# Judging Heuristics

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## INTRODUCTION

This Article tells a story about judges and the development of doctrine (or, arguably, lack thereof), and what happens when Congress both legislatively and rhetorically gives overworked federal courts the permission and the power to exercise docket control by eliminating cases at the motion-to-dismiss stage. It is also a story about the long run implications of a focus on procedure and form over substance in the realm of securities law.[1] The moral of the story is that when form over substance is the input, form over substance is the output.

The focus is on federal district court judges who are trial management specialists, faced with lengthy dockets. The story is drawn from the courts' moves and language, followed, largely, by exploring cases in which courts have deployed judge-made heuristics to securities-fraud claims. In the end, it is a story about the limits of the rule of law.

The larger story has its roots in the many years of cases decided since the Securities Act of 1933 and the Securities Exchange Act of 1934 were passed. But, the analysis contained in this Article reviews a more recent phenomenon which has been unfolding primarily since December of 1995, when Congress passed the Private Securities Litigation Reform Act (the "PSLRA") and statutorily created pleading standards for securities-fraud claims.[2] The securities law portion of this Article forms a backdrop for the story about judging and judges and the heuristics they use and the impression those heuristics create. Section One of the Article discusses district court judges, their workloads, and motives. Then, in Section Two, I explore the heuristics, or shortcuts, that are evolving out of those, largely, district court opinions, through the ways in which they have developed and applied one pre-PSLRA standard, called the Motive and Opportunity Test, to the scienter element of claims brought pursuant to the Securities Exchange Act. The analysis reveals that the district courts have eagerly and overwhelmingly accepted the "opportunity" Congress offered them by creating and using heuristics to eliminate cases on motions to dismiss that are arguably better preserved

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[1] *See* Stephen C. Yeazell, *The Misunderstood Consequences of Modern Civil Process*, 1994 WIS. L. REV. 631, 677 (describing mutability of procedure over time and downsides of interstitial alterations in procedure without focusing on basic principles).

[2] *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 [hereinafter PSLRA].

for summary judgment. In Section Three, I review those courts' rhetoric, how they exercise their discretion, and the comments and powers they invoke in doing so, arguing that the courts' commentaries create the appearance of disdain for these cases and, sometimes, contempt for the plaintiffs' lawyers involved. Using that language and rhetoric, in combination with the heuristics analyzed in Section Two, I then focus on the impressions created by the heuristics and rhetoric, arguing that the district courts are creating the impression that their own mixed motives can overwhelm the merits of the cases before them. Lastly, in Section Four, I explore the potential implications of these opinions and the heuristics for the legitimacy of both the securities markets and the courts.

## I. OF JUDGES AND MOTIVES

Judges are busy people. District court judges are especially busy people who exist in very noisy environments.[3] They have crowded dockets and limited courtroom time.[4] In addition to keeping track of their schedules and those of all the cases on their dockets, they must cope with motions and trials. Just like other busy "managers," judges find ways to meet the demands of their jobs through the use of cognitive biases.[5]

These cognitive biases are the same types of shortcuts, or heuristics, that we all develop to cope with the multiple decisions we must make on a daily basis.[6] In the context of this Article, the heuristics at issue are

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[3] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 129 (1997) [hereinafter Langevoort, *Organized Illusions*] (discussing effect of hectic work environments on decision making).

[4] *See In re* Ciena Corp., Sec. Litig., No. JFM-98-2946, 1999 WL 1027051, at *1 (D. Md. July 19, 1999) (containing memo to counsel stating "[u]nfortunately, my present schedule does not permit me to try to write an opinion of equal worth [to parties' briefings]"); J. Harvie Wilkinson III, *The Drawbacks of Growth in the Federal Judiciary*, 43 EMORY L.J. 1147, 1157-64 (1994) (discussing changes in federal courts and caseloads).

[5] *Cf.* Philip E. Tetlock & Ariel Levi, *Attribution Bias: On the Inconclusiveness of the Cognition-Motivation Debate*, 18 J. EXPERIMENTAL SOC. PSYCHOL. 68, 70-74 (1982) (describing bias inherent in decision making, specifically purely cognitive heuristics which are reaction to busy world with limited information).

[6] Management-school literature on these types of decision-making heuristics abounds and can reasonably be applied to judges as well. *See, e.g.*, Sara Kiesler & Lee Sproull, *Managerial Responses to Changing Environments: Perspective on Problem Sensing from Social Cognition*, 27 ADMIN. SCI. Q. 548, 549 (1982). For readings on decision making in the administrative context, see, for example, HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR, A STUDY OF DECISION-MAKING PROCESSES IN ADMINISTRATIVE ORGANIZATIONS (Free Press 1997).

simplistic, rule-like tests developed by the courts. When applied to securities-fraud cases these heuristics allow courts to dismiss in their entirety otherwise complex cases at the motion-to-dismiss stage.

To begin with, a further definition of the term "heuristic" is in order. The study of heuristics is one about how people make, or "come to" their decisions.[7] Psychological research indicates that people develop cognitive biases, or decision-making tools, to enable them to make judgments in the face of uncertainty.[8] Although heuristics can be sophisticated, the purpose of a heuristic is to simplify the decision-making process. Heuristics, then, may function like "rules of thumb."[9] One value of the heuristic is that it allows the decision-maker to accomplish a subjective assessment of probability, with data that is both limited in quantity and validity.[10] Thus, a good heuristic allows the decision-maker to reduce the amount of time and effort necessary to make a reasonable judgment about an outcome.[11]

Heuristics are present in our everyday lives. For example, we assess the distance of objects by relying, in part, on our sense of their clarity. To do so, we assume that clearer objects are closer.[12] This visibility heuristic may prove to be accurate much of the time, but it is subject to inaccuracies and systematic errors, whenever, for example, visibility is either poor or good.[13] The same potential for inaccuracy and systematic error applies to other heuristics as well.

This Article explores the potential for, and application of, the systematic errors inherent in the securities-fraud heuristics courts are now employing.[14] If a court repeatedly applies a heuristic, subject to a systematic error, to all securities-fraud cases, then some cases in which fraud actually occurred will be inappropriately dismissed before the fraud can be discovered or proved. Thus, the process will incorporate a

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[7] SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 109 (1993).

[8] *Id.*

[9] *Id.*

[10] *See* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, 3, 3 (Daniel Kahneman et al. eds., 1994).

[11] PLOUS, *supra* note 7, at 109.

[12] *See* Tversky & Kahneman, *supra* note 10, at 3.

[13] *Id.*

[14] For an empirical study of some heuristics and their use by federal district court judges, see *Inside the Judicial Mind: Heuristics and Biases*, Chris Guthrie, Jeffrey J. Rachlinski, & Andrew J. Wistrich, (working paper, on file with the author). *See also* Jeffrey J. Rachlinski, *Heuristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61, 64 (2000) (arguing that trial judges are not likely to recognize their own cognitive errors in fact finding).

systematic error prejudicing a particular group.[15] Further, depending on the nature and explicitness of the heuristic, it can create a safe harbor for fraud, and thus, has the potential to result in an increase in securities fraud.[16] Finally, the heuristic and its use has the potential to create a perception of bias on the part of the court — a lack of complete and fair review — thereby harming the court's reputation even if no fraud actually occurred. Thus, ironically, the heuristic designed to help the court protect its reputation by guarding against a hindsight bias has the potential to harm its reputation.[17]

To be sure, whether fraud will increase as a result of the use of these heuristics is an empirical question. We can deduce that plaintiffs will lose more cases, and that defendants will win more. Recent statistics support that proposition,[18] as does the analysis contained in this Article. From those statistics, we might deduce that fraud will increase. But, ultimately, whether the use of heuristics is problematic with respect to the creation of fraud is an empirical question that cannot be accurately answered.

Simply put, we do not, and usually cannot, know with certainty which case, the one with fraud or the one without, a court is dismissing. It is also impossible to know with certainty whether the heuristics will, by creating safe harbors, increase the occurrence of fraud. Ironically, the reason why we cannot know is the same reason why the courts employ the heuristics — they are making the decision in a state of uncertainty, exacerbated in the context of securities fraud by the stay of discovery applicable to these cases.

The key uncertainty in federal securities-fraud claims is connected to the scienter, or state-of-mind, element. Because to succeed with a standard securities-fraud, class-action claim, the plaintiff must prove that

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[15] *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 974-88 (1984) (discussing consequences of errors when repeated).

[16] Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 596 (1998) (discussing systematic errors and their potential to decrease intended effect of negligence laws).

[17] *See generally id. See also* John C. Anderson et al., *Evaluation of Auditor Decisions, Hindsight Bias Effects and the Expectation Gap*, 14 J. ECON. PSYCH. 711, 722 (1993) (discussing auditors and state and federal judges).

[18] Joseph Grundfest & Adam Pritchard, *Sowing Confusion?: An Empirical Analysis of the Judicial Response to Statutory Ambiguity in the Private Securities Litigation Reform Act* (working paper, on file with the author) (estimating 1996-98 dismissal rate to be as high as 48 percent); Fred Dunbar et al., *Recent Trends VI: Trends in Securities Litigation and the Impact of PSLRA* at 6, NERA (June 1999) (noting dismissal rate has increased from approximately 12 percent to 25-28 percent).

the defendant either intentionally, or with sufficient recklessness, made a misstatement or omission, the courts must attempt to determine the defendant's state of mind at the time of the misstatement or omission.[19] Yet, it is almost impossible to prove a defendant's state of mind, here scienter. There is always some uncertainty, and in the context of a motion to dismiss, considerable uncertainty, about what the defendant knew or did not know at the time of the alleged misstatement or omission. The result, even in the absence of the heuristic, is legal error.[20] This error comes in the form of false positive findings, those where the defendant did not commit the fraud, but the court finds that the defendant did; and false negatives, those where the defendant did in fact commit fraud, but the court finds that none occurred.[21]

The pleading standard imposed by the PSLRA is aimed at the false positive errors, commonly referred to as strike suits. By definition, a pleading standard will be imperfect. It is nearly impossible to know whether a defendant has committed fraud in the absence of mindreading or a "smoking-gun" memo, and it is even more unlikely that we can judge the likelihood of this fact, with accuracy, at the pleading stage, when discovery is stayed.[22] Further, a stricter pleading standard favors the defendants. Accordingly, as the pleading standard "increases," the number of false positives should decrease. Unfortunately, the number of false negatives is likely to increase. As a result, some fraud will go unremedied, but we can never know exactly how much.

Arguably, Congress accepted this risk when it passed the PSLRA. Although the debate surrounding the PSLRA includes discussion of the impact of fraud on the securities market, the focus of the debate was on the companies allegedly wrongly accused of such fraud. And, arguably, Congress assumed that the courts would attempt, in good faith, to implement a heightened pleading standard for scienter. But Congress did not prescribe exactly how the courts should go about doing so.[23]

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[19] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that cause of action pursuant to section 10(b) of Securities Exchange Act of 1934 requires plaintiff to plead and prove that defendants acted with scienter).

[20] *See* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996).

[21] *Id.*

[22] One of the procedural reforms in the PSLRA was to impose a stay of discovery on all cases, effective until the complaint survives a motion to dismiss. Pub. L. No. 104-67, 109 Stat. 737, 746-47 (1995).

[23] For a discussion of the statutory interpretation issues involved in selecting and applying the appropriate pleading standards, *see* Grundfest & Pritchard, *supra* note 18.

Indeed, one of the significant problems with the PSLRA is that it urges the courts to employ a pre-PSLRA pleading standard to cases filed after its effective date.[24] Courts developed the pre-PSLRA pleading standard through their review of complaints revised as plaintiffs gained access to company documents and other discovery information.[25] This discovery occurred before the final motion to dismiss.[26] Thus, through discovery, plaintiffs were able to plead and replead their complaints, with greater specificity, before the court reached a final conclusion on a motion to dismiss.[27] The standard that evolved is one that implicitly involves internal company information found through the discovery process. This so called internal-information standard is overly restrictive in the post-PSLRA era, where discovery is stayed. And, the effect of the standard is exacerbated by the courts' increasing use of heuristics, which, in turn, create new safe harbors for fraud.

A thorough examination of why shortcuts and heuristics have flourished in securities-fraud cases requires some consideration of what, if anything, the judges appear to "get" from their use.[28] Here, I want to stress, I am discussing perceived motives that I will later connect to the misimpressions these decisions have the power to create. The first and most obvious gain for district court judges is the timesaving nature of heuristics.[29] If a court can apply a quick and easy test to a lengthy complaint and arrive at a conclusion allowing it to dismiss the case, the court can use the time it saves to consider other more worthy matters. Rule-like heuristics that allow courts to dismiss allegations at a glance are, by their nature, timesaving devices. They not only allow dismissal of a case in its early stages, but, because of special legislative provisions applicable to securities-fraud cases, they allow for dismissal of a case before the district court must face the inevitable discovery disputes inherent in contested complex litigation. Dismissing otherwise complex cases without the need for discovery is a tremendous docket-clearing

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[24] *See* Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537 (1998).

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *See* Frederick Schauer, *Incentives, Reputation, and the Inglorious Determinants of Judicial Behavior*, 68 U. CIN. L. REV. 615, 617-18 (2000) (noting that proper study of court systems requires understanding of judges' motivations) [ hereinafter Schauer, *Incentives*].

[29] *See* Robert E. Keeton, *Times are Changing for Trials in Court*, 21 FLA. ST. U. L. REV. 1, 15 (1993) (noting that heavy caseload dictates that judges terminate cases quickly, not necessarily justly).

mechanism[30] and one that can work with speed.[31] Of course, even if a district court successfully dismisses these cases, it will still face others, but securities-fraud cases are complex and, currently, "out of vogue." Thus, their dismissal may be less costly in reputational and other terms.[32] Consistent with this hypothesis, a recent study indicates that busy judges who are likely to find such cases on their dockets are more likely both to adopt a strict scienter pleading standard[33] and to dismiss those cases.[34]

Speed may be key to district courts not only because they are busy, but also because their success in managing and controlling their dockets is scrutinized, and statistics about their success are published by the Administrative Office of the United States Courts.[35] And, unlike appellate courts, district court judges do not have available to them pre-screening and other docket-control measures; they must take whatever cases come their way.[36] Thus, heuristics offer them some measure of control over cases on their dockets.[37]

It is also reasonable to assume that like their appellate counterparts, district court judges "seek prestige" or respect and popularity among

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[30] RICHARD A. POSNER, WHAT DO JUDGES AND JUSTICES MAXIMIZE? (THE SAME THING EVERYBODY ELSE DOES) at 19 (John M. Olin Law & Economics, Working Paper No. 15, 1993) [hereinafter POSNER, WHAT DO JUDGES MAXIMIZE?] (pointing to judge-invented devices commonly used by appellate judges to reduce workloads); *cf.* Mitu Gulati & C.M.A. McCauliff, *On Not Making Law*, 61 LAW & CONTEMP. PROBS. 157, 196-207 (1998) (analyzing court norms with respect to summary dismissals and concluding that statistics can be interpreted to indicate that courts use such forms of judgment for alleviating complex cases about which they have little knowledge).

[31] *See, e.g.*, Plevy v. Haggerty, 38 F. Supp. 2d 816, 836 (C.D. Cal. 1998) (dismissing, with prejudice, consolidated amended complaint filed April 29, 1998 within four months of its filing and within six months of date of filing of initial individual complaint).

[32] *See* Frederick Schauer, *Judicial Incentives and the Design of Legal Institutions*, (working paper, on file with author) (noting that reputation is powerful incentive that may lead Justices to conform their behavior to relevant groups).

[33] Grundfest & Pritchard, *supra* note 18 at 59.

[34] *Id.* at 63.

[35] *See* Federal Court Management Statistics, published annually by the Administrative Office of the United States Courts; *see also* Civil Justice Reform Act of 1990, Title I, Judicial Improvements Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 (requiring various forms of reporting on federal court activity, including docket reports on individual judges).

[36] *See* RICHARD A. POSNER, THE FEDERAL COURTS CHALLENGE AND REFORM 160 (1996) (discussing curtailment of oral argument as response to increased caseloads and demand for court time); POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 19 (noting that appellate courts screen cases for importance).

[37] The heuristics may also help judges acquire more leisure time, one of the incentives the literature recognizes as important to judges. *See* Sidney S. Shapiro & Richard E. Levy, *Judicial Incentives and Indeterminacy in Substantive Review of Administrative Decisions*, 44 DUKE L.J. 1051, 1054 (1995). Of course, managing cases quickly may simply increase the number of cases assigned to a judge.

their peers, here defined as members of the bar involved in the cases before them and other judges.[38] If, like the rest of us, judges like to be liked and are "sensitive" to their popularity,[39] they have an incentive to produce opinions that increase their popularity and prestige.[40]

In securities-fraud cases, a district court is more likely to maximize popularity by drafting pro-defendant opinions. The plaintiffs' bar in these cases is limited in number. In contrast, the defense bar is more extensive. Consequently, opinions favoring defendants are likely to reach and affect more lawyers than those favoring plaintiffs. Further, the rhetoric surrounding the adoption of the PSLRA makes clear that the leading plaintiffs' lawyers in these cases are unpopular either in spite of, or because of their prominence, thus increasing the popularity cost of deciding in their favor.[41] And, generally speaking, defendants favor more specific pleading rules than plaintiffs. The heuristics pointed to in this Article are just such rules; thus, by crafting and applying them, district court judges can further enhance their popularity with the defense bar,[42] which generally is more likely to come from the "white-

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[38] POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 11 (citing Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 PUB. CHOICE 107, 129 (1983)). Note that here, as elsewhere in this Article, I draw analogies to appellate judges. I do so in part because the literature on district courts and their judges is limited. *See* Schauer, *supra* note 28 at 621-22 ("overwhelming bulk of [empirical research on judicial behavior] is . . . about Supreme Court of the United States"); *cf.* RICHARD A. POSNER, CARDOZO: A STUDY IN REPUTATION 75 (1990) ("legal profession, at least the part of it . . . that writes for law reviews is *much* more interested in Supreme Court justices than in other judges"). Perhaps that is why, in the words of the Honorable William G. Young, "[district court] judges are relatively anonymous." William G. Young, *Tribute to Honorable Joseph L. Tauro*, 81 B.U. L. REV. 5 (2001).

[39] POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 11; *see also* WILLIAM G. YOUNG, 6 REFLECTIONS OF A TRIAL JUDGE 253 (describing early experiences as judge, including embarrassment when he fell over, in his chair, during court session) (Mass. CLE materials, on file with author).

[40] *See* Shapiro & Levy, *supra* note 37, at 1054.

[41] *Cf.* POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 19-20 (employing spectator analogy for analysis of appellate judging and reasoning that meaning or value of cases may be informed by personal experiences or cultural context). Securities-fraud litigation has suffered from considerable derision by lobbyists, academics, politicians, and members of the media — that derision continues today. *See* Peter Elkind, *The King of Pain is Hurting*, FORTUNE, Sept. 4, 2000 (discussing Bill Lerach, "king of shareholder class-action suit" and his role in securities-fraud litigation). Judges are subject to the same noise as others and are, presumably, influenced by it as well. *Cf.* Patricia M. Wald, *The Rhetoric of Results and the Results of Rhetoric: Judicial Writings*, 62 U. CHI. L. REV. 1371, 1381 (1995) (noting that when appellate judges have difficult or bad relationships with their colleagues, tone of relationship creeps into opinions).

