way Justice Ruth Bader Ginsburg described it in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[175] the expenses and risks that investors ultimately bear probably do weigh against going forward.[176] I would thus be willing to extend this to materiality and duty as well, unless the inferences point strongly enough in favor of both materiality and a duty to speak, then the same result. That shifts power to judges and away from juries in ways that will not always be comfortable, but for the reasons described above is better than going through discovery and a trial that is itself largely a roll of the dice.[177]

Once a case survives this early-stage-merits test, however—and many will—there is no need for the overly harsh second round of prediscovery defenses on matters such as market impact or loss causation that are mainly remedial, as in *Oscar*. Nor is there reason for obsession in class certification with distractions such as measures of market efficiency, as in *PolyMedica*. If there is a strong inference of fraud (not just scienter), the work of class certification could revert

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174. For a thoughtful discussion along these same lines, see Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723 (1989); *see also* Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218 (1987).

175. 127 S. Ct. 2499 (2007).

176. *See* Geoffrey P. Miller, *Pleading After* Tellabs, 2009 WIS. L. REV. 510.

177. I am not suggesting that this is consistent with the Federal Rules of Civil Procedure or the PSLRA, and thus I am thinking in terms of possible legislative reform. And to be clear, I would not take the approach that requires compelling econometric evidence of materiality as in *Merck*, although a lack of price impact should certainly be an important factor in the analysis.

simply to what rule 23(b)(3) instructs: an examination of whether common issues predominate, without awkward or disingenuous efforts to turn class certification into a merits inquiry. And while loss causation necessarily remains plaintiffs' burden under the PSLRA, the inevitable doubts should be resolved against the wrongdoer so long as there is a solid basis for believing that some portion of the loss was actually attributable to the fraud. This approach, which is tough on the merits at an early stage of the lawsuit but more forgiving once there is a strong inference of fraud, balances the competing interests of deterrence, compensation and cost minimization. Without better balance up front, however, courts are likely to continue to be excessively harsh on these ancillary questions.

CONCLUSION

Basic has left us an odd legacy after twenty years. Without explaining adequately how or why, it made market efficiency seem essential to the presumption of reliance, which invited courts to use the tools of financial economics as if they could readily produce clear-cut solutions to messy, complex fraud cases. That was an illusion. Doctrinally, the explanations in cases like *PolyMedica*, *Merck* and *Oscar*—even *Dura,* perhaps—do not make a great deal of sense except as expressions of faith in that possibility, notwithstanding evidence to the contrary.

In the mid-1980s, when *Basic* was decided, market efficiency claims (and market stories generally) were appealing and persuasive across a fairly wide spectrum of intellectual opinion. There was an air of sophistication to invoking cutting-edge theory, separate from actually understanding the internal mechanics of the marketplace.[178] That, of course, was Justice White's point in his dissent. Over time, however, as financial economics has become less convinced that market efficiency works quite so cleanly or powerfully, sophistication has given way to what often sounds like simplistic expressions of faith. I suspect that the courts' promotion of market efficiency beyond what *Basic* likely intended is partly due to the sense that this is a way to impose order on what otherwise becomes a very messy set of jury

178. The classic article on how market efficiency is generated is often cited (including in *Basic*) as a testament to efficiency; in fact, it warned that efficiency was a highly complex phenomenon and unlikely to be accurate under all conditions all of the time. *See* Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). That it was read as a testament says much about the intellectual environment of the times. *See* Donald C. Langevoort, *Foreword: Revisiting Gilson and Kraakman's Efficiency Story*, 28 J. CORP. L. 499, 501 (2003). For more on the ideological point, see Langevoort, *supra* note 28, at 912–20.

questions with too many maybes as answers. In this, they are clinging to Fischel and Easterbrook's vision, but not Justice Blackmun's.

Basic's legacy would have been stronger had the Court more clearly articulated the only sensible justification for its presumption: a common law-like entitlement to rely on stock-price integrity, granted as a matter of juristic grace even though it is not particularly reasonable for investors simply to assume the absence of fraud. There are good reasons for fraud-on-the-market lawsuits, in terms of both compensation and, more likely, deterrence, but also good reasons to worry about indeterminacy and disproportion. Reliance and loss causation have never been the right subjects for dealing with this, and one can imagine a better world in which neither is a significant element of the cause of action.[179] Unfortunately, *Basic* and the line of cases that followed made reliance and causation the biggest battleground, thereby becoming a distraction from what really is important.

179. *See, e.g.*, Alexander, *supra* note 65 (suggesting a purely deterrence-based measure of damages to be shared by the class); Langevoort, *supra* note 65, (same).