[42] *See* Stephen C. Yeazell, *Judging Rules, Ruling Judges*, 61 LAW & CONTEMP. PROBS. 229 (1998) [hereinafter Yeazell, *Judging Rules*].

shoe" elite corporate law firms.[43] The fact that "few, if any, [judges] come from the ranks of plaintiffs' lawyers who specialize in high-stakes commercial litigation" may compound this effect.[44]

Others have argued that prestige seeking judges may also desire to please the litigants.[45] Although in many cases it may be difficult to please both the winners and losers,[46] in securities-fraud class actions, courts can win by ruling for defendants. For example, in a traditional, nonclass action case, a district-court order granting a motion to dismiss would divide the parties into winners and losers. In securities-fraud cases, the effect on the winners is direct, but the effect on the losers is diffused by the class action mechanism. Many securities fraud lead plaintiffs do not attend arguments or read opinions because their financial stake in the litigation is usually quite small. Indeed, that is the reason for creating the class-action mechanism in the first place. Thus, ruling for the defendants is arguably a winning proposition for district court judges.

Another hypothesis in the literature about what motivates judges is their power to vote and the deference accorded them by virtue of that power.[47] District court judges cast multiple votes on a daily basis. They overrule and sustain objections to evidence and determine whether and when to schedule a trial. They also cast "bigger" votes. A district court opinion dismissing a case, rather than allowing it to move forward for discovery and settlement, directly controls the outcome of the case. If the case moves forward, the judge takes on the role of a trial manager,

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[43] CHICAGO LAWYERS: THE SOCIAL STRUCTURE OF THE BAR 66 (John P. Heinz & Edward O. Laumann eds., rev. ed. 1994) (revealing that securities lawyers enjoy high prestige relative to others); Mark C. Suchman, *Working Without A Net: The Sociology of Legal Ethics in Corporate Litigation*, 67 FORD. L. REV. 837, 837 n.1 (1998) (noting that corporate litigators are at "pinnacle of legal profession's status hierarchy");. Many of the judges come from such firms as well. *See* Grundfest & Pritchard, *supra* note 18, at 53 (noting that judges deciding majority of securities fraud cases from 1996-98 had either corporate law or prosecutorial backgrounds). And, recent empirical work on plaintiff litigation reveals that, at least on the appellate level, plaintiffs face an uphill battle. *See* Kevin M. Clermont & Theodore Eisenberg, *Anti-Plaintiff Bias in the Federal Appellate Courts*, 84 JUDICATURE 128 (2000). The authors conclude, in part, that the bias may well be due to an incorrect perception that trial courts favor plaintiffs. *See also* Kevin M. Clermont & Theodore Eisenberg, *Plaintiphobia in the Appellate Courts: Civil Rights Really Do Differ From Negotiable Instruments*, Working Paper (July 9, 2001). According to one paper, in securities-fraud cases, plaintiffs have won only four of the sixteen appeals. Grundfest & Pritchard, *supra* note 18, at 43.

[44] *In re* Oracle Sec. Litig., 131 F.R.D. 688, 695 (N.D. Cal. 1990).

[45] Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 PUB. CHOICE 107, 129 (1983).

[46] POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 10.

[47] *See id.* at 12-13.

monitoring the process, urging settlement, and, though rare, handing off the power to control the outcome to the jury. Thus, the district court loses significant control over both the timing and the outcome of the case. A vote to dismiss the case, then, is one of the most powerful available to a district court.[48] And that type of vote is proliferating in securities-fraud cases.

Judges who like to write opinions may also receive particular satisfaction from handling securities-fraud cases. Many of the district court, securities-fraud, motion-to-dismiss opinions read like appellate decisions. A well-crafted securities-fraud opinion contains an exposition of the law and the complaint and an analytical section. The analysis allows the district courts to play with the allegations, sorting them into categories. These categories include actionable and nonactionable misstatements, those statements for which scienter is alleged through the motive and opportunity test, and those statements for which scienter is alleged through recklessness. The courts can further subdivide the allegations, attempting to fit each into a different heuristic box. A match between an allegation and a dismissal heuristic allows the court to eliminate the allegation, and, eventually, to dismiss the entire complaint. The process has a game-like dimension where each allegation fits into a dismissal box with its own code.[49] The intellectual challenge is in both finding the box and building the arguments to go with it.

Catchy language or easily applied heuristics are likely to have the additional benefit of citation and, thus, advertisement of a judge's intellectual talents and writing skills.[50] Further, for any judge who enjoys

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[48] *Cf.* Wald, *supra* note 41, at 1397 (noting, in context of discussion of particular cases and rhetoric, power that judges can wield when they articulate tests others use).

[49] Richard A. Posner, *The Learned Hand Biography and the Question of Judicial Greatness*, 104 YALE L.J. 511, 525 (1994) [hereinafter Posner, *Learned Hand Biography*] (stating that Judge Hand described his work as "solving crossword puzzles").

[50] *See* Richard A. Epstein, *The Independence of Judges: The Uses and Limitations of Public Choice Theory*, 1990 B.Y.U. L. REV. 827, 838 (noting that judges maximize prestige through writing and that "it matters to judges that their opinions are cited"); *see also* Mita Bhattacharya & Russell Smyth, *The Determinants of Judicial Prestige and Influence: Some Empirical Evidence From the High Court of Australia*, 30 J. LEGAL STUD. 223 (2001) (noting that studies count citations to measure judges' influence); Ronald A. Cass, *Judging: Norms and Incentives of Retrospective Decision-Making*, 75 B.U. L. REV. 941 (1995) (discussing value of notice from law professors); William M. Landes et al., *Judicial Influence: A Citation Analysis of Federal Courts of Appeals Judges*, 27 J. LEGAL STUD. 271, 274 (1998) (pointing out that self-citations are way of advertising judge's own opinion); Posner, *Learned Hand Biography*, *supra* note 49, at 534 (indicating that citation counts may be reasonable measure of judges' influence); Wald, *supra* note 41, at 1372 ("some judges write for the personal gratification that comes from being quoted, cited and republished"); *cf.* William M. Landes & Richard A. Posner, *The Influence of Economics on Law: A Quantitative Study*, 36 J. LAW & ECON. 385, 389

the "intrinsic pleasure of writing" or who wishes to "exercis[e] and display[ ] analytical prowess,"[51] securities-fraud opinions on motions to dismiss offer an excellent vehicle for such psychic benefits, without any of the accompanying irritations of discovery battles and scheduling hearings.[52] Many of the district-court opinions bear these hypotheses out. They are lengthy, chock full of heuristics, and filled with analysis, albeit in the form of shortcuts.[53] The motion to dismiss opinion, then, is an excellent vehicle for meeting both goals — docket clearing and enhancing one's reputation through the written opinion.[54]

In sum, whether it is time, control, power, intellectual stimulation, or simple, writing pleasure, district court judges have many motives impelling them in the direction of securities-fraud motions to dismiss, which, in turn, may lead to heuristics. To be sure, as noted above, heuristics are not inherently bad.[55] But the question remains whether, when combined with precedent and rhetoric, the heuristics actually increase fraud and decrease the legitimacy of the courts. As the analysis in Section Two of the Article reveals, the heuristics at work in securities-fraud cases are, arguably, cascade-like in nature[56] and have the potential to be particularly problematic.

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(1993) (using citations to measure effect of scholars' work).

[51] POSNER, WHAT DO JUDGES MAXIMIZE?, *supra* note 30, at 14.

[52] *See* Sale, *supra* note 24, at 582 (noting that judges dislike discovery and its inevitable, accompanying battles); *cf.* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1941 (1998) (discussing Delaware judges and their role in center of complex business litigation).

[53] Indeed, when I was describing my impression of these opinions to one appellate court scholar, he noted that the potential for crafting such opinions would make a job that he had not previously viewed as desirable, that of being a district court judge, much more appealing. No pun intended.

[54] Although these opinions like any other final judgment are subject to appeal, statistics on appeals and reversals reveal that this threat is not significant. For example, in 1995, the rate of appeal in the federal courts was only about 20 percent. *See* Michael E. Solimine & Christine Oliver Hines, *Deciding to Decide: Class Action Certification and Interlocutory Review by the United States Courts of Appeals Under Rule 23(f)*, 41 WM. & MARY L. REV. 1531, 1561 n.163. The reversal rate is even lower, averaging somewhere between 13 and 26 percent of those filed. *Id.* at n.164. District courts are assured of affirmance 80 to 90 percent of the time. *Id.* at n.165.

[55] *See supra* notes 6-13 and accompanying text. *See generally* Jay J.J. Christensen-Szalanski, *Problem Solving Strategies: A Selection Mechanism, Some Implications, and Some Data*, 22 ORG. BEHAV. & HUM. PERF. 307 (1978); Jay J.J. Christensen-Szalanski, *A Further Examination of the Selection of Problem-Solving Strategies: The Effects of Deadlines and Analytic Aptitudes*, 25 ORG. BEHAV. & HUM. PERF. 107 (1980).

[56] *See generally* Eric Talley, *Precedential Cascades: An Appraisal*, 73 S. CAL. L. REV. 87 (1999).

## II. THE MOTIVE AND OPPORTUNITY HEURISTIC

One of the effects of the PSLRA has been to narrow the ways in which district courts begin their examination of the particularity of the plaintiffs' scienter pleadings.[57] The courts have articulated two types of

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[57] In passing the PSLRA, Congress stated two goals. One was to decrease the so called class action strike suits against companies. *See* John C. Coffee, *The Unfaithful Champion: Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROB. 5, 5 (1985) (noting shift away from perception of shareholder litigation from respected "regulator of corporate management"); *see also* Edward Labaton, *Consequences, Intended and Unintended, of Securities Law Reform*, 29 STETSON L. REV. 395, 403 (1999) (noting that PSLRA was part of 1994 Congress's Contract With America). Indeed, the legislative history is replete with references to and accusations about the plaintiffs' bar that filed these suits, allegedly whenever a company's stock price dropped more than 10 percent. *See, e.g.*, William S. Lerach, *"The Private Securities Litigation Reform Act of 1995–27 Months Later": Securities Class Action Litigation Reform Acts Brave New World*, 76 WASH. U. L.Q. 597, 598 (1998); *see also* Queen Uno Ltd. P'ship v. Coeur D'Alene Mines, Corp., 2 F. Supp. 2d 1345, 1353 (D. Colo. 1998) ("The Reform Act was designed to deter perceived abuses of the Exchange Act by overzealous attorneys intending not to right a securities fraud wrong, but to make a quick buck by coaxing settlements out of well-intentioned companies and executives fearful of a large but unwarranted jury verdict." (citing S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679)). To some extent, the argument is that in securities fraud, like other areas, the lawyers are not properly performing their gate-keeping function or their roles as agents in solving the collective action problem. *See generally* Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337. On the role of lawyers in conflicts and society in general, *see, e.g.*, Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509 (1994); Robert C. Clark, *Why So Many Lawyers? Are They Good or Bad?*, 61 FORD. L. REV. 275 (1992); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990).

Several people have reexamined these allegations and found them either to be untrue or at least to be based on motives other than simple stock price drops. Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438, 442-44, 448-49 (1994) (noting that number of lawsuits filed had not increased significantly); Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567 (2000) (rejecting argument that securities litigation is frivolous and cases are only of strike-suit nature); Labaton, *supra*, at 402; *see also* Denise M. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L., BUS., & FIN. 122 (1999) (summarizing class action information and concluding that difficulty of proof, rather than alleged lack of merit, accounts for settlement size). *See also* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998) (arguing that rhetoric supporting passage of Uniform Standards Act also lacked empirical basis). *See generally* Lucian Arye Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. OF L. & ECON. 3 (1990).

The other goal was to create uniformity in the way in which the courts handle securities-fraud complaints. *See* Marilyn F. Johnson et al., *In re* Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting from the Private Securities Litigation Return Act's Pleading Standards*, 73 S. CAL. L. REV. 773, 790 (2000).

The provisions of the PSLRA, which are overwhelmingly procedural in nature, have achieved neither of these goals. *See* Steve Bailey & Steven Syre, *'95 Reform Act Fails to Limit*

tests for scienter pleadings, both of which have their roots in the Second Circuit. This Section examines one of those tests, the Motive and Opportunity Test (or the "Test"). After a brief review of the pleading of claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5, promulgated pursuant thereto (Exchange Act Claims),[58] this Section explores the heuristics the courts are developing under the rubric of the Test, and, in the process, tells a story about its increasing stringency and the problems with the implicit, and sometimes, explicit, assumptions courts are making in applying it.

### *A. Pre-PSLRA Heuristics*

Although it appears that from early on, courts applied heightened pleading standards to Exchange Act Claims, the so called Motive and Opportunity Test is a recent judicial invention. To succeed with their Exchange Act Claims, plaintiffs must plead, with particularity, that the defendants made a misstatement or omission of a material fact, with scienter, and that their reliance on that misstatement or omission caused their injury.[59] In 1976, the Supreme Court held that an Exchange Act

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*Class-Action Lawsuits by Shareholders*, BOSTON GLOBE, April 22, 1998, at F1 (reporting that "reduction in class-action lawsuits by shareholders" never materialized); Labaton, *supra*, at 407 (noting number of cases is at or higher than years preceding PSLRA); *id.* at 403 (noting that main plaintiffs' firm is stronger than other and has filed more suits than any other firm since PSLRA). *But see* Jonathan Weil, *Number of Suits Charging Fraud Fell Last Year*, WALL ST. J., May 29, 2001, at B13 (noting decline in year-2000 suits filed). The average number of new securities cases filed per year before 1995 was 176. *See* Joseph A. Grundfest & Michael A. Perrino, *Securities Litigation Reform: The First Year's Experience, A Statistical and Legal Analysis of Class Action Securities Fraud Litigation Under the Private Sec. Litig. Reform Act of 1995*, (2/27/97). But in 1998, there were 244 cases filed and in 1999, there were 216. *See* Securities Class Action Clearinghouse, *at* http://securities.stanford.edu/stats/. *See also* Antonio E. Bernardo et al., *A Theory of Legal Presumptions*, 16 J. L., ECON. & ORG. 1, 29-33 (2000) (noting that lack of decline in litigation rate can be explained by posited theory). Moreover, the pleading standards for Exchange Act claims have already evolved into a Circuit split for those deciding the question and considerable diversity among the district courts within the circuits that have not yet resolved the question. In 1999, the Supreme Court rejected an opportunity to resolve the question. Kasaks v. Novak, 148 L. Ed. 2d 486 (1999).

[58] 15 U.S.C. § 78(j) (1994). Section 10 of the Securities Exchange Act of 1934 (the "Exchange Act") makes it "unlawful for any person . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[59] *See, e.g.*, San Leandro Emergency Med. Plan v. Philip Morris, 75 F.3d 801, 808 (2d Cir. 1996). The Supreme Court incorporated the scienter element into the cause of action in its 1976 opinion, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). That opinion resolved a circuit split over whether, because Exchange Act Claims are implied and not express, they

Claim would not "lie" without any allegation of "'scienter' — [the] intent to deceive, manipulate or defraud,"[60] limiting its holding to requiring some form of intent and specifically declining to decide whether proof of recklessness could meet that requirement.[61]

The heightened pleading standard that is now legislated arose initially from the courts' application of Federal Rule of Civil Procedure 9(b) ("Rule 9(b)") to Exchange Act Claims.[62] Rule 9(b) requires greater specificity in the pleading of claims involving fraud or mistake than other claims subject to Rule 8 of the Federal Rule of Civil Procedure's "short and plain statement of the claim" provisions.[63] Thus, it was a natural early move[64] for the courts to apply Rule 9(b) to Exchange Act Claims and, thereby, to require those plaintiffs to plead with greater specificity than plaintiffs making nonfraud based claims.[65]

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require proof of scienter, rather than simple negligence. *See id.* at 193 n.12 (citing cases holding that negligence or "flexible duty" was appropriate in such cases); *id.* at 196 (accepting implied cause of action by virtue of its being "well-established," but noting section 10(b) does not create "express civil remedy," and no evidence existed as to whether either Congress or Commission had planned remedy under section).

[60] *Ernst & Ernst*, 425 U.S. at 193.

[61] *Id.* at 193-94 n.12.

[62] Courts began applying Rule 9(b) to Exchange Act claims at least as early as 1948. *See* Seward v. Hammond, 8 F.R.D. 457 (D. Mass. 1948).

[63] *See, e.g.*, Sale, *supra* note 24, at 542 (providing more detailed discussion of difference between pleading standards); *id.* at 543 n.21 (comparing effect of Rule 9(b) on fraud pleading to Rule 8 standard in gender discrimination case).

[64] *See, e.g., Seward*, 8 F.R.D. at 459 (applying Rule 9(b) to Exchange Act claim to reject general allegation of fraud as insufficient).

[65] The most "natural" reading of Rule 9(b) would be one that requires plaintiffs to plead the circumstances that constitute the alleged fraud with specificity and not the defendant's state of mind, or the scienter element. The cases preceding the PSLRA, however, often required specific pleadings relating to the defendant's alleged state of mind. *See Securities Fraud Litigation: Concerning Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Telecomm. & Fin., Comm. on Energy & Commerce*, 103d Cong. 38 (1994) (statement of Arthur C. Levitt, Chair, SEC) (noting in testimony that Rule 9(b) does not, by its terms, require particularity about defendants' state of mind but that several circuit courts, including First, Second, Fifth, and Seventh, had adopted such requirements). *Compare In re* Glenfed, Inc. Sec. Litig., 42 F.3d 1541, 1547-49 (9th Cir. 1994) (requiring pleading with particularity for all elements of claim except scienter, which could be pleaded generally), *with*, Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 361, 368 (1st Cir. 1994) (requiring plaintiffs to plead with particularity both why alleged misstatement was misleading when made and scienter).

Over time, the heightened pleading under Rule 9(b) evolved to varying degrees of specificity across circuits. *See* Sale, *supra* note 24, at 544. The Second Circuit devised two general ways in which plaintiffs could plead fraud, through the Motive and Opportunity Test or through recklessness or conscious misbehavior. *See, e.g., In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993) (noting two ways for plaintiffs to plead scienter); Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129-30 (2d Cir. 1994) (same). This Article

The Motive and Opportunity Test achieved prominence fairly quickly. Its history can be explored through a few cases. The first case that appears to describe the Test, without so-naming it, is *Goldman v. Belden*.[66] The *Goldman* court analyzed the plaintiffs' pleadings for allegations of both motive and opportunity, but does not refer to them as such.[67]

The *Goldman* district court rejected the plaintiffs' complaint, finding that, with respect to one defendant, the allegations were "so without foundation that an award of costs, including attorney's fees, was appropriate."[68] On appeal, the Second Circuit reached a different conclusion about the complaint, pointing to the scienter allegations. Specifically, the Second Circuit noted that the complaint alleged that the defendant had "sold some 26 percent of his . . . stockholdings during the period in question."[69] The district court had dismissed this allegation, concluding that because the defendant retired during the class period, it was both "reasonable" and "logical" that he would liquidate a large portion of his holdings.[70] The Second Circuit rejected that conclusion as improper, noting that the complaint contained other allegations against that defendant, including several describing his access to nonpublic information and role in publishing and disseminating some of the misstatements in question.[71] The court held that those allegations, combined with the ones involving the stock sales were sufficient to establish scienter at the pleading stage.[72] Thus, without explicitly describing the allegations as ones involving the motive (stock sales) and opportunity (access to information and ability to make statements) to commit fraud, the court found such circumstances and, presumably, laid the groundwork for what is now called the Motive and Opportunity

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focuses only on the former test and the manner in which courts have attempted to apply it in light of the PSLRA.

Debate existed at the time Congress passed the PSLRA as to what standard it was attempting to impose. *See, e.g.*, 141 CONG. REC. H15215 (daily ed. Dec. 20, 1995) (containing President Clinton's veto message which specifically objected to pleading standard based on understanding that Congress intended to raise it beyond Second Circuit's); *see also* Sale, *supra* note 24, at 558-61 (describing legislative history of heightened pleading provision of PSLRA). The debate has not yet been resolved and, indeed, has resulted in a split among the circuits, with several adopting the Second Circuit's pleading standard and several rejecting it.

[66] 754 F.2d 1059 (2d Cir. 1985).

[67] *Id.* at 1069-71.

[68] *Id.* at 1070.

[69] *Id.*

[70] *Id.* at 1071.

[71] *Id.*

[72] *Id.*

Test.[73]

Many of the more recent Second Circuit cases discuss the Test.[74] One of the most frequently cited[75] cases is *Shields v. Citytrust Bancorp, Inc.*,[76] a 1994 case defining and exploring the Test. After noting that pleadings that meet the standards of the Test are sufficient to meet the pleading requirement for scienter, the court defined the term motive to include some form of concrete benefits to be realized by the alleged misstatements or omissions. In *Shields*, the Second Circuit applied this definition to allegations that the defendants desired to inflate the price of the company's stock and, thereby, conceal its financial situation and protect their positions, compensation, and "prestige." The court rejected these allegations as simplistic, noting that implicit in the Test is the assumption that the defendants are "acting in [their] informed self-interest."[77] Further, the court argued, "it is hard to see what benefits accrue from a short respite from an inevitable day of reckoning."[78]

This type of assumption, which the courts make repeatedly in these cases, is problematic. People facing high-risk situations, are more likely to gamble on a risky outcome than to accept the loss upfront.[79] "Rational" or not, their commitment to the situation escalates, sunk costs dominate, and the ability to pull back and reexamine the situation is diminished.[80] Fraud, then, arguably occurs most often at the "inevitable day of reckoning" or when the defendants are in their "last period" of

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[73] Two years later, in *Beck v. Manufacturers Hanover Trust Company*, the Second Circuit cites to *Goldman* for the Motive and Opportunity Test, referring to it as a "common method for establishing a strong inference of scienter." 820 F.2d 46, 50 (2d Cir. 1987). However, the *Beck* plaintiffs did not allege any facts indicating a motive and "concede[d] that the defendants did not stand to gain financially from the allegedly fraudulent transactions." *Id.* at 50. Thus, *Beck* is important because it names the Test and cites to *Goldman*, albeit with few facts to elucidate it. *Id.* (citing Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1985)).

[74] *See, e.g.*, Fishbaum v. Liz Claiborne, Inc., No. 98-9396, 1999 U.S. App. LEXIS 18155, *4 (2d Cir. July 27, 1999); Chill v. Gen. Elec. Co., 101 F.3d 263, 267 (2d Cir. 1996); Acito v. IMCERA Group, 47 F.3d 47, 52 (2d Cir. 1995); Shields v. Citytrust Bancorp, 25 F.3d 1124, 1130 (2d Cir. 1994).

[75] As of August 2000, *Shields* had been cited in 411 opinions.

[76] 25 F.3d 1124 (2d Cir. 1994).

[77] *Id.* at 1130.

[78] *Id.*

[79] Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 18 (1993).

[80] *Id.*; *see also* Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1415 (2000) (discussing litigation and ethical risk taking in various contexts); Richard W. Painter, *Irrationality and Cognitive Bias at a Closing in Arthur Solmssen's* The Comfort Letter, 69 FORDHAM L. REV. 1111 (2000) (discussing decision making and framing in context of review of *The Comfort Letter* and lawyers' ethics).

employment and most desperate to keep the company going.[81]

### *B. Permutations on the Heuristic Post-PSLRA*

One of the stated reasons for the PSLRA was the creation of a uniform requirement that plaintiffs plead scienter, as well as all other elements of their claims, with particularity. The courts have engaged in a vigorous debate about what Congress intended in the PSLRA and whether pleadings sufficient to meet the Motive and Opportunity Test should survive a motion to dismiss.[82] Regardless of whether the Circuits accept such pleadings as sufficient to meet the scienter requirement,[83] all of the

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[81] Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724-27 (1992).

[82] For a discussion about these debates and the statutory-interpretation approaches of the courts, *see generally* Grundfest & Pritchard, *supra* note 18.

[83] In 1998, Congress passed the Uniform Standards Act. Pub. L. No. 105-353, 112 Stat. 3227. That Act contained further amendments to the Securities Act and the Exchange Act, and, in its legislative history, included a statement presumably intended to resolve this debate by indicating that the intent of the PSLRA was to adopt the Second Circuit's pleading standard. *See* J. Explanatory Statement of the Comm. of Conf., 144 CONG. REC. H11020, H11021 (daily ed. Oct. 15, 1998) (stating that managers' "clear understanding in 1995" was not to alter actual scienter standard, but to establish uniform standard for pleading based on that of Second Circuit); *see also* 144 CONG. REC. S12906 (daily ed. Oct. 21, 1998) (statement of Sen. Reed) (noting concern that courts were imposing pleading standard higher than Second Circuit's and higher than PSLRA); 144 CONG. REC. E2296 (daily ed. Oct. 21, 1998) (statement of Rep. Eshoo) (same) (reporting on "the true content of the Managers' statement"); 144 CONG. REC. S12737 (daily ed. Oct. 20, 1998) (statement of Sen. Leahy) (same) (noting that Administration, Securities and Exchange Commission, and Congress have worked together on PSLRA, all agreeing on Second Circuit's standard); 144 CONG. REC. E2246 (daily ed. Oct. 20, 1998) (statement of Rep. Dingell) (same) (calling it "flat wrong" that Congress would have adopted Second Circuit's pleading standard, yet rejected allegations of motive, opportunity and recklessness).

The Act was unsuccessful and the Circuits remain split as to whether motive and opportunity is sufficient to meet the heightened pleading requirement for scienter. The Second Circuit accepts such allegations. *See* Press v. Chem. Inv. Servs., 166 F.3d 529, 538 (2d Cir. 1999); *see also* Novak v. Kasaks, 216 F.3d 300, 308-10 (2d Cir. 2000) (noting that Congress adopted language from Second Circuit's pre-PSLRA pleading standard, but reformulating to four-prong test of which motive-and-opportunity (described as concrete benefits) is only one prong). So does the Third Circuit. *See In re* Advanta Sec. Litig., 180 F.3d 525, 534-35 (3d Cir. 1999).

The First, Fifth, Sixth, Eighth, Ninth, Tenth, and Eleventh Circuits have rejected the Test. *See* Greebel v. FTP Software, 194 F.3d 185, 197 (1st Cir. 1999); Nathenson v. Zonagen, Inc., 267 F.3d 400, 410-12 (5th Cir. 2001); *In re* Comshare, Inc., Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999); Helwig v. Vencor, Inc., 210 F.3d 612, 620 (6th Cir. 2000); Fla. State Bd. Of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 659-60 (8th Cir. 2001); *In re* Silicon Graphics Sec. Litig., 183 F.3d 970 (9th Cir. 1999); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1261-62 (10th Cir. 2001); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282-83, 1285 (11th Cir. 1999).

The Fourth Circuit has declined to address the sufficiency of motive-and-

Circuits consider pleadings that address the motive of the defendants as a proxy for scienter.[84] This Section of the Article examines how the courts have created heuristics from certain recurring types of allegations, those involving stock trades, and have further strengthened the initial heuristics in response to plaintiffs' attempts to respond to the courts' first-round heuristics. The cases are from a database that contains all available opinions on motions to dismiss since the PSLRA became effective in 1995. The tables below contain the statistics on the heuristics and reveal the growth in the use of the heuristics on an annual basis.

1. Opportunity Heuristics

To meet the requirements of the Motive and Opportunity Test, plaintiffs must plead facts to meet both the motive and opportunity prongs. The latter element, opportunity, is the easiest to plead. Under this prong of the Test, the plaintiffs must plead that the defendants had the opportunity to make the alleged misstatement or omission. Often, the plaintiffs allege only that the defendants, by virtue of their positions as controlling and managing persons within the company, were in a position to speak to the market, investors, or analysts. Such allegations are generally acceptable in the Second Circuit.[85] For example, one court approved of an allegation that the Chair/CEO and the CFO of a company had the opportunity to commit fraud, without requiring the plaintiffs to plead anything further to meet the opportunity prong.[86]

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opportunity allegations, determining that none of the plaintiffs' allegations were sufficient to withstand the motion to dismiss under any test, and, that, therefore, it need not decide whether to adopt the Motive and Opportunity Test. *See* Phillips v. LCI Int'l, Inc., 190 F.3d 609, 621 (4th Cir. 1999).

The Seventh Circuit has not yet faced the question, but district courts within it have all adopted it. *See* Danis v. USN Communications, Inc., 73 F. Supp. 2d 923 (N.D. Ill. 1999); Spyglass, Inc., Sec. Litig., 1999 WL 543197 (N.D. Ill. July 21, 1999).

[84] The Supreme Court recently denied certiorari in a matter raising the circuit split on the scienter issue. *See* Kasaks v. Novak, 216 F.3d 300 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000).

[85] *See, e.g.*, Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994) (noting only that opportunity "entail[s] means and likely prospect of achieving concrete benefits by the means alleged" and then discussing motive); *In re* Time Warner, Inc., Sec. Litig., 9 F.3d 259, 262, 269 (2d Cir. 1993) (referring to defendants only as "officers" and holding that "no one doubts that the defendants had the opportunity, if they wished, to manipulate the price of Time Warner's stock"); Cohen v. Koenig, 25 F.3d 1168, 1173-74 (2d Cir. 1992) (holding opportunity prong met where defendants were officers, directors, and majority shareholders).

[86] *See In re* Am. Bank Note Holographics, Inc. Sec. Litig.,93 F. Supp. 2d 424, 444 (S.D.N.Y. 2000) (finding that senior executives have opportunity to commit fraud).

Since the PSLRA, some courts require that the plaintiffs plead the opportunity allegations with greater specificity or, generally, facts rather than circumstantial evidence. For example, one court required the plaintiffs to plead facts to show that the defendants had, at a minimum, access to the alleged channel of communication such that the defendant could "effectively disseminate" the allegedly misleading information and access to "specific non-public, internal information" to support the misstatement.[87] When applying this standard, the court concluded that the plaintiffs' general allegations concerning the CEO, the Corporate Controller, and the Vice President of the Strategic Business Unit were sufficient given the defendants' "positions at the company, reporting requirements, corporate responsibilities, access to all corporate information, and actual involvement in the dissemination of [the company's] financial and business information."[88] The court rejected allegations pertaining to three other vice-president defendants who worked in Human Resources, Corporate Quality, and the Communications Strategic Business Unit.[89] Instead, the court found that given those areas of expertise, "nondescript allegations" of access to information or the media were insufficient to meet the pleading standard of describing, with particularity, how those defendants had the requisite opportunity to make the alleged misstatements or omissions.[90]

In a similar vein, another district court within the Ninth Circuit rejected "conclusory" allegations of opportunity, pointing to the insufficiency of a complaint's "rough" description of the defendants' employment histories and complaining that the plaintiffs had not set out, in one paragraph, which officers were employed when.[91] After sorting the timeframes by defendant, the court criticized the plaintiffs for neglecting to identify separately which defendants were tied to which misstatements.[92] According to that district court, although such nonparticularized allegations might have been sufficient before the PSLRA, they were unacceptable under a standard requiring that scienter be pleaded with specificity as to each defendant.[93] The Ninth Circuit has now rejected the Motive and Opportunity Test as insufficient for

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[87] Allison v. Brooktree Corp., 999 F. Supp. 1342, 1352 (S.D. Cal. 1998).

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *In re* PetsMart, Inc. Sec. Litig., 61 F. Supp. 2d 982, 997-98 (D. Ariz. 1999).

[92] *Id.* at 998.

[93] *Id.*

pleading the requisite scienter under the PSLRA.[94] Whether the trend of requiring increased specificity in the pleading of opportunity will continue remains to be seen, but, arguably, the development of the motive heuristic indicates that such increased specificity is likely.

2. Motive Heuristics

a. Background

The Motive prong of the Test has evolved with increasing stringency since the PSLRA. As defined by the Second Circuit, motive "entail[s] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged."[95] Courts often begin their review of the plaintiffs' motive allegations by delineating those that are insufficient. In general, allegations of motive applicable to all defendants or similarly situated companies are unacceptable.[96] For example, allegations that corporate officers wish to increase their compensation or keep their jobs are rejected because presumably, all officers wish to remain employed and be paid more.[97] Indeed, these courts have held that if these motives are found sufficient to allow a complaint to survive a motion to dismiss, all complaints would survive motions to dismiss because these motives apply to all officers.[98]

In practice, this shortcut allows district courts to dismiss troubling scienter allegations. For example, one district court dismissed compensation-based motive allegations it described as "clearly shocking."[99] The defendant in question was paid $430,000 in salary, plus bonuses that were calculated on the basis of company performance amounting to $65 million in one year and $102 million the next.[100]

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[94] *In re* Silicon Graphics Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999)

[95] Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994); *see also* Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000) (listing access to concrete benefits as one of four ways in which plaintiffs can plead scienter with specificity).

[96] *See* Sale, *supra* note 24, at 550 (collecting and describing cases for motive prong).

[97] *See, e.g., In re* Am. Bank Note Holographics, Inc., Sec. Litig., 93 F. Supp. 2d 424, 445 (S.D.N.Y. 2000)(noting that "generic allegations" of motive from benefits held by "similarly situated executives have been routinely rejected" as insufficient for pleading scienter through motive); *see also* Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995) (rejecting allegations that officers' motive to increase their pay as insufficient); Glickman v. Alexander & Alexander Serv., Inc., No. 93 CIV. 7594, 1996 WL 88570 (S.D.N.Y. Feb. 29, 1996).

[98] *See, e.g., In re* Am. Bank Note Holographics, Inc., Sec. Litig.,93 F. Supp. 2d at 445.

[99] *In re* Green Tree Fin. Corp., Stock Litig., 61 F. Supp. 2d 860, 873 (D. Minn. 1999).

[100] *Id.* at 865. Another defendant in this case received bonuses of $850,000 and

For the same reason, motive allegations based on the defendants' alleged desire to increase or maintain stock prices have also been deemed insufficient.[101] Other allegations relegated to this status include those that a company or its officers wished to maintain its credit rating, either in the context of a potential stock offering or for borrowing,[102] and allegations concerning potential strategic combinations.[103] Finally, district courts also reject allegations concerning basic business functions like building or protecting relationships with customers and clients, because such functions are common to businesses in general.[104] Again, although seemingly innocuous, such rationales have many complicated permutations that raise questions about the use of these heuristics.

b. Insider-Trading Heuristics

As before the PSLRA, allegations concerning insider trades continue to serve as a mainstay of the type plaintiffs use to survive the Motive and Opportunity Test. Indeed, according to the Securities Class Action Clearinghouse, 40 percent of complaints filed after the PSLRA contain allegations concerning the stock trades of defendants.[105] The motions to dismiss tell a similar story. In 1996, there were two opinions discussing insider trades, 12 in 1997, 23 in 1998, 28 in 1999, and 44 in 2000.

Table 1
Insider Trades in Motion-to-Dismiss Opinions

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Opinions Analyzing Insider Trading Allegations | 2 | 12 | 23 | 28 | 44 |

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$1,250,000. *Id.*

[101] *See, e.g., id.* at 873 (rejecting allegations that defendants schemed to hide company's financial situation in order to preserve stock prices).

[102] *See, e.g., In re* Health Mgmt. Sec. Litig., 970 F. Supp. 192 (E.D.N.Y. 1996); Leventhal v. Tow, 48 F. Supp. 2d 104 (D. Conn. 1999).

[103] *See, e.g., In re* Hudson Techs., Inc., Sec. Litig., No. 98 Civ. 1616, 1999 WL 767418 (S.D.N.Y. Sept. 28, 1999); *In re* APAC Teleservice, Inc. Sec. Litig., No. 97 Civ. 9145, 1999 WL 1052004 (S.D.N.Y. Nov. 19, 1999); *cf.* Bell v. Fore Sys., Inc., 17 F. Supp. 2d 433 (W.D. Pa. 1999) (finding that stockholders alleged claim of securities fraud with sufficient particularity).

[104] *See In re* Crystal Brands Sec. Litig., 862 F. Supp. 745, 749 (D. Conn. 1994).

[105] Grundfest & Perrino, *supra* note 57; *see also* Vanessa O'Connell, *Lawyers Scan Insider Sales to Build Suits*, WALL ST. J., June 5, 1996, at C1.

Table 2
Outcomes–Insider-Trading
1996-2000

| | Dismissal Granted | Dismissal Denied |
|---|---|---|
| Opinion Outcomes Insider Trading | 68 | 41 |

In addition, although trades are included in complaints in the hope that their presence will decrease the likelihood of a successful motion to dismiss, approximately 62 percent of the complaints containing such allegations are dismissed. Moreover, the courts' approach to analyzing these allegations has changed substantially, with new and different heuristics appearing every day. In the Second Circuit, such allegations were sufficient to meet the Motive and Opportunity Test for scienter before the PSLRA.[106] But, as applied across the country after the PSLRA, the analysis is increasingly textured and the standard harder to meet. As a result, it is more difficult for the plaintiffs to use stock trades, no matter how questionable, to meet the scienter requirement and, thereby, to survive a motion to dismiss.

Generally, to use insider trades to support the motive prong of the scienter test, plaintiffs must plead that the sales are suspicious. Courts focus on both the timing and the amount of the alleged trades.[107] Since the PSLRA, this heuristic has several new permutations, or requirements, that make it increasingly difficult for the plaintiffs to survive a motion to dismiss by using insider trades, no matter how arguably suspicious the timing of the alleged trades or how large the actual dollar amount involved. Further, even the rhetoric the courts use to describe the test for insider trades has changed. For example, the requirement began as one that the trades be "unusual,"[108] but now is often phrased as one which demands that the trades be "drastically out of line with" prior trades.[109]

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[106] *See, e.g.*, Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1985) (holding that combination of defendants' portrayal of selves as knowledgeable with this insider trade was sufficient to meet requisite pleading standard).

[107] *See, e.g.*, Marksman Partners, L.P. v. Chantal Pharm., Corp., 927 F. Supp. 1297, 1312-13 (C.D. Cal. 1996) (finding sufficient claim when amount of insider trading during class period is dramatically out of line with prior trading practices).

[108] *Id.*

[109] *In re* Sys. Software, Assoc., Inc., No. 97 Civ. 177, 2000 WL 283099 (N.D. Ill. Mar. 6, 2000). For a discussion of rhetoric and its power, see Gerald B. Wetlaufer, *Rhetoric and Its Denial in Legal Discourse*, 76 VA. L. REV. 1545 (1990).

(1) The Timing Heuristic

In revamping the Test and making the heuristic more stringent, district courts have begun to offer what appear to be their own arguments as to why the timing of the alleged trades is not problematic. This action by the courts has led to the development of a Timing Heuristic, which allows for the dismissal of fraud-based allegations where the defendants argue that the timing of the trades is not sufficiently suspicious. For example, one district court rejected an allegation involving trades by several defendants that occurred immediately after the company issued a press release announcing its revenues and its first profitable quarter.[110] Within a few months of those trades, the company had been forced to restate those previously announced revenues, decreasing them, because it had improperly recognized, or included, revenues in its prior public statements about its performance.[111] The plaintiffs argued that the timing of the trades allowed the defendants to capitalize on the stock price bounce that occurred as a result of the improperly inflated revenue estimates.[112]

The district court rejected the plaintiffs' argument, offering what appeared to be its own inferences as to why the trades were not sufficient to meet the pleading requirement for scienter.[113] Positing that the "opposite inference [was] equally, if not more, plausible,"[114] the district court made several arguments that supported the defendants' motion to dismiss, but neglected to state any alternative arguments, including those I pose below. For example, first, the court found that it was reasonable to infer that if the defendants anticipated the company's first profitable quarter, they would want to wait to trade until after announcing it.[115] The restated revenues revealed, however, that the company had not had a profitable quarter. Second, the district court argued that the defendants had been subject to a lock-up agreement, and, thereby, were precluded from earlier trading.[116] The district court

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[110] *See* FVC.COM Sec. Litig.,136 F. Supp. 2d 1031, 1038-40 (N.D. Cal. 2000).

[111] *See id.*

[112] *See id.*

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] After an IPO, the market may negatively perceive significant secondary sales of stock by "insiders." Underwriters commonly require existing shareholders to agree not to sell before the expiration of a "lockup period," usually 90 to 270 days following the IPO. *See* Alan S. Gutterman, *Strategic Business Planning Analysis and Marketing the High Technology Initial Public Offering Candidate*, 6 SANTA CLARA COMPUTER & HIGH TECH. L.J.

did not, however, explain how its rationale accorded with the fact that the lock-up had expired well before the questioned trades and, thus, that there was not an obvious correlation between the two.[117]

Third, the district court offered the following argument: if the plaintiffs' supposition were correct, "one would expect that defendants would have continued to sell their stock" from the time of the trades the plaintiffs alleged were suspicious until "it became apparent" that they would have to restate the revenues.[118] Here, although the district court stated that it was choosing between plausible inferences, it did not note that such choices are, at a minimum, properly reserved for summary judgment when no genuine issue of material fact exists and they are not made at the motion-to-dismiss stage.

Further, it is not necessarily true that the defendants would or should have continued to trade as posited by the court. Larger trades are more suspicious, and, according to the district court, the closer the trades to the announced revenue reversal, the more likely it would have regarded them with suspicion. Indeed, given the district court's argument, making the trades immediately after the announcement was in fact the best time to capitalize on any bounce in stock price resulting from it and, at least after this opinion, may be a safe harbor for future fraud. The district court's attempt to justify its dismissal, made in the context of a choice between equally probable inferences, raises questions about the outcome.

The first few years after the PSLRA, the heuristic began to take root. And, the courts have continued to use it, with 68 percent of the opinions issued in 2000 employing it.

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197 (1991). Even this time-honored procedure seems to be in question in today's high-tech boom. *See* Suzanne McCree, *New Key Helps Insiders Open Their Lockups on Some IPOs*, WALL ST. J., Aug 22, 2000, at C1 (noting that underwriters are considering doing away with, or decreasing lock-up periods for some companies and that part of pressure to do so may be due to competition among underwriters for work).

[117] *See In re* FVC.COM Sec. Litig., 136 F. Supp. 2d 1031, 1040 (N.D. Cal. 2000) (stating only defendants may not have sold stock until three months after lock-up expired because they might have anticipated announcement of profitable quarter).

[118] *Id.*

Table 3
Timing Heuristic

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Timing Heuristic In Opinions | 2 | 8 | 18 | 20 | 30 |
| Percent of Opinions Analyzing Trades | 100 | 67 | 78 | 71 | 68 |

Table 4
Outcomes – Timing Heuristic
1996-2000

| | Motion Granted | Motion Denied |
|---|---|---|
| Opinion Outcomes Timing Heuristic | 46 | 32 |

The Timing Heuristic favors defendants. Of the seventy-eight opinions containing it, forty-six granted the motion to dismiss. Thus, over five years, when the courts have used the Timing Heuristic, defendants have won 59 percent of the time.

(2) The Percentage Heuristic

This heuristic shifts the focus from the dollar value of the alleged trades to the percentage of shares traded. Consider first a post-PSLRA case finding allegations of certain trades to be sufficiently suspicious to meet the motive heuristic. In *Marksman Partners, L.P. v. Chantal Pharmaceutical Corporation,*[119] the district court described the factors that would make trading allegations sufficient to survive a motion to dismiss and noted that for the trades to be sufficiently suspicious, they would have to occur during the class period and be unusual in amount and timing.[120] The court applied this test to the plaintiffs' allegations that the

[119] 927 F. Supp. 1297, 1312-13 (C.D. Cal. 1996) (citing Acito v. IMCERA, 47 F.3d 47, 54 (2d Cir. 1995)). The court first rejected several allegations of scienter as "generic." *Id.* at 1312 (quoting *Glickman v. Alexander & Alexander Serv., Inc.*, No. 93 CIV. 7594 1996 WL 88570, at *11 (S.D.N.Y. Feb. 29, 1996)). For a more recent case examining insider sales and refusing the defendants' argument that the plaintiffs should be required to contrast the allegedly problematic trades with prior trades, see *In re Orbital Sci.s Corp., Sec. Litig.*, 58 F. Supp. 2d 682, 686 (E.D. Va. 1999) (noting that defendants "unloaded" $3,146,814 worth of stock at "suspiciously fortuitous time" to "enjoy the fruits" of allegedly fraudulent scheme).

[120] Marksman Partners, L.P. v. Chantal Pharm., Corp., 927 F. Supp. 1297, 1313 (C.D. Cal.

defendant: (1) sold 300,000 shares, at over $20.00 per share, (2) earned $6,300,000, and (3) had not sold any stock in the previous three years.[121] The district court then found that the sales amounted to 20 percent of the defendant's holdings in the company and declared that percentage to be suspicious, given the dollar amount involved and the lack of previous trades.[122]

This widely accepted "Percentage Heuristic" approach does not focus on the absolute amount, or dollar amount, of the alleged trades. Instead, it implicitly requires the court to consider the dollar value of shares traded only to support suspicious percentages. This seemingly innocuous heuristic can have dramatic consequences. Focusing on the percentage rather than the dollar value of the trades enables district courts to dismiss trades that are significant in dollar amount but not as a percentage of shares held. For example, one district court dismissed trades resulting in proceeds of over $60,000,000, arguing that the sales amounted to only 9 percent of the defendant's holdings.[123] In another case, the Second Circuit affirmed the dismissal of trades amounting to $20,000,000, noting that the trades represented only 9.9 percent of the defendant's holdings.[124]

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1996) (citing Acito v. IMCERA, 47 F.3d 47, 54 (2d Cir. 1995)).

[121] *Id.*

[122] *Id.*; *see also* Fitzer v. Sec. Dynamics Tech., 119 F. Supp. 2d 12, 25 (D. Mass. 2000); *In re* World Access, Inc., Sec. Litig., 119 F. Supp. 2d 1348, 1356 (N.D. Ga. 2000) (finding suspicious trades amounting to over $38 million at percentages of over 80 and 90 percent of defendants' holdings).

[123] *See In re* Credit Acceptance Corp., Sec. Litig., 50 F. Supp. 2d 662, 668, 677 (E.D. Mich. 1999) (rejecting motive-and-opportunity pleading as insufficient to meet post-PSLRA scienter pleading standard but analyzing allegation anyway). The court does not even recount the dollar value of the proceeds in connection with its analysis of motive. Instead, it considered only the percentage of shares traded, not the dollar value, an amount recounted only in the factual setting of the opinion. *See id.* at 677.

Other courts have dismissed smaller, but still significant, amounts on the same basis. For example, one court dismissed allegations against one individual whose trades in the class period yielded profits of over $4.1 million but which amounted to 15 percent of his holdings, noting that the defendant retained "significantly more shares" than he sold, thereby defeating any inference of fraud. *In re* PetsMart, Inc., Sec. Litig., 61 F. Supp. 2d 982, 999 (D. Ariz. 1999). A third court rejected $5,000,000 worth of trades because it was only 10 percent of the person's shares held. *In re* Milestone Scientific, Sec. Litig., 103 F. Supp. 2d 425 (D.N.J. 2000). A fourth court dismissed insider sales that amounted only to 2.6 percent, 4.1 percent, 6.9 percent, and 7.1 percent of the insiders' holdings, even though the dollar value of those sales totaled over four million dollars. *In re* Silicon Graphics Sec. Litig., 970 F. Supp. 746, 767-68 (N.D. Cal. 1997); *see also In re* Baan Co. Sec. Litig., 103 F. Supp. 2d 1, 19 (D.D.C. 2000) (rejecting trade-based allegations for failure to cite percentage).

[124] Rothman v. Gregor, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,007, at 94,544 (2d Cir. Aug. 8, 2000).

Again, the use of this heuristic has grown dramatically since 1995. Where only two opinions utilized the Percentage Heuristic in 1996, twenty-eight applied it in 2000. Table 5 compares the opinions employing the Percentage Heuristic to the total universe of opinions analyzing allegations of suspicious stock trades. Like the Timing Heuristic, after the first couple of years, the number of opinions employing the Percentage Heuristic appears to be increasing both in absolute and in percentage terms.

Table 5
Percentage Heuristic

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Percentage Heuristic In Opinions | 2 | 10 | 8 | 15 | 28 |
| Percent of Opinions Analyzing Trades | 100 | 83 | 35 | 54 | 64 |

Moreover, the opinions reveal that the Percentage Heuristic is very powerful. By almost a three to two margin, courts are more likely to dismiss cases in which they employ the Percentage Heuristic. Thus, it contributes to outcomes favoring defendants approximately 60 percent of the time.

Table 6
Outcomes–Percentage Heuristic
1996-2000

| | Motion Granted | Motion Denied |
|---|---|---|
| Opinions Outcomes Percentage Heuristic | 38 | 25 |

In contrast, although too few in number to serve as a predictor, courts rejecting the Percentage Heuristic and focusing on the absolute dollar amount of trades have the opposite ratio. That is, plaintiffs are twice as likely to defeat a motion to dismiss when the court focuses on the absolute dollar amount of the trades at issue.

Table 7
Outcomes–No Percentage Heuristic

| | Motion Granted | Motion Denied |
|---|---|---|
| Opinion Outcomes<br>Dollar Amount of Trades | 2 | 4 |

(3) The Option-Basis Heuristic

A further permutation of the Percentage Heuristic compares shares sold to the pool of shares and options held, not just to shares held. The effect of this focus on options is to increase the denominator of the fraction, resulting in a smaller and, thus, less suspicious, percentage. Again, the difference can be both dramatic and decisive, decreasing the percentage traded by as much as 18 percent in one case.[125] This Option-Basis Heuristic first appeared, with little discussion, in the district court opinion in the *Silicon Graphics* case.[126] In the second opinion in that case, the district court offered an explanation of its rationale for including options in the denominator of its calculations:

> As the Court noted in its earlier order, it is important to consider available options in evaluating stock sales. Exercisable options, not actual stock holdings, represent the owner's trading potential; by limiting their allegations to stock shares, plaintiffs artificially inflate defendants' activities. The differences between vested options and stock shares noted by plaintiffs — transfer and voting rights and dividends — are irrelevant for purposes of this analysis.[127]

[125] *See In re* Boeing Sec. Litig., 40 F. Supp. 2d 1160, 1174 (W.D. Wash. 1998) (comparing plaintiffs' allegations that defendants sold approximately 23 percent of shares held with defendants' option-basis approach decreasing percentage traded to 5 percent).

[126] *See In re* Silicon Graphics Sec. Litig., No. C 96-0393, 1996 WL 664639, at *12 (N.D. Cal. Sept. 25, 1996) (stating that defendants "collectively had available millions of options that could have been exercised and sold during the class period").

[127] *In re* Silicon Graphics Sec. Litig., 970 F. Supp. 746, 768 n.13 (N.D. Cal. 1997).

Since that opinion, the use of the Option-Basis Heuristic has grown.[128] Where *Silicon Graphics* was the only opinion in which the Option-Basis Heuristic was applied in 1996, by 2000 fourteen opinions utilized it. Again, the PSLRA applied only to complaints filed after its effective date; so in the early years, the use of the heuristics is just beginning. The Option-Basis Heuristic, however, does appear to have taken root, and by the year 2000, 32 percent of the opinions analyzing trading allegations deployed it.

Table 8
Option-Basis Heuristic
1996-2000

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Option-Basis Heuristic In Opinions | 1 | 1 | 3 | 6 | 14 |
| Percent of Opinions Analyzing Trades | 50 | 8 | 13 | 21 | 32 |

The Percentage and Option-Basis Heuristics allow courts to focus on only half of the story, making a decision best preserved for summary judgment. An opinion containing a complete set of arguments, or the full story, would include a discussion of the way in which options can increase the incentive to commit fraud. For example, the arguments against the Option-Basis Heuristic might include the following. As the "elixir of the technology boom," options allow companies to "attract great workers without the hassle of actually paying them grandiose salaries."[129] Thus, options may account for a significant part of an individual's package, yet the base salary may be very small in comparison.[130] The wealth of such people depends directly on the

[128] *See, e.g., In re* Comshare Inc., Sec. Litig., 183 F.3d 542 (6th Cir. 1999); *In re* Ultrafem Inc., Sec. Litig., No. 91 F. Supp. 2d 678, 689 (S.D.N.Y. Apr. 6, 2000); *In re* Computer Assoc. Sec. Litig., 75 F. Supp. 2d 68 (S.D.N.Y. 1999); Chalverus v. Pegasystems, Inc., 59 F. Supp. 2d 226, 236 (D. Mass. 1999); ; *In re* Orbital Scis. Corp., Sec. Litig., 58 F. Supp. 2d 682 (E.D. Va. 1999); Coates v. Heartland Wireless Communications, Inc., 55 F. Supp. 2d 628 (N.D. Tex. 1999); Plevy v. Haggerty, 38 F. Supp. 2d 616, 833-34 (C.D. Cal. 1998).

[129] Robert McGough, *Stock Options Paid Cash Flow of Technology Highfliers*, WALL ST. J., July 17, 2000, at C1. Apparently, employees are increasingly unwilling to accept options as pay — cash is back. Susan Pulliam, *New Dot-Com Mantra: 'Just Pay Me in Cash, Please'*, WALL ST. J., Nov. 28, 2000, at C1 (describing trend of increased demand for cash payments as stock prices have plummeted).

[130] *See* Adam Bryant, *How Companies Make the Boss Buy Stock, but Soften the Pinch*, N.Y.

company's stock market performance. On any given day, their company's stock price can fluctuate dramatically.[131] To such a person, the sale of shares at the right time can mean a large profit, perhaps well beyond what the company could justify paying the person in straight salary terms.[132] Those individuals, then, have an incentive to sell shares and cash in when the stock price goes up, or even simply to diversify their portfolios and avoid significant losses in their wealth.[133] Arguably, their incentive to commit fraud in order to create or to capitalize on a high market price also increases.[134]

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TIMES, Feb. 1, 1998, at A1 (noting that "few ideas in corporate America have so quickly attained motherhood-and-apple-pie status as the notion that top executives should own big stakes in their companies"); *id.* (stating that in prior five years, more than 20 percent of country's largest companies adopted guidelines requiring officers to own stock equal to three to five times their annual salaries); *id.* (noting that companies discount and subsidize purchases for executives, but shareholders pay directly); *see also In re* Home Health Corp. of Am., Inc., Sec. Litig., No. CIV. A. 98-834, 1999 WL 79057, at *16 (E.D. Pa. Jan. 29, 1999) (rejecting plaintiffs' insider-trading allegations noting that plaintiffs failed to plead that defendants' profits from alleged sales were "substantial *In re*lation to their salaries"); Blum v. Semiconductor Packaging Materials Co., Inc., No. C.A. 97-7078, 1998 WL 254035, at *4 (E.D. Pa. May 5, 1998) (same).

[131] *See, e.g.*, E.S. Browning, *Old-Economy Rally: Is It Repeating Its Fade?*, WALL ST. J., May 22, 2000, at C1 (noting rebounds of blue chip stocks and "mauling" of high-tech stocks). For a discussion of the initial support of union and other institutional shareholders for stock options as a significant portion of executive pay and how that support has declined as executive pay through options has "exploded," see Marleen O'Connor, *Union Pension Power and the Shareholder Revolution*, at 15 (1999) (prepared for National Heartland Labor Capital Conference) (on file with author).

[132] *See In re* Milestone Scientific, Sec. Litig., 103 F. Supp. 2d 425 (D.N.J. 2000)(noting that 500,000 in trades reaped $5,000,000 in profits).

[133] *See* Robert Luke, *Insider Trading Antec Directors, Officers Sell As Stock Rebounds*, ATL. J. & ATL. CONST., Mar. 28, 1999, at C4 (noting that flurry of sales by officers and directors "reflected a desire . . . to diversify net worths"); *OTC Communications President Comments on Nona's Recent Price Decline*, PR NEWSWIRE, Apr. 16, 1996 (quoting company president as stating that recent large sales by insiders were necessary in order for them to "feed their families," because they had been paid in nothing but stock); James Kim, *Executive Order: Buy Stock or Else*, USA TODAY, May 5, 1993, at 1B (quoting executive-compensation expert as saying that executives whose companies do not prosper "see their net worth fall" and are, therefore, "really at risk"). *But see* Mark Maremount & John Hechinger, *If Only You'd Sold Some Stock Earlier — Say $100 Million Worth*, WALL ST. J., Mar. 22, 2001, at A1 (discussing study of 50 insiders in high tech companies who sold shares at market highs and before market fell); *id.* (noting that some companies had multiple insiders who reaped more than $100 million in sales; at least one insider collected more money from stock sales than company was currently worth).

[134] *But see In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 542 (3d Cir. 1999) (noting that defendants' profits from sales were significant relative to base salaries, sales were from options which were intended to be part of compensation package and, thereby, not significant for scienter pleading purposes). *See also In re* Burlington Coat Factory, 114 F.3d 1410, 1424 (3d Cir. 1995) (stating that many corporate executives are compensated with stock and options and that therefore, it "follows . . . that these individuals will trade those

The Option-Basis Heuristic can mask this potential motive. The effect of both increasing the denominator, which decreases the percentage of shares sold, and reflecting solely on the percentage of shares traded, rather than the value, is to prevent this story from being told. Indeed, a court need not even explore the possibility that as the total number of shares increases, a smaller trading percentage is arguably more suspicious. As an individual's holdings increase, a smaller trading percentage is likely to yield larger absolute profits. Again, the Percentage and Option-Basis Heuristics mask this effect, even in the face of evidence suggesting that today's "dotcom" executives are focused on "cashing out" before the price of their shares decline and not on the investors for whom they are supposed to be working.[135]

Further, the Option-Basis Heuristic is also a powerful dismissal tool. Opinions containing it favor defendants 84 percent of the time.

Table 9
Opinion Outcomes—Option-Basis Heuristic
1996-2000

| | Motions Granted | Motions Denied |
|---|---|---|
| Opinion Outcomes Option-Basis Heuristic | 21 | 4 |

(4) The All-Defendant Heuristic

Another evolution in the Insider Trading Heuristic is the dismissal of allegations against defendants where some, but not all, had insider trades during the class period.[136] This is the All-Defendant Heuristic. The rationale for the All-Defendant Heuristic is that if only some defendants traded during the class period, their trades were less likely to be fraudulent.[137] This heuristic has allowed dismissal of trading allegations where the defendants who did trade were not the chief

securities in the normal course of events").

[135] Michael R. Davisson, *D & O Liability Update: Trends for D & O Insurers*, 14 DEL. CORP. LITIG. RPTR. 9 (2000).

[136] *See In re* Glenayre Tech. Inc. Sec. Litig., No. 96 CIV. 8252(HB), 1998 WL 915907, at *4 (S.D.N.Y. Dec. 30, 1998); *see also In re* Splash Tech. Holdings, Inc., Sec. Litig., No. C 99-00100 SBA, 2000 WL 1727405 (N.D. Cal. Sept. 29, 2000).

[137] *See Glenayre*, 1998 WL 915907, at *4.

officers of the company, on the theory that if a fraud existed, the "high-ranking" and "most-knowledgeable" corporate officers were likely to be part of it.[138] And it has been combined with the Percentage Heuristic, allowing for the dismissal of allegations against all of the defendants where their "collective percentage" of shares traded was relatively small.[139]

A different version of the All-Defendant Heuristic focuses on shares retained, rather than sold. To dismiss the allegations before it, one court first aggregated the defendants' trades of $7.5 million into a collective percentage of 13.3 percent.[140] Then, it pointed out that, collectively, the defendants had retained over 86 percent of their holdings. As a result, the focus became the large percentage of shares retained, rather than the defendants' sales, which, either in percentage or absolute terms, were substantial. Two defendants sold over 20 percent of their holdings, a third sold 29 percent, and a fourth sold 92 percent.[141]

In support of the dismissal of the 92-percent defendant, the district court made several arguments. First, it argued that the defendant had owned fewer shares than the others. This argument, of course, contradicts the Percentage Heuristic. The court then argued that the defendant was only a Vice President in the company;[142] thus laying the groundwork for a new heuristic based on job title. Indeed, the district court stated that, "[i]n sum, the selling of a high percentage of shares by a Vice President cannot — without more — support an inference of scienter let alone a strong inference."[143] Not noted by the court, however, is that this statement, which is overbroad at a minimum, arguably

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[138] *See id.; see also In re* Credit Acceptance Corp., Sec. Litig., 50 F. Supp. 2d 662, 677-78 (E.D. Mich. 1999) (granting less credence to plaintiffs' fraud allegations because complaint alleged no stock sales by CFO who "would have been essential participant in any fraudulent scheme"); *In re* Burlington Coat Factory, 114 F.3d at 1423 (rejecting inference of scienter where neither CEO or general manager traded); *In re* Comshare, Inc. Sec. Litig., No. 96-73711-DT, 1997 WL 1091468, at *9 (E.D. Mich. Sept. 18, 1997) (rejecting inference of scienter for all defendants where neither CEO nor CFO traded).

[139] *See* Head v. NetManage, No. C97-4385 CRB, 1998 WL 91774, at *6 (N.D. Cal. Dec. 30, 1998); *see also In re* Ashworth, Inc., Sec. Litig., Civ. No. 99cv0121-L (JAH), 2000 U.S. Dist. LEXIS 15237, at *33 (S.D. Cal. July 18, 2000) (rejecting trades of 61,000 shares amounting to 73 percent of individual's holdings as only 5 percent of total defendants' holdings); *In re* Milestone Scientific, Sec. Litig., 103 F. Supp. 2d 425 (D.N.J. 2000).

[140] *See* FVC.COM Sec. Litig.,136 F. Supp. 2d 1031, 1038-40 (N.D. Cal. 2000); *see also In re* Healthsouth Corp., Sec. Litig., No. CV 98-J-2634-S, 2000 U.S. Dist. LEXIS 20650 (N.D. Ala. Sept. 13, 2000) (focusing on percentage of shares retained rather than sold).

[141] *See FVC.COM*, 136 F. Supp. 2d at 1039.

[142] *Id.*

[143] *Id.*

creates a new safe harbor for "Vice Presidents," regardless of their individual stories, trading circumstances, or roles.[144]

The Ninth Circuit has also added a twist to the All-Defendant Heuristic. After rejecting allegations of stock trades against several defendants as insufficient under the Percentage and Option-Basis Heuristics,[145] one defendant, whose trades amounted to 43.6 percent of his shares and options during the class period, and, therefore, were too significant for dismissal under either of those heuristics, successfully argued the trades were only a small percent of the trades of all the defendants combined.[146] Noting the significance of this percentage, the court applied the All-Defendant Heuristic, compared this defendant's sales to the total number of shares sold by all of the defendants, and concluded that his sales amounted only to 5 percent of all the sales alleged.[147] Then the court argued that the defendant had been with the company for only a year and a half and, because he had never before sold such a large quantity of stock, it was difficult to determine whether these trades were an aberration. Yet, arguably, a large trade, in the absence of prior trades, is suspicious. But, instead of concluding that the alleged trades were deserving of further scrutiny, or at least should withstand dismissal, the court concluded that the trades could not support an inference of "deliberate recklessness."[148]

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[144] *See In re* Vantive Corp. Sec. Litig., 110 F. Supp. 2d 1209, 1219 (N.D. Cal. 2000) (noting trading activity in case was "undoubtedly substantial" but rejecting allegations based on trades because one defendant was outside director and other sold only 13 percent of his shares).

[145] *In re* Silicon Graphics, Inc., Sec. Litig., 183 F.3d 970, 987 (9th Cir. 1999).

[146] *Id.*

[147] *Id.*

[148] *Id.* The court also rejected the sales of another Senior-Vice-President defendant that amounted to 75.3 percent of his holdings, arguing that he had acquired his shares when his company was acquired by the defendant company and that he was "legally forbidden" to trade his shares prior to the timeframe in which he did so. *Id.* Further, according to the court, that defendant worked in Toronto and had no day-to-day contact with the other officers. *Id.* at 987-88. These inferences, too, are only reasonably made, if at all, at summary judgment, after discovery has occurred. At least at the motion-to-dismiss stage, an equally plausible inference is that this defendant dumped his shares as soon as he became aware of the alleged fraud and could legally do so. Moreover, just because he was in Toronto does not mean that he did not have contact with the company's California-based executives. Consider, for example, the possibilities of communication by telephone and e-mail. Ironically, in the next sentence of its opinion, the court offers a better reason for dismissing this defendant — that he did not make any of the allegedly misleading misstatements and omissions. *Id.* at 988. Thus, the trading analysis is an example of the court using a heuristic when a more careful analysis would have solved the problem.

The alternative to dismissing all defendants through the All-Defendant Heuristic is dismissing only those who did not have any insider trades (and for whom the plaintiff has not pleaded scienter in another manner)[149] and denying the motion to dismiss against the defendants who did have such trades.[150] This approach preserves a claim against those who did have suspicious trades until the plaintiffs have an opportunity to engage in discovery and, presumably, collect the stories of the trading defendants through depositions. Thus, it would preserve for summary judgment a question about which reasonable alternative inferences exist and whether any of those proposed inferences are reasonable given the facts.

And, again, the use of the All-Defendant Heuristic has grown since its creation. One opinion contained it in 1996 and eleven contained it in 2000. The percentage of opinions employing it has also grown, so that by the year 2000, 25 percent of the opinions analyzing trading allegations employed the All-Defendant Heuristic.

Table 10
All-Defendant Heuristic

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| All-Defendant Heuristic In Opinions | 1 | 4 | 3 | 8 | 11 |
| Percent of Opinions Analyzing Trades | 50 | 33 | 13 | 29 | 25 |

As the description of this heuristic reveals, it is extremely powerful. Thus, its growth has the potential to increase decisions favoring defendants more than any other single Trading Heuristic. This may be true, in part, because as described above, courts often employ it in addition to other heuristics, or as an additional measure to eliminate a particular defendant. For the same time period as explored above, the

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[149] *See* Schlagel v. Learning Tree Int'l, No. CV 98-6384 ABC (EX), 1998 WL 1144581, at *16 n.13 (C.D. Cal. Dec. 23, 1998) (refusing to dismiss non-trading CFO defendant from case where complaint contained allegations of scienter for accounting fraud); *see also In re* Microstrategy, Inc., Sec. Litig., 115 F. Supp. 2d 620, 645-46 (E.D. Va. 2000) (refusing to adopt All-Defendant Heuristic, which yielded 5 percent in trades, because it "masked" individual trades ranging from 10 percent to 85 percent).

[150] *See, e.g., In re* APAC Teleservice, Inc., Sec. Litig., No. 97 Civ. 9145(BSJ), 1999 WL 1052004, at *7 (S.D.N.Y. Nov. 19, 1999) (rejecting defendants' argument that because some did not trade during class period, complaint should be dismissed).

outcome of opinions containing this heuristic favors defendants 74 percent of the time.

Table 11
Outcomes — All-Defendant Heuristic
1996-2000

| | Dismissal – Granted | Dismissal – Denied |
|---|---|---|
| Opinions Outcomes All-Defendant Heuristic | 20 | 7 |

(5) The Stock-Purchase Heuristic

A new twist on the Trading Heuristic, that is just beginning to take root, involves purchases by defendants. Under this heuristic, courts use purchases of stock to negate any inference of fraud based on sales,[151] presumably because a person selling stock to profit on a fraud would not also buy stock. The Stock-Purchase Heuristic, however, allows courts to dismiss otherwise troubling sales, when the defendants purchase any amount of shares in the class period. Thus, it also creates another safe harbor. Defendants, who wish to commit fraud and profit from selling shares, should also purchase and, thereby, presumably offset their otherwise suspicious sales.[152] Again, this is a newer heuristic, but its budding existence reveals how these heuristics grow and the potential for further growth in dismissals of cases with otherwise troubling allegations.

Table 12
Stock-Purchase Heuristic

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Stock-Purchase Heuristic In Opinions | 0 | 0 | 3 | 3 | 5 |
| Percent of Opinions Analyzing Trades | 0 | 0 | 13 | 11 | 11 |

[151] *See In re* K-Tel Int'l, Inc., Nos. Civ. 98-2494 ADM/JGL, 2000 WL 1055894, at *11 (D. Minn. July 31, 2000); *In re* Res. Am. Sec. Litig., No. CIV. 98-5446, 2000 WL 1053861, at *7 (E.D. Pa. July 26, 2000); *In re* Staffmark, Inc., Sec. Litig., 123 F. Supp. 2d 1160 (E.D. Ark. 2000).

[152] Arguably, in *Silicon Graphics*, the Ninth Circuit further expanded this heuristic, arguing that the failure to trade during the questioned time period can negate an inference of scienter. *See In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 986 (9th Cir. 1999).

Like the others, the opinions employing this heuristic result in pro-defendant outcomes more often than not; eight granted the motion to dismiss and three denied it. Or, 73 percent of the Stock-Purchase Heuristic opinions granted the motion to dismiss.

Table 13
Outcomes – Stock-Purchase Heuristic
1996-2000

| | Dismissal – Granted | Dismissal - Denied |
|---|---|---|
| Opinion Outcomes Stock-Purchase Heuristic | 8 | 3 |

(6) The Resignation Heuristic

Courts have also restricted the use of insider-trading allegations offered to support the scienter element by considering other plausible reasons why the defendants might have made the questionable trades. One reason offered by defendants is that, sometimes, employees who are leaving a company must sell their stock. By considering this argument, or, in some cases, appearing to tell the stories at their own initiative, the courts have eviscerated the motion-to-dismiss standard, and, instead, are making arguments that are appropriate only, if even then, at summary judgment. In so doing, the courts are allowing defendants who trade during the class period to tell their own story about the reasons they did so, or to argue that they had good reasons for doing so, and, thereby, potentially to persuade the courts to grant their motions to dismiss.

One of the most troubling examples is *Greebel v. FTP Software.*[153] In *Greebel,* the First Circuit rejected scienter allegations about a defendant who had made most of the allegedly suspicious trades just before and after he retired from the company.[154] The court dismissed the trading allegations, stating that "often" companies require retiring individuals to exercise their options or sell shares within a "limited period of time."[155] According to the court, the defendant's retirement thus removed any

[153] 194 F.3d 185 (1st Cir. 1999). Note that the First Circuit has never accepted the Motive and Opportunity Test, but it is willing to consider insider-trades as evidence of scienter.

[154] *Id.* at 206.

[155] *Id.*

potential stigma from the trades.[156]

Although some companies have such policies, and it may be difficult for a retiring defendant to commit fraud in this manner, this holding, and the accompanying story told by the court, is limited and flawed.[157] First, the court did not cite to either the plaintiffs' complaint or the defendants' motions to dismiss as sources of its conclusion about whether such employment restrictions actually applied here. As a result, the court arguably, even if unintentionally, created the appearance that it dismissed these trades on its own conjecture about the potential impact of a retirement on an employee's share holdings.[158] This opinion, then, arguably provides any defendant who sells shares close to her retirement to advance the position that her sales are not properly subject to scrutiny under the Motive and Opportunity Test. Thus, this opinion potentially creates another safe harbor in which defendants who wish to commit fraud presumably can.[159]

Second, to reach this conclusion, the First Circuit had to presume that the retirement, and not some other motive, like the fraud alleged, was actually the reason for the stock sale. To do so, the court again created the impression that it was assuming facts not in evidence and making judgments about disputes about those facts, supposedly reserved for summary judgment or the fact finder.[160] And third, this assumption

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[156] *Cf.* Ruskin v. TIG Holdings, Inc., No. 98 Civ.1068 (LLS), 2000 WL 1154278, at *5 (S.D.N.Y. Aug. 14, 2000) (rejecting retirement argument where sales were otherwise suspicious); *In re* Read-Rite Sec. Litig., Fed. Sec. L. Rep. [Current Transfer Binder] (CCH) ¶90,929, p. 93,950 (N.D. Cal. Mar. 1, 2000) (finding that defendant's allegedly suspicious stock sales "roughly coincide[d]" with retirement date, thus rendering trades insufficient for scienter).

[157] *See* Frederick Schauer, *Opinions as Rules*, 62 U. CHI. L. REV. 1455, 1465 (1995) (noting that opinions should explain and justify and that results "should be reached by a process of 'reasoned elaboration'"); *cf.* Martha I. Morgan, *The Constitutional Right to Know Why*, 17 HARV. C.R.-C.L. L. REV. 297 (1982) (discussing purposes of reasons and reasoned process in context of due process protections). *See also* Edward L. Rubin, *Legal Reasoning, Legal Process and the Judiciary as an Institution*, 85 CAL. L. REV. 265 (1997) (reviewing LEGAL REASONING AND POLITICAL CONFLICT by Cass Sunstein and arguing that institutional focus would provide valuable explanations for form and substance of opinions).

[158] Legal realists might criticize the court for doing little more than reasoning backward from a chosen result to a rationale. *See* Brian Leiter, *Rethinking Legal Realism: Toward a Naturalized Jurisprudence*, 76 TEX. L. REV. 267, 267 (1997).

[159] *See, e.g.*, Feasby v. Industri-Matematik Int'l, Corp., No. 99 Civ. 8761 (HB), 2000 WL 977673, n.5 (S.D.N.Y. July 17, 2000) (rejecting trades made at time of resignation as not "unusual" in timing).

[160] *See* Goldman v. Belden, 754 F.2d 1059, 1071 (2d Cir. 1985) (criticizing district court for assuming motive behind sales of retiring defendant); *see also* Chu v. Sabratek Corp., 2000 WL 765062, at *15 (N.D. Ill. 2000) (dismissing allegations based, in part, on defendants' argument that they traded when shares became available under terms of

arguably evades consideration of the possibility that an impending retirement might motivate an individual to commit fraud by either attempting to inflate the price, or capitalizing on an already inflated price of the shares she plans, or will be forced, to sell at retirement.[161] The court discussed none of these points.

The *Greebel* court is not alone. Like the Stock-Purchase Heuristic, the Resignation Heuristic has begun to crop up in motion-to-dismiss opinions. In 1997, two opinions utilizing the Resignation Heuristic appeared. In 2000, five opinions, or 11 percent of those analyzing trading allegations, appeared.

Table 14
Resignation Heuristic

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Resignation Heuristic in Opinions | 0 | 2 | 1 | 3 | 5 |
| Percent of Opinions Analyzing Trades | 0 | 17 | 4 | 11 | 11 |

employment contract and other agreements).

[161] *See Belden*, 754 F.2d at 1071. The *Greebel* court also rejected other insider-trading allegations because the trades did not occur at the class period's highest market price. Again, this reasoning is incomplete. The alleged trades occurred at prices more than twice as high as those available after the alleged "truth" entered the market. *Greebel*, 194 F.3d at 190. By rejecting the trades because the price garnered was not the "highest," the First Circuit has arguably created the impression that it will accept a motion-to-dismiss argument from defendants that such trades are never sufficiently suspicious to meet the dismissal threshold for the scienter element. *See also* Plevy v. Haggerty, 38 F. Supp. 2d 816, 834 (C.D. Cal. 1998) (noting defendants' argument that insider sales were not suspicious because none occurred at class-period's highest market price). *But see* Rehm v. Eagle Fin., Corp., 954 F. Supp. 1246, 1254-55 (N.D. Ill. 1997) (rejecting plaintiffs' allegations that defendant sold stock at highest market price because total sales amounted to only 6 percent of holdings). This stock-price argument, then, may also create a safe harbor for defendants who wait to trade until the market price drops, however minimally, from a market high.

The *Greebel* lower court also rejected evidence the plaintiffs apparently attempted to present to the court after the opposition period had ended. 182 F.R.D. 370, 376 & n.8. According to the court, it had initially rejected a motion to dismiss and allowed discovery based on a particular claim the plaintiffs made. *Id.* That claim turned out to be "groundless" but during discovery, the plaintiffs apparently found some evidence to support their claims of fraud. *Id.* The court refused to consider the evidence, opining that the PSLRA requires that plaintiffs "plead particular facts sufficient to show their case has merit before gaining unfettered access to [d]efendants' files." *Id.* According to the court, the plaintiffs had failed to accomplish that task and, therefore, dismissal with prejudice was appropriate. *Id.* Together, the opinions may have created another heuristic for motions to dismiss and, potentially, sanctioned fraud.

It, too, results in outcomes favoring defendants. Of the eleven opinions in which it was deployed, eight granted the motions to dismiss.[162]

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[162] In addition to allegations involving insider trades, there are two other significant categories of allegations that sometimes survive the Motive and Opportunity Test, those concerning offerings, whether IPOs or otherwise, and occasionally, those concerning acquisitions. The Offering Heuristic involves allegations that the defendant made material misrepresentations to the market in order to enhance sales of securities for an offering or the company's credit rating. A securities offering is a firm-sponsored form of insider trading, because, by definition, it involves asymmetric information. *See* Sale, *supra* note 24, at 590-91. Often, company insiders sell their own shares into the stock offering. Indeed, approximately one quarter of the IPOs occurring in the first eight months of 1999 allowed insiders to sell their shares into the companies' initial stock offering. *See* Danielle Sessa & Terzah Ewing, *Some Insiders Sell Shares at Time of* IPO, WALL ST. J., Sept. 1, 1999, at C1. (showing new stock transactions with insider sales had median return of 16 percent compared to their non-insider-sale counterparts for same time period). Thus, arguably, cases involving offerings can be analogized to cases involving insider-trading allegations. One purpose of the Securities Act is to eliminate the informational asymmetry that exists in securities offerings and that is most serious in the context of IPOs. Consistent with their approach in the insider-trading context, the courts have rejected generalized allegations of the defendants' desire to make an offering or maintain their company's credit rating as applicable to all defendants. *See, e.g., Rehm*, 954 F. Supp. at 1253 (rejecting access-to-capital allegations where plaintiffs failed to allege "single example of Eagle actually seeking to acquire capital" in class period).

Courts have also developed a Merger Heuristic. Courts use this heuristic to dismiss allegations that a planned or hoped-for strategic combination served as the motive for the commission of fraud. *See, e.g., In re* Unisys Corp., Sec. Litig., No. Civ. A. 00-1849, 2000 WL 1367951 (E.D. Pa. Sept. 21, 2000). For example, in *Zeid v. Kimberley*, the district court rejected an allegation that a potential merger served as a motive for fraud. The complaint included specific pleadings about the dates of meetings between the two companies and proposed pricing discussions, dates of draft agreements, and dates when discussions ended. 973 F. Supp. 910, 923 (N.D. Cal. 1997). The court invoked two arguments in support of its decision to reject the plaintiffs' tendered scienter pleadings. First, the district court found that the plaintiffs failed to show how the transaction could have been completed in the alleged timeframe. *Id.* Second, the district court relied on the acquirer's rejection as proof that the defendants could not have been attempting to commit fraud. *Id.* According to the district court, the plaintiffs' story was implausible because acquisition discussions ended when the acquirer discovered "certain" information in the course of its due diligence process. *Id.*; *see also* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (due diligence refers to level of attention certain outside professionals are expected to use in their review of company documents in offering process; failure to provide requisite due diligence may result in liability); *cf.* Debra Baker, *Who Wants To Be A Millionaire?* A.B.A. J., Feb. 2000, at 36 (noting role of attorneys and accountants is now under attack because their investments in their clients raise concern that their motives in offerings are suspect).

To be sure, the early failure of negotiations could mean that the defendants were not aware of the problems the plaintiffs alleged and that appears to be the assumption made by the court. But the district court's opinion neglected to include the alternative arguments. The failed-acquisition story is subject to more than one interpretation, and therefore, not necessarily appropriate for a motion-to-dismiss determination. The interpretation favored by the court allowed for dismissal of the case. The alternative story is one involving

Table 15
Outcomes – Resignation Heuristic
1996-2000

| | Dismissal - Granted | Dismissal - Denied |
|---|---|---|
| Opinion Outcomes Resignation Heuristic | 8 | 3 |

c. Conclusion

The above-detailed analysis reveals both the growth in and the power of the heuristics. In addition, the analysis reveals that the heuristics, although useful for dismissing opinions, usually mask the plaintiffs' side

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defendants who want to complete the merger and may hope that due diligence would reveal the alleged problems. Indeed, if the defendants were sure of what the due diligence process would reveal, they probably would not have been willing to engage in the acquisition discussions at all. Accepting either version of the story allows the court to make inappropriate assumptions about what the defendants did, or did not, believe at the motion-to-dismiss stage. *See In re* Green Tree Fin. Corp., Stock Litig., 61 F. Supp. 2d 860, 874 (D. Minn. 1999) (making such assumptions to dismiss allegations).

Additionally, the speed with which the discussions were terminated after due diligence began is arguably a fact from which scienter might be inferred. *Cf. In re* Reliance Sec. Litig. v. Taylor Capital Group, Inc., No. MDL 1304, Civ. A. 99-858-RRM, 2000 WL 432792, at *12 (D. Del. Apr. 19, 2000) (acknowledging in support of sufficiency of scienter allegations that new CFO discovered fraud within months of taking office). The premise of the due diligence requirement is "mistrust of management" as the only reliable source of information. *See* Langevoort, *Organized Illusions, supra* note 3, at 159. Thus, when the due diligence process turns up problems, particularly with ease, it is, at least arguably, potential evidence that the defendant's attempt at a merger was reckless. A determination by a court that the inference should be that the defendants could not have been committing fraud, limits the defendants' potential motives only to "good" ones, again selecting an inference, which, if made properly at all, belongs at the summary-judgment stage.

Finally, fraud often occurs when defendants are in "last-period" situations. *See* Arlen & Carney, *supra* note 81, at 724-27; *see also* Langevoort, *Organized Illusions, supra* note 3, at 114-16 (noting that motives to commit fraud can occur in many circumstances and that analysis of such motives should be more textured); *id.* at 129 (arguing that managers face much "noise" in daily work that some problems may not actually be "known" to them, therefore, appropriate term for their failure to know of problems may actually be recklessness). Last-periods are those stages of a company's life in which officers are, for various reasons, anxious or desperate to complete certain transactions. *See* Arlen & Carney, *supra* note 81, at 694. As their commitment to their project or idea escalates and their ability to consider walking away diminishes, the likelihood of fraud increases. Thus, failure to complete the transaction might actually be evidence of a risk-preferring manager, or one who is behaving, arguably, with a level of recklessness sufficient to be fraudulent, and not with a lack of guile — again, evidence properly compiled and then considered in a summary-judgment motion.

of the story. Indeed, as deployed by the judges, the heuristics often tell only one side, the defendants', and neglect the other. The tables contained in this section also reveal the role of the heuristics in dismissing cases. When combined, the full power of the heuristics is even more telling.

Table 16
Annual Heuristic Use – All Types

| Heuristics in Opinions | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Timing | 2 | 8 | 18 | 20 | 30 |
| Percentage | 2 | 10 | 8 | 15 | 28 |
| Option-Basis | 1 | 1 | 3 | 6 | 14 |
| All-Defendant | 1 | 4 | 3 | 8 | 11 |
| Stock-Purchase | 0 | 0 | 3 | 3 | 5 |
| Resignation | 0 | 2 | 1 | 3 | 5 |
| Total | 6 | 25 | 36 | 55 | 93 |

From 1996 to 2000, the use of the various heuristics increased from 6 to 93, or over fifteen times. In a short period of time, that is a dramatic change, with an obvious benefit to the defendants. Of course, the outcome, not the heuristics, is what Congress wanted. As the next Section reveals, however, there may well be more at work than courts attempting to meet the requirements of the PSLRA.

## III. RHETORIC AND MOTIVE

By themselves, the heuristics are just bright-line rules. When viewed in the context of the rhetoric the courts employ while applying, expanding, and ultimately using the heuristics to dismiss complaints, however,[163] the heuristics are particularly troubling. Although the courts

[163] The courts have developed other heuristics to assist them in clearing their dockets. Although judicial notice in its most basic form has been around for a long time, the trend

frequently cite the legislative debate about the PSLRA or the Conference Committee report when evaluating the appropriate pleading standard to apply, they also make other statements that create the impression that their decisions to dismiss these cases are affected by time pressure, crowded dockets, and a frustration with the cumbersome and complex nature of the complaints in these cases.[164] The rhetoric, in combination with some of the scholarship on judges and judging, provides a

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for its expansion in securities-fraud suits is stunning. For example, initially, defendants sought to include various publicly filed documents, like quarterly reports filed with the SEC, in their motions to dismiss. *See, e.g., In re* Silicon Graphics, Inc., Sec. Litig., 183 F3d 970, 986 (9th Cir. 1999). Some courts began to accept these documents, rejecting claims by plaintiffs that their inclusion would convert a motion to dismiss into one for summary judgment. *See, e.g., id.* In support of the decision to include the documents, the courts noted that the documents were publicly filed and that plaintiffs often engaged in selective quotation from them. *See, e.g., id.* Again, this decision by the courts was seemingly innocuous in its early stages.

Since the PSLRA, however, the practice of incorporating documents has expanded to include documents not signed or publicly filed by defendants. For example, in a few recent cases, the courts have accepted the transcripts of conference calls that the defendants have submitted in response to allegations by the plaintiffs about what occurred in the conference calls. *See, e.g., In re* Milestone Scientific, Sec. Litig., 103 F. Supp. 2d 425, 450 n.15, 464 n.25 (D.N.J. 2000); *In re* Ciena Corp. Sec. Litig., No. Civ. A. JFM-98-2946, 99 F.Supp.2d 650 (D. Md. 2000);. *Compare* Cooper v. Pickett, 137 F.3d 616, 622 (9th Cir. 1997) (rejecting additional documents based on pre-PSLRA standards), *with* Wenger v. Lumisys, Inc., 2 F. Supp. 2d 1231, 1240-42 (N.D. Cal. 1998) (using PSLRA to distinguish *Cooper* and accept conference-call transcripts). *But see In re* Stratosphere Corp., Sec. Litig., 1 F. Supp. 2d 1096, 1109-10 (D. Nev. 1998) (accepting plaintiffs' argument that defendants' use of additional documents and accompanying arguments required court to accept defendants' interpretation of documents at issue, including issues related to authenticity of documents and dates documents were created). *See also In re* Vantive Corp., Sec. Litig., 110 F.Supp.2d 1209 (N.D. Cal. 2000). The courts have used those transcripts to reject the plaintiffs' characterization of the statements made. Yet, at the time of the motion to dismiss, the plaintiffs have not had the opportunity to compare the transcripts to tapes, if any, of those calls, or to depose the defendants who participated in the calls. *Cf.* In re *Stratosphere Corp.*, 1 F. Supp. 2d at 1109-10 (finding that when plaintiffs cite documents in complaint, court must accept plaintiffs' interpretation as true, unless no factual basis for interpretation exists, because to do otherwise creates summary judgment arguments). Ironically, if the plaintiffs had asked the defendants to produce such transcripts, their request would likely have been met with loud protests and repeated assertions of the protections afforded by the discovery stay.

[164] On the federal docket crisis in general, *see, e.g.*, Martha J. Dragich, *Once a Century: Time for a Structural Overhaul of the Federal Courts*, 1996 WIS. L. REV. 11 (1996); Rochelle Cooper Dreyfuss, *Specialized Adjudication*, 1990 B.Y.U. L. REV. 377 (1990) (discussing proposal of specialized adjudication as solution to overcrowded dockets); Marc Galanter, *The Life and Times of the Big Six; or the Federal Courts Since the Good Old Days*, 1988 WIS. L. REV. 921 (1988); Ruth B. Ginsburg, *Reflections on the Independence, Good Behavior, and Workload of Federal* Judges, 55 U. COLO. L. REV. 1 (1983); Carl McGowan, *The View from an Inferior Court*, 19 SAN DIEGO L. REV. 659 (1982); Diane P. Wood, *Generalist Judges In a Specialized World*, 50 SMU L. REV. 1755 (1997); Stephen Reinhardt, *A Plea to Save the Federal Courts, Too Few Judges, Too Many Cases*, A.B.A. J., Jan. 1993, at 53 (noting district courts face workload problem).

framework for exploring the possibility that the courts are, consciously or unconsciously, utilizing the heuristics to clear complex cases that would otherwise remain on the dockets for lengthy periods of time. And, the rhetoric conveys impressions, through lawyers to clients, that some types of fraud are not particularly important.[165]

Indeed, the rhetoric of the opinions arguably reveals that the courts are not simply applying pre-PSLRA standards designed to sort the good cases from the bad.[166] Instead, the language of the opinions creates an impression of frustrated or even angry judges, disdainful of the plaintiffs' attorneys before them and aggravated by the length and complexity of the complaints. Indeed, the language, tone, and rhetoric of the opinions have the potential to create a perception of animosity, which is disappointing in its openness and intensity — particularly given our standard assumption that judges are unbiased.[167] These opinions are,

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[165] Peter C. Kostant, *Sacred Cows or Cash Cows: The Abuse of Rhetoric in Justifying Some Current Norms of Transactional Lawyering*, 36 WAKE FOREST L. REV. 49 (2001) (discussing likelihood that lawyers assist clients in committing some forms of securities fraud, in part, because courts refuse to consider ethical issues in conjunction with certain types of fraud cases).

[166] In addition, courts are now granting motions to dismiss with prejudice early and often — sometimes after the first motion to dismiss. *See, e.g.*, Caprin v. Simon Transp. Serv., 112 F. Supp. 2d 1251 (D. Utah 2000); Cheney v. Cyberguard, No. 98-6879-CIV-GOLD, 2000 WL 1140306 (S.D. Fla. July 31, 2000); FVC.COM Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,908, at 93,832 (N.D. Cal. Feb. 14, 2000) (refusing leave to file second amended complaint in first order on motion to dismiss because plaintiffs had more than four months to correct complaint and court found no evidence to show they would be able to correct "glaring deficiencies," but specifically noting that leave to amend is usually freely given); Ronconi v. Larkin, 1998 WL 230987, at *7 (N.D. Cal. May 1, 1998) (dismissing with prejudice amended complaint in first motion to dismiss opinion, noting that plaintiffs were aware that PSLRA increased pleading standard). And, some courts have prejudicially dismissed cases after what appears to be the plaintiffs' first attempt at meeting the heightened pleading standard. *See, e.g., In re* Credit Acceptance Sec. Litig., 50 F. Supp. 2d 662, 680 (E.D. Mich 1999) (dismissing with prejudice what appears to be first complaint). In doing so, the courts are able to decrease the docket time for pending cases. *See, e.g.*, EP Medsystems, Inc. v. Echocath, Inc., 30 F. Supp. 2d 726, 772 (D.N.J. 1998) (dismissing with prejudice complaint within one year of initial filing date); Havenick v. Network Express, Inc., 981 F. Supp. 480, 482 (E.D. Mich. 1997) (same). Yet, the PSLRA did not discuss with-prejudice dismissals. A similar trend is beginning to appear in judicial reviews of proposed damage amounts for settlement. *See* Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits*, 56 BUS. LAW. 483 (2001) (noting that judges are no longer "reflexive[ly]" accepting plaintiffs' damages claims).

[167] *See* Wald, *supra* note 41, at 1373 (noting that judges facing rising casesloads often draft opinions that are "dismissive in tone"); *cf. id.* at 1381 (noting same tendency in criticizing colleagues in opinions). For a discussion of judicial opinion writing and styles of writing, *see generally* Richard A. Posner, *Judges' Writing Styles (And Do They Matter?)*, 62 U. CHI. L. REV. 1421 (1996). For articles on judging, decision making, and the roles of judges and how it affects their opinions, in general, *see* Cass, *supra* note 50; Tracey E. George, *The*

in the words of one federal judge, "Scroogelike" in nature.[168] That rhetoric, then, may create an impression that the courts are biased against these cases as a category.[169]

For example, the opinions suggest intolerance of the manner in which the plaintiffs style their complaints.[170] The opinions contain repeated references to the length of the complaints, stressing that complaints longer than approximately forty pages are too cumbersome.[171] Although the heightened pleading standard requires considerable specificity, and therefore, presumably, longer complaints, the courts also criticize the style of the complaints, arguing that despite the specificity required in pleading, the complaints before them are "ridiculously long and rambling."[172] And, some opinions actually contain prescriptions for

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*Dynamics and Determinants of the Decision to Grant En Banc Review*, 74 WASH. L. REV. 213 (1999); Tracey E. George, *Developing a Positive Theory of Decisionmaking on U.S. Courts of Appeals*, 58 OHIO ST. L.J. 1635 (1998); Tracey E. George & Lee Epstein, *On the Nature of Supreme Court Decision Making*, 86 AM. POL. SCI. REV. 323 (1992); Lewis A. Kornhauser, *Adjudication by a Resource-Constrained Team: Hierarchy and Precedent in a Judicial System*, 68 S. CAL. L. REV. 1605 (1995); Lewis A. Kornhauser and Lawrence G. Sager, *Unpacking the Court*, 96 YALE L.J. 82 (1986); Gregory C. Sisk et al., *Charting the Influences on the Judicial Mind: An Empirical Study of Judicial Reasoning*, 73 N.Y.U. L. REV. 1377 (1998).

[168] Wald, *supra* note 41, at 1373; *see, e.g., In re* PetsMart, Inc. Sec. Litig., 61 F. Supp. 2d 982, 1001 (N.D. Cal. 1999):

> We conclude that plaintiffs' complaint is merely a series of conclusory allegations insufficient to support a single claim of securities fraud. The Consolidated Amended Complaint is dismissed in its entirety. We dismiss without prejudice and with leave to amend within 60 days. We, however, caution plaintiffs against refiling unless they can cure the significant deficiencies discussed above. This would require plaintiffs to commit to a theory of who knew what when, who did what when, and why.

*See also* Chan v. Orthologic Corp., 1998 WL 1018624, at *23-24 (D. Ariz. Feb. 5, 1998).

[169] Janet Cooper Alexander, *Judges' Self-Interest and Procedural Rules: Comment on Macey*, 23 J. LEGAL STUD. 647, 663-64 (1994) (reasoning that language can reveal stereotypes and biases about importance of issues).

[170] *Cf.* James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 22 (1999) (noting that level of judicial scrutiny reflects judges' perception of social value of case).

[171] *See, e.g.*, Branca v. Paymentech, Inc., No. Civ. A.3:97-CV-2507-L, 2000 WL 145083, at *7 (N.D. Tex. Feb. 8, 2000) (referring to "long-winded and detailed 60-page complaint"); Danis v. USN Communications, Inc., 73 F. Supp. 2d 923, 932 (N.D. Ill. 1999) (noting complaint was "in excess of one-hundred pages"); Coates v. Heartland Wireless Communications, Inc., 55 F. Supp. 2d 628, 639 (N.D. Tex. 1999) (complaining of 42-page, 65-paragraph (including ten footnotes) amended complaint); *In re* Number Nine Visual Tech. Corp., Sec. Litig., 51 F. Supp. 2d 1, 31 (D. Mass. 1999) (describing complaint as "78 pages of dense prose"); *In re* Aetna Inc., Sec. Litig., 34 F. Supp. 2d 935, 952 (E.D. Pa. 1999) (referencing 83 page complaint); Zuckerman v. Foxmeyer Health Corp., 4 F. Supp. 2d 618, 623 (N.D. Tex. 1998) (referring to complaint which "spans eighty pages").

[172] Queen Uno Ltd. P'ship v. Coeur D'Alene Mines, Corp., 2 F. Supp. 2d 1345, 1354 n.3

further pleadings, covering the acceptable length and form the complaint should take if the plaintiffs replead.

Indeed, one court prescribed the grammatical formulation of any new complaint, requiring delineation of "each particular allegation (i.e., every sentence or clause separated by a comma or conjunction) and descri[ption of] all witnesses, documents, and other information necessary to support it."[173] Another court included an entire paragraph instructing the plaintiffs how to revise their complaint and specifically circumscribed the plaintiffs' use of exclamation points. According to that court, the revised complaint had to:

> (1) Specify which statements were allegedly false and which were allegedly misleading due to omissions; 2) clarify which allegedly false and misleading statements were forward-looking and which were not; 3) clearly state the bases for each of their allegations; . . . and 5) avoid gratuitous hyperbole (such as exclamation marks) and shorten the background portion of the complaint.[174]

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(D. Colo. 1998) (noting that complaint was thorough but "unnecessarily repetitive, as if Plaintiffs thought their claims could be proven by dint of sheer repetition"; that court "serious[ly] consider[ed]" dismissing it "for failure to comply with" short-and-plain-statement command of Federal Rule of Civil Procedure 8(a); and that plaintiffs should not mistake its failure to dismiss complaint "as leave to file throughout the course of these proceedings other ridiculously long and rambling pleadings, motions, or briefs"); *see also In re* Ultrafem Inc., Sec. Litig, 91 F. Supp. 2d 678, 690 (S.D.N.Y. 2000) (accusing plaintiffs of forcing it to "parse their allegations"); Bryant v. Avado Brands, Inc., 100 F. Supp. 2d 1368, 1377 (M.D. Ga. 2000) (complaining that court had to "sift[] through . . . irrelevant and repetitive material . . . compris[ing] substantial portion" of 85-page complaint); *In re* Peritus Software Servs., Inc., Sec. Litig., 52 F. Supp. 2d 211, 225 (D. Mass. 1999) (opining that "narrative that trickles out of the Complaint is only loosely-formed, with rough character contours and an unforgivably vague plotline"); Schlagel v. Learning Tree Int'l, No. CV 98-6384 ABC (EX), 1998 WL 1144581, at *18 n.1 (C.D. Cal. Dec. 23, 1998) (describing plaintiffs' complaint as incredibly unwieldy and far from "short and plain statement" envisioned by federal rules and citing Fed. R. Civ. P. 8(a)); Novak v. Kasaks, 997 F. Supp. 425, 431 (S.D.N.Y. 1998) (rejecting complaint as "woefully devoid" of requisite particularity); Clark v. TRO Learning, Inc., No. 97 C 8683, 1998 WL 292382 at *4 (N.D. Ill. 1998) (complaining of inability to "discern from 133 paragraphs in [plaintiff's] complaint allegedly actionable statements); *In re* Portannese v. Donna Karan Int'l, Sec. Litig, No. 97-CV-2011 CBA, 1998 WL 637547, at *5 (E.D.N.Y. Aug. 14, 1998) (noting that careful consideration of allegations was "not an easy task" because of "repetitive and sometimes confusing 61 page pleading that contain[ed] over 150 paragraphs).

[173] Lirette v. Shiva Corp., 999 F. Supp. 164, 165 (D. Mass. 1998) (requiring plaintiffs to refile new pleading within ten days of court order).

[174] Hockey v. Medhekar, 1997 WL 203704, at *11 (N.D. Cal. Apr. 15, 1997) (allowing plaintiffs leave to replead); *see also* Chan v. Orthologic Corp., 1998 WL 1018624, at *23-24 (D. Ariz. Feb. 5, 1998):

> The court will not look kindly upon an attempt to "plead around" pertinent facts

The courts do not reserve their rhetoric for the complaints. They openly criticize the lawyers litigating the cases. For example, in response to a client's assertion that if designated lead plaintiff, it would choose a particular law firm to serve as lead counsel, a court made a gratuitous reference to a lawsuit and settlement against that law firm in another, unrelated matter.[175]

Another court stated that it felt compelled to "spend at least a few words on" plaintiff's counsel,[176] noting that it was "the least [it] c[ould] do, given the lavish attention [counsel] ha[d] shown the Court with his repeated ex parte phone calls to chambers."[177] Although, presumably, counsel in this case was annoying, it is worth questioning what, if any, value the court's apparent sarcasm provides.

These examples of the language in the opinions and seeming frustration expressed over these cases reveal what might be interpreted as hostility to these cases and to the plaintiffs' bar litigating them. To be sure, although Congress, a lack of symmetry, the class-action mechanism, and many other factors contributed to the enactment of higher pleading standards through the PSLRA, the rhetoric the courts are employing creates an impression that the courts have been heavily influenced by political issues and may even lack respect for the litigants before them. The opinions also create the impression that the courts are

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> in this matter. In addition, the court cautions that an amended complaint should respect the mandate of both Rule 9(b) and Rule 8. . . .While Rule 9(b) and the Reform Act, of necessity, tend to lengthen a well plead complaint, they do not give license to violate Rule 8. The length and confusing nature of the present complaint is unnecessary as a pleading device and Plaintiffs should use care in redrafting this complaint. Nor should this order be interpreted as leave to increase the size and repetitive nature of an already oversized document.

*Id.* at 24 n.16.

> Other courts have dealt with similar complaints by requiring Plaintiffs to adhere to a page limitation or create a short and plain chart outlining the claims presented in the complaint. *See* Conner Peripherals, Inc., Fed. Sec. L. Rep. ¶ 99,021 (N.D.Cal. Jan. 18, 1996).
>
> > While the court will not issue such an order at this time, Plaintiffs should consider these possibilities when redrafting. Plaintiffs may choose such an alternative, if they so desire. However, the court cautions that whatever avenue Plaintiffs choose to pursue, it should be the one that best observes the mandate of Rule 8.

[175] *See In re* Comdisco Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,437, at 96,573 (N.D. Ill. Apr. 12, 2001).

[176] Krim v. pcOrder.com, No. A 00 CA 776 SS, 2001 U.S. Dist. LEXIS 6592, at *13 (W.D. Tex. May 14, 2001).

[177] *Id.* at n.2.

unconcerned about expressing any such lack of respect or hostility. Indeed, the opinions may create an impression that the courts are predisposed to defendants and the defense bar.

## IV. HEURISTICS, MOTIVES, AND LEGITIMACY: THE NORMATIVE QUESTION AND IMPLICATIONS

Does it matter if the courts use these heuristics and dismiss these cases? If all of these cases were merely strike suits, the answer, at least with respect to the securities-fraud regime, might be no. But the answer is more complicated than that because the opinions have the potential to have multiple effects on the legitimacy of the markets and the court system. Thus, in many ways the answer depends on the unknown.

It is impossible to know whether the suit being brought is one where a misstatement or omission actually occurred. Arguably, the cases in which the fraud is both flagrant and obvious, like those the SEC investigates, survive, but those in which the fraud is more difficult to identify are dismissed.[178] Indeed, little can be said with confidence about the effect of the PSLRA, beyond that: it "makes it harder for meritorious claims to survive,"[179] makes it both more difficult and more expensive for plaintiffs to prevail,"[180] and, thereby, "makes a merit-based adjudication even more difficult to obtain."[181] This last point is the one worthy of the most attention, both practically and theoretically.

In the five years since the PSLRA became law, courts have narrowed the range of pleadings sufficient to meet the motive prong of the Motive and Opportunity Heuristic. The use and the outcome-determinative effect of the heuristics have increased dramatically. Practically speaking, the effect of these opinions is at least twofold. First, they increase the

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[178] Of the post-PSLRA, 1996-2000, decisions on motions to dismiss in which the plaintiffs pleaded that the Securities and Exchange Commission had investigated (or was investigating) the defendants for fraud, approximately 71 percent survived the motion to dismiss. This number is important for two reasons. First, the survival rate of complaints with such claims is approximately 20 percent higher than for those without. Second, ironically, because the SEC is already investigating these defendants, the need for sanctions through the private-plaintiff mechanism is less.

[179] *Developments in the Law: The Paths of Civil Litigation*, 113 HARV. L. REV. 1752, 1806 (2000); *cf.* Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, J. LEG. STUD. 399, 437 (1973) [hereinafter Posner, *Economic Approach*] (noting that liberal pleading rules likely decrease number of meritorious cases dismissed).

[180] Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM & MARY L. REV. 1055, 1087-88 (1999); *see also* Davisson, *supra* note 135, at 9 (noting that 60 percent of class actions are dismissed, compared with 40 percent in years prior to PSLRA).

[181] Ramirez, *supra* note 180, at 1087.

likelihood of dismissal of cases in which fraud actually occurred.[182] Second, the courts are creating and deploying safe harbors in which, if defendants so desired, they could commit fraud and be protected.[183] Indeed, if Professors Priest and Klein's prediction is correct, the heuristics, which are simplistic and clear by definition, could have such an effect.[184]

These opinions also have other potential, if more subtle, effects. As the above analysis of the evolution of the Motive Heuristic reveals, the application of the heuristics allows for dismissal of a complaint with opinions that appear to provide a detailed analysis of the plaintiffs' claims. That appearance is inaccurate, because, as described above, the heuristics are shortcuts that prevent the courts from exploring the allegations in detail.[185] However, because the heuristics function as shortcuts that eliminate cases and preempt the opportunity for the creation of substantive securities law, they actually have the potential to

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[182] *See* Jules Coleman & Charles Silver, *Justice in Settlements*, 4 SOC. PHIL. & POL. 102, 112 (1987) (noting that in world with zero litigation costs, ideal is full adjudication of all complaints to ensure full compensation to injured parties and no compensation to noninjured parties). To the extent the heuristics favor defendants, it is a form of biased error. *See* Posner, *Economic Approach*, *supra* note 179, at 406 (defining biased error as one systematically more likely to defeat plaintiffs or defendants).

Pleading is an inexact art and includes incomplete stories. Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675, 706 (1996) (noting that, by definition, no perfect pleading standard exists). Accordingly, although the PSLRA probably decreases the number of Type I cases, it also probably increases the number of Type II cases. To the extent the courts are further restricting the pleading standard, it is also likely that they are eliminating Type II cases. *See supra* notes 19-21 and accompanying text.

Professor Charles Yablon has argued that rather than relegating securities litigation to the frivolous strike-suit category, we should consider the possibility that they fall into the group of cases referred to as longshots. Yablon, *supra* note 57, at 568. This switch allows for a focus on the actual losses, which he argues are substantial, incurred by dismissing Type II cases. *Id.* at 593. To support this argument, he notes that the deterrence of four longshots, with a 25 percent chance of success, will result in one meritorious suit, a suit in which fraud actually occurred, not being brought. *Id.* Given the primary purposes of the securities laws, deterring fraudulent conduct and increasing full and truthful disclosures, he argues that the deterrence of any longshots is a bad result. *Id.* at 594.

[183] *See* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1696 (1976) ("Rules, on the other hand, allow the proverbial 'bad man' to 'walk the line,' that is, to take conscious advantage of underinclusion to perpetrate fraud with impunity.").

[184] *See generally* George Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984) (predicting that people will follow reasonably clear and enforceable legal rules).

[185] Indeed, the illusion of certainty is a potential downside of heuristics. *See* Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 CHI.-KENT L. REV. 1569, 1572-73 (2000).

stunt the development of the common law beyond the pleading stage.[186] By failing to develop the underlying, substantive law of fraud in this area, and, in fact, by using the heuristics to create safe harbors in which fraud can freely occur, the courts are decreasing "the risk of being caught for" committing securities fraud.[187] The heuristics, then, can undermine the purposes and enforcement of the securities laws and the integrity of the legal system.[188]

The heuristics also allow for the elimination of complicated cases early in the litigation process through the choice of alternative interpretations of the alleged facts. Considering alternative inferences and assuming the pleaded facts to be true, however, reveals that many of these cases should survive the motion to dismiss and proceed through discovery to summary judgment (or even trial if the determination to be made depends on the credibility of witnesses). Because the opinions at issue usually refer to the downside of securities-fraud suits, like their potential use as strike suits, without discussing the value of such litigation to the legitimacy of the markets, the opinions have the potential to decrease both the protection offered by the Acts, as well as the creation of substantive law in this area as a whole and, arguably, the legitimacy of the markets and the judicial system.[189]

To be sure, in passing the PSLRA, Congress expressed its desire to eliminate abusive claims and needless litigation, but it also reiterated the motives of the Congress adopting the Acts in the 1930's — protecting investors investing in, and the market for, securities.[190] Through the application of the ever evolving and narrowing heuristics, the courts are

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[186] This perspective is different from the point of view that common law evolves efficiently. *See* Richard A. Posner, ECONOMIC ANALYSIS OF LAW 559-60 (4th ed. 1992); John C. Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. LEGAL STUD. 393 (1978); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977). The difference may be attributable to the procedural focus and the resulting inhibition of the development of the underlying substantive law.

[187] Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 351 (1997) [hereinafter Kahan, *Social Influence*]; Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2026 (1987) [hereinafter Sunstein, *On the Expressive Function*] (noting that law can influence social norms).

[188] Note, *Living in a Material World: Corporate Disclosure of Midquarter Results*, 110 HARV. L. REV. 923, 933 (1997) (noting that ease of application alone is insufficient reason to undermine purposes of securities laws); *cf.* Ian F. Haney Lopez, *Institutional Racism: Judicial Conduct and a New Theory of Racial Discrimination*, 109 YALE L.J. 1717, 1722 (2000) (noting that unexamined judicial decision-making may lead to problematic outcomes).

[189] *Cf.* Cass R. Sunstein, *Foreward: Leaving Things Undecided*, 110 HARV. L. REV. 4, 99-100 (1996) [Sunstein, *Foreward*] (positing that courts should adopt minimalist approach when they lack information sufficient to make more comprehensive rulings).

[190] *See supra* note 57.

creating an impression of disregard for that portion of Congress's message. As such heuristics continue to multiply, the ability of the cause of action to protect the securities markets will diminish, and, arguably, so too will investor confidence in those markets.[191]

The existence of fraud or the appearance of unregulated fraud in the securities markets prevents purchasers from determining which companies are committing it and which are not.[192] As a result, the argument is that investors will discount all securities in the market, not just those of the low-quality companies. Over time, the effect of such discounting is to force quality firms from the market because they will not be able to sell their securities for an appropriate price. The result, then, is diminished "legitimacy" in the markets.

Because the heuristics are employed at the motion-to-dismiss stage, effectively preempting discovery and full adjudication of the claims, they also prevent the courts from developing the underlying substantive law of securities fraud.[193] Of course, not all cases filed are ones where fraud is present, but when an opinion uses the Percentage-Based Heuristic to dismiss a complaint for failure to plead scienter, even where the trades in question amount to tens of millions of dollars, the result is no discovery, even for summary judgment purposes of potentially suspicious facts. The application of the heuristic, thus, allows for a seemingly well developed discussion of securities fraud, but prevents any discovery as to the real issue — whether fraud did indeed occur.[194]

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[191] *See* Labaton, *supra* note 57, at 413 ("investor confidence in the fairness of American markets is bolstered by a system that permits private lawsuits for securities fraud").

[192] This is commonly referred to as the problem of the market for lemons. *See* Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567-69 (2000) (using securities markets as example of market for lemons); Bernard Black, *Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 570-72 (discussing market for lemons in IPO context).

[193] *Cf.* Jonathan R. Macey, *Judicial Preferences, Public Choice and the Rules of Procedure*, 23 J. LEGAL STUD. 627, 644-45 (1994) (noting that Delaware judges have used procedural rules to avoid having to master more complex substantive law).

[194] *See* Wade H. McCree, Jr., *Bureaucratic Justice: An Early Warning*, 129 U. PA. L. REV. 777, 778 (noting that reforms to increase judicial efficiency can undermine quality of justice); *cf.* Coleman & Silver, *supra* note 182, at 112 (arguing that settlements in securities fraud cases are likely to undermine public policy behind law). The discussions about settlements and the lack of information available to judges in evaluating the cases in that context are also applicable here. *See, e.g.*, Coffee, *supra* note 57; Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984); Geoffrey C. Hazard, Jr., *The Settlement Black Box*, 75 B.U. L. REV. 1257 (1995); Jack B. Weinstein & Karin S. Schwartz, *Notes from the Cave: Some Problems of Judges in Dealing with Class Action Settlements*, 163 F.R.D. 369 (1995); *see also* Samuel R. Gross & Kent D. Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 MICH. L. REV. 319 (1991).

Terminating such a case at this stage not only undermines the potential legitimacy of the system, but also diminishes the "supply of [substantive] precedents available for cases" because they cannot hurdle the heuristic.[195] In this manner, the heuristics undermine what is certainly one of the purposes of a regime of shareholder litigation, that of creating substantive legal standards, which here would occur through fact patterns in cases by which individuals can measure their conduct.[196] And, in turn, the heuristics may actually decrease the supply of the underlying substantive law available to help guide courts faced with determining the reasonableness of arguments at the summary judgment or trial stage.[197] The heuristics thus build on themselves and compound their own effects and any initial problems of bounded rationality.[198]

Indeed, the heuristics, designed as motion-to-dismiss pleading standards and not substantive explications of the underlying law, are beginning to leach into summary judgment evaluations. For example, in a recent First Circuit opinion, the court applied its pleading standards to a summary judgment motion, holding that arguments favoring a heightened pleading standard for a motion to dismiss were "at least as

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[195] *See* Macey, *supra* note 193, at 642:

> Legal precedents are of general social value because they lower the transaction costs of doing business. Judges' self-interest leads them to craft procedural rules that reduce the percentage of cases ultimately resolved on the merits. Because more cases are resolved on technical, procedural grounds, the available supply of precedents is adversely affected by judicial self-interest.

*Cf.* Coleman & Silver, *supra* note 182, at 115 (noting that settlements decrease availability of information that fully litigated lawsuits produce).

[196] *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

[197] *Cf.* Yeazell, *Judging Rules*, *supra* note 42, at 239-40 (noting as judges spend less time in trials, their knowledge about practical operation of procedural rules diminishes).

[198] *See* Stephen M. Bainbridge & Mitu Gulati, *Judging Shortcuts*, (working paper, on file with author) [hereinafter Bainbridge & Gulati]; Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1635 (1999) (discussing bounded rationality and judicial incentives in context of Supreme Court decision making); L.J. Bourgeois, III, *On the Measurement of Organizational Slack*, 6 ACAD. MGMT. REV. 29, 35 (1981) (noting that bounded rationality can diminish optimal decision behavior and result in "satisficing" or choice of "first feasible alternative" rather than "optimal solution"); Lopez, *supra* note 188, at 1725 (arguing that institutional analysis allows focus on judges' reliance on scripts and path-dependent behavior). For general works on the bounded rationality of corporate managers, officers, and directors and administrative decisions, see, for example, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR, (Free Press 1957); Lucian Arye Bebchuk, Symposium, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

forceful, if not more so, with regard to proof requirements" at the summary judgment stage.[199] It then dismissed this case, noting that the evidence provided was insufficient to meet the Circuit's pleading standard.[200] Thus, the pleading standard has the potential to become the substantive law, without regard to evidence.

The nature of precedent further complicates the evolution of substantive law in this area.[201] Once the heuristic is crafted and applied, courts may feel compelled to reapply it in the next case.[202] A court that has not yet decided such a case will look first to other courts within and then beyond its district, and, where possible, to the circuit court for precedent or guidance.[203]

The use of precedent is self-reinforcing in several ways. First, it cabins the decision-makers' approach to the problem from the beginning, making it more difficult for them to consider different approaches to the

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[199] Geffon v. Micrion Corp., 249 F.3d 29 (1st Cir. 2001).

[200] *Id.* at 37.

[201] On the nature of precedent and its value to judges, see BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS 19-23 (University Press 1921); Jonathan R. Macey, *The Internal and External Costs and Benefits of Stare Decisis*, 65 CHI-KENT L. REV. 93 (1989) (discussing positive and negative aspects of precedent).

[202] *See* Coffee, *supra* note 57, at 27 (noting that once courts adopt certain procedures or approaches to cases, precedent requires them to continue it). Judges, like other people, are resistant to change, even when new evidence appears that should urge them to change their perspective on these cases. *See* SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION 149-51 (2d ed. 1991) (noting that once psychological "schemas" become well-developed, they are resistant to change); *cf.* John D. Stanley, *Dissent In Organizations*, 6 ACAD. MGMT. REV. 13 (1981) (noting that people may "subconsciously choose" favored alternatives and then build cases for them). This sort of behavior is similar to the commitment bias that exists in the context of overcapacity in industry. *See, e.g.*, Jerry Ross & Barry M. Staw, *Organizational Escalation and Exit: Lessons from the Shoreham Nuclear Power Plant*, 36 ACAD. MGMT. J. 701 (1993). For other works on decision making and cognitive biases, see L. FESTINGER & E. WALSTER, POST-DECISION REGRET AND DECISION REVERSAL (1964) (studying cognitive dissonance and commitment and loss of objectivity in decision making); KURT LEWIN, RESOLVING SOCIAL CONFLICTS: SELECTED PAPERS ON GROUP DYNAMICS (Gertrude Weiss Lewin ed., 1948) (noting that commitment to decisions can prohibit changes); Kurt Lewin, *Group Decisions and Social Change*, *in* READINGS IN SOCIAL PSYCHOLOGY (Theodore M. Newcomb & Eugene L. Hartley eds., 1947) (noting that social pressure can lead to judgmental errors); Plous, *supra* note 7; Tversky & Kahneman, *supra* note 10.

[203] At this stage, the guidance is mostly in the form of district court opinions, but the circuit court opinions that exist utilize the same types of heuristics. *See, e.g.*, Novak v. Kasaks, 216 F.3d 300, 328-29 (2d Cir. 2000); Greebel v. FTP Software, 194 F.3d 185 (1st Cir. 1999). On appellate review as a form of error correction, *see, e.g.*, Steven Shavell, *The Appeals Process as a Means of Error Correction*, 24 J. LEG. STUD. 379 (1995). On appellate review and lower court autonomy, *see* Evan H. Caminker, *Why Must Inferior Courts Obey Superior Court Precedents?*, 46 STAN. L. REV. 817 (1994) (reviewing and categorizing various arguments about autonomy of lower courts).

problems.[204] Second, it affects the way that lawyers present their cases, such that they seek out and invoke precedent, again reinforcing the power of the precedent being used.[205] And third, it provides courts with a certain comfort level in the opinions they draft. That is, precedent allows courts to avoid mistakes and reversal.[206] Combining their ease of application with the nature of precedent further explains why these heuristics have flourished and why they are likely to continue to do so.[207]

A study of norms and legal development also indicates that such opinions have potentially detrimental effects.[208] Law "shapes information about the beliefs and intentions" of individuals.[209] The perception of those beliefs and intentions influences how individuals behave and whether they are willing to break the law.[210] Thus, the deterrence value of law depends to some extent, on the "statements" that

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[204] *See* Jack Knight & Lee Epstein, *The Norm of Stare Decisis*, 40 AM. J. POL. SCI. 1018, 1033 (1996) (finding that norm favoring stare decisis works as constraint on decision making by limiting choices of judges and further "forces justices to modify their decisions in the direction of the rules established by existing precedent"); *cf.* Cass, *supra* note 50, at 979 (stating that judges experience opinion writing as lacking in discretion and constrained).

[205] *See* Knight & Epstein, *supra* note 204, at 1033 (arguing that norm of stare decisis results in use of arguments invoking precedent which, in turn, affect nature and substance of rules court establishes).

[206] *See* Cass, *supra* note 50, at 973 (noting preference of judges for "following orders"); Frank H. Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802 (1982); Kamar, *supra* note 52, at 1959 (stating that judges follow trends to avoid blame for mistakes).

[207] *See* Frederick Schauer, *Precedent*, 39 STAN. L. REV. 595 (1987) (discussing use and power of precedent and rationales for it); Anastasoff v. United States, 223 F.3d 898, 904-05 (8th Cir. 2000) (discussing doctrine of precedent as historic method of judicial decision making and role of it in modern decision making); *see also* Frank I. Michelman, *Norms and Normativity in the Economic Theory of Law*, 62 MINN. L. REV. 1015, 1046 (1978) ("Flowers are fine. Dandelions are flowers. Dandelions are weeds. Flowers are weeds when they take over the garden and crowd out the rest of life.").

Law clerks and their increased use for drafting opinions may be in part to blame for the proliferation of these heuristics. Presumably, they know even less law than the judges for whom they work, so heuristics are even more valuable to them. *Cf.* Richard A. Posner, *The Material Basis of Jurisprudence*, 69 IND. L.J. 1, 30 (1993) (noting use of law clerks increases uniformity in opinions across judges).

[208] A full discussion of norms and their connection to the law and legal rules is beyond the subject of this Article, but the significance of that body of work is not. For works on norms and the law, see, for example, Richard H. McAdams, *The Origin, Development, and Regulation of* Norms, 96 MICH. L. REV. 338 (1997); Eric Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133 (1996) [hereinafter E. Posner, *Regulation of Groups*]; Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996) [hereinafter Sunstein, *Social Norms*].

[209] Kahan, *Social Influence*, *supra* note 187, at 351.

[210] *Id.* *See also* E. Posner, *Regulation of Groups*, *supra* note 208, at 160 (noting that norms may subvert law and legal sanctions).

the courts make about it.[211] Expression, in combination with coercion, makes laws effective.[212]

In the securities-fraud regime, these "story lines"[213] are evolving largely through the employment of heuristics. The heuristics and the courts' rhetoric and tone convey the message that these cases, and the alleged fraud, are not worthy of the courts' time. Such messages have the potential to increase fraud.[214] Consider, for example, the cases in which the courts have detailed the plaintiffs' allegations, including allegations about significant amounts of insider trading, and then dismissed the case. One message such an opinion can send is that fraudulent conduct may be widespread, but the risk of being caught is low.[215] That opinion can have a feedback effect because its message may increase the occurrence of the conduct the securities laws are designed to deter.[216]

By applying the heuristics and using language and arguments that can appear as, at best, dismissive and, at worst, disdainful of the plaintiffs and their lawyers, the courts may send a message about their view of these cases. As lawyers and their clients absorb these messages, they might reasonably conclude that the "stigma" or "reputation costs" associated with accusations of securities-fraud claims are minimal.[217] The result is a message that counteracts the one intended by the law.[218] Those

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[211] Kahan, *Social Influence, supra* note 187, at 350.

[212] Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 595 (1998) [hereinafter Cooter, *Expressive Law*].

[213] Mark C. Suchman, *On Beyond Interest: Rational, Normative and Cognitive Perspectives In the Social Scientific Study of Law*, 1997 WIS. L. REV. 475, 491 ("legal system shapes behavior . . . by hammering out the 'story line' that society subsequently enacts in the performances of daily life.").

[214] Cass, *supra* note 50, at 957 (noting importance of prospective effects of decisions).

[215] *Id.*

[216] *See* Kahan, *Social Influence, supra* note 187, at 350 (noting that people commit crimes when their perception is that questionable activity is widespread); Dan M. Kahan, *Between Economics and Sociology: The New Path of Deterrence*, 95 MICH. L. REV. 2477, 2487 (1997) (same); Sunstein, *Social Norms, supra* note 208, at 931 ("The norm affects the belief, just as the belief affects the norm."); *see also* Sunstein, *On the Expressive Function, supra* note 187, at 2032 (noting feedback effect of norms and law in context of reputation).

[217] *See* Kahan, *Social Influence, supra* note 187, at 351; *see also id.* at 354 (stating that empirical studies of why people obey laws support this proposition). Ironically, one of the bases for heightened pleading standard was to protect defendants' reputations. *See, e.g.*, Lovelace v. Software Spectrum Inc., 78 F.3d 1015, 1020 (5th Cir. 1996); Shields v. Citytrust Bancorp, 25 F.3d 1124, 1128 (2d Cir. 1994); Tuchman v. DSC Communications. Corp., 14 F.3d 1061, 1067 (5th Cir. 1994).

[218] *See* Peter H. Huang and Ho-Mou Wu, *More Order Without More Law: A Theory of Social Norms and Organizational Cultures*, 10 J.L. ECON. & ORG. 390 (1994) (modeling how shame and remorse can counteract monetary incentives).

stories then may influence the way people think about and internalize the law. People obey laws out of an internalized respect for them.[219] Here people might reasonably conclude that the risk of being caught is low and that the community does not value the purposes of the securities laws.[220] Accordingly, the behavior is likely to increase, and as it does so, people are even "less likely to form moral aversions" to it.[221] Any shame once attached to the behavior dissipates.[222]

Empirical data reveals that people rapidly change their "moral convictions" to match those of their peers.[223] Those who do not change become "chumps."[224] And, as the group begins to internalize the behavior, it can even become "status enhancing."[225] Risky behavior will beget risky behavior,[226] as the courts' stories begin to spread through the

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[219] TOM R. TYLER, WHY PEOPLE OBEY THE LAW 3-4(1990) [hereinafter TYLER, WHY PEOPLE OBEY]; Tom Tyler, *Compliance with Intellectual Property Laws: A Psychological Perspective*, 29 N.Y.U. J. INT'L L. & POL. 219 (1997) [hereinafter Tyler, *Compliance*].

[220] *See* Kahan, *Social Influence*, *supra* note 187, at 351 (noting that law shapes perceptions about what communities' "beliefs and intentions" are).

[221] *Id.* at 350 (stating that where wrongdoing incurs with greater frequency, people are less likely to "form moral aversions" to it); *see also* Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984) (discussing conditions for convergence of decision and conduct rules).

[222] On the nature of shaming as a form of sanction, see Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 635-52 (1996).

[223] Kahan, *Social Influence*, *supra* note 187, at 351; Cox, *supra* note 170, at 5 (people make choices "by reference to the conduct of others"); *see also* John Scholtz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253 (Summer 1997); Davisson, *supra* note 135, at 9 (noting disturbing nature of attitudes of "dotcom" executives who are focused on themselves and cashing out and not on investors). *See generally* Sigal G. Barsade, *The Ripple Effect: Emotional Contagion In Groups*, Working Paper No. 91 (Oct. 2000) (discussing how emotions and attitudes ripple through groups and affect group dynamics).

[224] Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181, 2185 (1996) [hereinafter Lessig, *Social Meaning*].

[225] *Id.*; Sunstein, *On the Expressive Function*, *supra* note 187, at 2032 (noting connection between reputations and social norms and postulating that "when norms shift, the expressive content of acts shifts as well, thus producing changes in reputational effects"). Interestingly, having an IPO has apparently become the new "status symbol" for post-baby boomer Americans, replacing former symbols such as Gulfstream jets. Nina Munk, *It's the IPO, Stupid!*, 473 VANITY FAIR, JAN. 2000, at 78; *id.* at 76 (quoting newly-created millionaire describing IPO as "rite of passage"). For studies about the norms that certain groups have developed and the reasons why, *see generally*, ROBERT ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991); ELINOR OSTRUM, GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION (1990); Steven N.S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J.L. & ECON. 11 (1973); Steward Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Richard H. McAdams, *Group Norms, Gossip, and Blackmail*, 144 U. PA. L. REV. 2237 (1996).

[226] *See* Sunstein, *Social Norms*, *supra* note 208, at 934; *see also* Claire A. Hill, *Why Financial Appearance Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of*

business community and the feedback effect begins to diminish the deterrence value of the securities laws and increase the potential for fraud to occur.[227] Such changes can happen with speed, as the changes in corporate governance since the 1980s reveal.[228] Given the SEC's stated belief that securities fraud is actually on the increase, the heuristics and the potential concomitant effects are particularly troubling.[229]

The courts are also making explicit statements about the fraud by creating safe harbors. The type of heuristics the courts are using, largely bright-line rules, can have the effect of actually sanctioning fraudulent behavior. The First Circuit's opinion in *Greebel v. FTP Software* is one example.[230] There the court created a bright-line rule by stating that because retiring executives are often required to sell shares held, shares sold at or near retirement are insufficient to support allegations of scienter. Now, arguably, any executive who is retiring and wants to commit fraud can do so, presumably without fear of sanction.[231] The Percentage Heuristic has the same effect for executives who want to sell shares and who are careful to sell only small percentages at any given time. By sanctioning fraud, these safe harbors have the potential to diminish the "expressive function" or deterrence value of the securities

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*Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 179-80 (1997) (arguing that as accounting norms shift, companies may change financial accounting practices to less acceptable ones out of fear of not doing so); Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 809 (1992) (discussing peer pressure to conform to norms).

[227] *Cf.* Judith Chevalier & Glenn Ellison, *Career Concerns of Mutual Fund Managers*, 114 Q. J. ECON. 389 (1999) (revealing herding characteristics of mutual fund managers in portfolio selection). *But see* Steven M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1051-52 (2000) (arguing that U.S. capital markets are so dispersed and diverse that norms are not likely to be important). For an interesting discussion of the evolution of corporate norms in post-war Japan, see Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Non-Legal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083 (2001).

[228] *See* Peter C. Kostant, *Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel's Changing Role*, 28 J. SOCIO-ECON. 1 (1999).

[229] Anna Snider, *Levitt Challenges Lawyers to Fight Accounting Fraud*, N.Y. TIMES, Feb. 16, 1999, at 1; *see also* Davisson, *supra* note 135, at 9 (stating internet companies are "believed to be engaging in questionable accounting practices" and "creative accounting,"); Yablon, *supra* note 57, at 569; Richard A. Oppel, Jr., *Buffet Deplores Trend of Manipulated Earnings*, N.Y. TIMES, Mar. 15, 1999, at C2. If, as the SEC contends, fraud does exist and is growing, laws created to prevent it will be ineffective if unenforced. RICHARD H. MCADAMS, A FOCAL POINT THEORY OF EXPRESSIVE LAW 20 (May 2, 2000) (working paper on file with author). That is, people obey the law when it is likely that they will be sanctioned for not doing so. *See also* TYLER, WHY PEOPLE OBEY, *supra* note 219; Tyler, *Compliance*, *supra* note 219.

[230] 194 F.3d 185 (1st Cir. 1999).

[231] *See supra* notes 144-50 and accompanying text.

laws.[232] Yet, that deterrence goal is "undeniably crucial to the ultimate goal of producing accurate stock prices."[233] Undermining it, then, can undermine the legitimacy of the market.[234]

As this discussion reveals, these heuristics have the potential to do considerable damage to the securities-fraud regime that Congress and the courts have spent seventy years creating. They have the potential to create negative externalities by, at best, decreasing the incentive of issuers to ensure that they do not commit fraud and, at worst, by encouraging issuers to commit fraud. They undermine the goals of the law, and, arguably, the purpose of shareholder litigation — the creation of standards to regulate behavior and set the norms of corporate behavior.[235] In short, the context in which the standards develop matters if we expect the law to "discipline managers."[236]

Ultimately, the opinions may also undermine the public's faith in the judges and judicial system they represent. One of the strengths of our legal system is its sensitivity to the particulars of legal disputes.[237] Yet, the heuristics detailed in this Article allow judges to explore just a "handful of exemplary cases," rather than knowing "a great deal of law," before producing their opinions.[238] The ease of application of these heuristics may be an explanation for why they exist, but it is not the key to judging well[239] or, more importantly, to expanding the substantive law of securities fraud or to protecting investors. Instead, the simplistic, fill-in-the blank nature of, for example, the Percentage Heuristic, at best reduces the law to a system of bright-line rules that may be easy to

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[232] *See* Sunstein, *On the Expressive Function*, *supra* note 187; Sunstein, *Foreword*, *supra* note 189, at 69 (noting that decisions have at least "short-term effects in communicating certain messages"); *see also* ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH (1962); Lessig, *Social Meaning*, *supra* note 208; Cooter, *Expressive Law*, note 212; Christopher L. Eisgruber, *Is the Supreme Court an Educative Institution?*, 67 N.Y.U. L. REV. 921 (1992) (discussing educative value or nature of Supreme Court opinions); *cf.* Matthew Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000) (criticizing some legal works on expressive theories as underinclusive).

[233] Langevoort, *Organized Illusions*, *supra* note 3, at 128.

[234] *See* Marcel Kahan, *Securities Law and the Social Costs of Inaccurate Stock Prices*, 41 DUKE L.J. 977, 1028 (1992) (discussing how inaccuracies in market prices can affect both market and behavior of management).

[235] *See* Rock, *supra* note 196.

[236] Cox, *supra* note 170, at 6.

[237] *See* Richard A. Posner, *Conceptions of Legal "Theory": A Reply to Ronald Dworkin*, 29 ARIZ. L. REV. 377, 387 (1997).

[238] *Id.*

[239] *Id.*

apply,[240] but that is "rigid, inflexible, or unworkable."[241] The result is problematic opinions on motions to dismiss that, unlike "a bad settlement [are not] almost always better than a good trial"[242] or summary-judgment opinion.[243] Indeed, if the goal is to fashion reasoning to contribute to the legitimacy of the legal system, these heuristics may indicate that the courts are failing us.[244]

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[240] *See* Frederick Schauer, *Opinions as Rules*, 62 U. CHI. L. REV. 1455, 1467 (1995) (noting "common charge" against open ended or balancing tests is that they are difficult to apply); *cf.* Frank H. Easterbrook, *What's So Special About Judges?*, 61 U. COLO. L. REV. 773, 781 (1990) (comparing standards which may "boost levels of generality" and bright-line rules which may "be a calamity for different reasons"). For discussions on rules and standards in general, *see* Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14 (1967); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258-60 (1974); Jason Scott Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON & ORG. 256 (1995); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Kennedy, *supra* note 183; Wayne R. LaFave, *Case-by-Case Adjudication: Versus "Standardized Procedures": The Robinson Dilemma*, 1974 SUP. CT. REV. 127 (1974); Kathleen M. Sullivan, *Foreword The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992); Wald, *supra* note 41, at 1394 (describing bright-line rules as "using very specific words that cabin judges' discretion tightly" and balancing tests as "mansions of many rooms in which implementing judges may move about freely").

For discussions about how Delaware case law has evolved in a fact-intensive manner and whether that approach is effective, see Deborah A. DeMott, *Puzzles and Parables Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15 (1990); Kamar, *supra* note 52; Andrew G.T. Moore, II, *The 1980's — Did We Save the Stockholders While the Corporation Burned?*, 70 WASH U. L. QTLY. 277 (1992); Rock, *supra* note 196; *cf.* Macey, *supra* note 193, at 644 (noting that Delaware cases are really form over substance).

[241] Labaton, *supra* note 57, at 414; Note, *Living in a Material World: Corporate Disclosure of Midquarter Results*, 110 HARV. L. REV. 923 (1997) (discussing bright-line rules and standards in context of materiality in securities cases); *see also* RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 39-45 (1977); LON FULLER, ANATOMY OF THE LAW 106-08 (1968); OLIVER W. HOLMES, THE COMMON LAW 111-29 (1881); *cf.* Anthony D'Amato, *Legal Uncertainty*, 71 CAL. L. REV. 1, 8 (1983) (discussing theory of why evolution of law tends to certainty).

[242] *In re* Warner Communications Sec. Litig., 618 F. Supp. 735, 740 (S.D.N.Y. 1985).

[243] *See, e.g., In re* K-Tel Int'l, Inc., Sec. Litig., 107 F. Supp. 2d 994 (D. Minn. 2000) (ignoring insider trades within days of bad news because it was small percentage of total alleged trades for class period); *In re* Vantive Corp. Sec. Litig., 110 F. Supp. 2d 1209 (N.D. Cal. 2000) (noting trading activity in case was "undoubtedly substantial" but rejecting allegations based on trades because one defendant was outside director and other sold only 13 percent of his shares); *In re* Milestone Scientific, Sec. Litig., 103 F. Supp. 2d 425 (D.N.J. 2000) (rejecting one individual's trades of 500,000 shares, which totaled over $5,000,000 in profits, because it amounted to only 10 percent of total shares held). Indeed, a good settlement may require a judge to have some working knowledge of the facts and issues in the case, unlike the heuristics described in this Article. *See* Alexander, *supra* note 169, at 651.

[244] *See* Michelman, *supra* note 188, at 1046 (task of judiciary is "not to bring about an administratively simplifying purification of law or to reduce all of law to some one factor that currently seems to explain more of it than any other single, comparatively simple factor").

The continued proliferation of the heuristics also has the potential to cut the "heart" out of the "common law system . . . the written judicial opinion."[245] Respect for judges arises, in part, out of the opinions that they write.[246] In the words of one federal district court judge, "Judges are law teachers."[247] Opinions are one of the main ways in which they do that teaching.

Yet, opinions that are not "carefully reasoned and explained" do not reflect the judges' "struggles and deliberations."[248] Instead, they decrease respect for judges and, ultimately, judicial authority.[249] Opinions littered with heuristics that become "little more than boilerplate" and can result in a diminished sense of obligation on the part of the people to whom they are directed.[250]

Indeed, by definition, the heuristics are only proxies for whether fraud may have occurred and which facilitate the elimination of cases[251] but lack the form of "reason" we have to come to expect from our judicial system.[252] Accordingly, they have the power to diminish the public's belief in the process as neutral.[253] Eventually, the heuristics may even cause the courts to "lose their right to speak with the authority of the law."[254] The result is the corrosion of the very process that gives our system, and derivatively, the securities laws, their legitimacy.[255]

Court opinions promote and prescribe public values. The opinions described in this Article, however, provide little substantive information about the area they are meant to help regulate. Instead, the heuristics

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[245] John Reid, *Doe Did Not Sit —The Creation of Opinions by an Artist*, 63 COLUM. L. REV. 59 (1963).

[246] *See* Wilkinson, *supra* note 4, at 1172 (citing Joseph Vining, *Justice, Bureaucracy, and Legal Method*, 80 MICH. L. REV. 248, 253-58 (1981)).

[247] Young, *supra* note 39, at 273.

[248] Wilkinson, *supra* note 4, at 1172; Shapiro & Levy, *supra* note 37, at 1055 (discussing importance of respect for judges and profession).

[249] Wilkinson, *supra* note 4, at 1171-72.

[250] *Id.* at 1172.

[251] *See* Macey, *supra* note 193 (stating that where judges' self-interest conflicts with efficient outcome, self-interest will prevail in types of procedural rules they create and implement); Lauren K. Robel, *Caseload and Judging: Judicial Adaptations to Caseload*, 1990 B.Y.U. L. REV. 3, 14 (1990) (arguing procedural changes can diminish judicial accountability).

[252] McCree, *supra* note 194, at 780 (noting that society expects judges to justify decisions with reason).

[253] Yeazell, *Judging Rules*, *supra* note 42 (stating that parties' belief in judges as neutral is key to justice).

[254] Owen M. Fiss, *Objectivity and Interpretation*, 34 STAN. L. REV. 739, 747 (1982).

[255] *See* Owen M. Fiss, *The Bureaucratization of the Judiciary*, 92 YALE L.J. 1442, 1443 (1983) (such changes can "corrode" process that is source of legitimacy).

result in opinions that read like collections of shortcuts, with minimal substantive analysis of the actual securities laws and regulations involved. As a result, they have the appearance of, or at least the potential to create the appearance of, a judiciary that is indifferent to the truth. And, that, perhaps, is the ultimate failing of the heuristics and the opinions containing them.

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