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A Prolonged Slump for 'Plaintiff-Pitchers': The Narrow 'Strike Zone' for Securities Plaintiffs in the Fourth Circuit

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A PROLONGED SLUMP FOR "PLAINTIFF-PITCHERS": THE NARROW "STRIKE ZONE" FOR SECURITIES PLAINTIFFS IN THE FOURTH CIRCUIT

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This Article focuses on the narrow "strike zone" that plaintiffs must overcome in private securities actions instituted in the Fourth Circuit. Based on empirical data generated over a fourteen-year span, there emerges a clear finding that during that time period defendants were victorious in almost all cases, either on the merits of the case or due to procedural obstacles. The authors posit that this pattern of difficulty for plaintiffs arises, at least in part, from the Fourth Circuit's restrictive interpretation of various requisite elements of these causes of action, such as materiality and scienter, as well as the Fourth Circuit's approach to the pleading standards mandated by the Private Securities Litigation Reform Act and the Federal Rules of Civil Procedure. The authors examine in detail some of the leading securities cases that establish Fourth Circuit precedent in these areas, as well as notable cases from the survey period, to illustrate the confines of the narrow "strike zone" available to plaintiffs to establish a meritorious claim.

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I. TRYING TO GET THE BALL OVER THE PLATE

The Official Rules of Major League Baseball[1] define the strike zone—the target area that designates a "good" pitch—as follows:

> The Strike Zone is that area over home plate the upper limit of which is a horizontal line at the midpoint between the top of the shoulders and the top of the uniform pants, and the lower level is a line at the hollow beneath the knee cap. The Strike Zone shall be determined from the batter's stance as the batter is prepared to swing at a pitched ball.[2]

1. The current rules of Major League Baseball were codified and adopted in 1949 and have been amended many times throughout the years. *See* PLAYING RULES COMM., MAJOR LEAGUE BASEBALL, OFFICIAL BASEBALL RULES, at i (2008), *available at* http://mlb.mlb.com/mlb/downloads/y2008/official_rules/001_introduction.pdf. The basic structure of the rules, however, has changed remarkably little since they were first transcribed in the mid-1800s by Alexander Joy Cartwright of the New York Knickerbockers, one of the first athletic clubs to popularize the game of baseball. *See generally* ROGER I. ABRAMS, LEGAL BASES: BASEBALL AND THE LAW 10–12 (1998) (describing the origins of baseball and its rules).

2. PLAYING RULES COMM., *supra* note 1, at 23–24. For a detailed examination of how the area of the strike zone has changed over time, see The Strike Zone: A Chronological Examination of the Official Rules by Baseball Almanac, http://www.baseball-almanac.com/articles/strike_zone_rules_history.shtml (last visited

As this description shows, the strike zone has no objectively measurable area—unlike, for example, the rigidly defined height and width of the goal space in ice hockey or soccer.[3] Instead, the strike zone varies, not only from batter to batter, but even from pitch to pitch depending on factors such as the player's height and the stance assumed before each throw. Perhaps because of this inherent variability, baseball provides a rich source of metaphors for many areas of life. The law is no exception, particularly with regard to the obstacles potential plaintiffs face when bringing suit; the unique facts of each case, the basic fluidity of the law, and the subtle glosses applied by separate jurisdictions (as well as individual judges) combine to ensure that even similar cases may not always be decided in exactly the same fashion. These factors necessarily affect the "strike zone" that a plaintiff will confront in any given instance.

In this regard, plaintiffs in private securities actions[4] face a challenging set of circumstances. This was true even before passage of

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Aug. 26, 2010). "Home plate" or "home base," where the batter stands to receive a pitch, is denoted by a five-sided slab of whitened rubber fixed in the ground level with the ground surface. PLAYING RULES COMM., *supra* note 1, at 2–4. Home plate is formed by a "17-inch square with two of the corners removed so that one edge is 17 inches long, two adjacent sides are 8 1/2 inches and the remaining two sides are 12 inches and set at an angle to make a point," and it is the starting point to determine the placement of most other important features of the playing field, such as the "diamond" shape formed by the bases. *Id.* Second base is placed 127 feet, 3 3/8 inches from home plate, and first and third bases are then placed at the intersection of lines measured 90 feet from home plate and second base so that the distance from first to third will also equal 127 feet, 3 3/8 inches. *Id.*

3. The dimensions of the hockey and soccer goals are 6 feet (1.8 meters) wide by 4 feet (1.2 meters) high, and 8 yards wide (7.32 meters) by 8 feet (2.44 meters) high, respectively. FEDERATION INTERNATIONALE DE FOOTBALL ASSOCIATION, LAWS OF THE GAME 2009–2010, at 9 (2009), *available at* http://www.fifa.com/mm/document/affederation/federation/81/42/36/lawsofthegameen.pdf; NATIONAL HOCKEY LEAGUE, OFFICIAL RULES 2007–2008, at 3 (2007), *available at* http://www.nhl.com/ext/0708rules.pdf. Soccer is, of course, the term used in the United States to refer to the sport that most countries know as simply "football." This name originated in newspapers such as the *New York Times* as early as 1906 to distinguish the game "association football" from the "gridiron" form of the game that would eventually become American football. *See* DAVID WANGERIN, SOCCER IN A FOOTBALL WORLD 23–24 (2008); *infra* note 131.

4. Section 10(b) of the Securities and Exchange Act of 1934 is the primary anti-fraud provision of the federal securities regulation scheme. 15 U.S.C. § 78j(b) (2006). Pursuant to its rule-making authority, the Securities and Exchange Commission ("SEC") promulgated Rule 10b-5, which works in conjunction with the statute to provide civil and criminal liability for certain deceptive or manipulative conduct in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5 (2009). Although neither section 10(b) nor Rule 10b-5 expressly provide for a private right of action by aggrieved purchasers or sellers, the Supreme Court has recognized an implied right of action for violation of these provisions. *See* Herman & Maclean v. Huddleston, 459 U.S. 375, 380 (1983) (stating that "[t]he existence of this implied [section 10(b)] remedy is simply beyond peradventure"). To establish a claim under this private right of action, a plaintiff must prove: (1) requisite

the Private Securities Litigation Reform Act ("PSLRA") in 1995,[5] which significantly narrowed the defined strike zone available to plaintiffs.[6] For example, one statistical study has shown that the two federal circuits that historically represent the bulk of private securities actions, the Second and Ninth,[7] dismissed well over half of the class action complaints filed in their circuits between 1996 and 2003.[8] Moreover, obtaining class action certification often poses an even more troublesome obstacle to potential plaintiffs.[9]

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jurisdictional means; (2) as a purchaser or seller of the subject securities; (3) an actionable disclosure deficiency, such as a material misrepresentation or omission by the defendant; (4) scienter (signifying intentional or knowing misconduct); (5) a requisite connection between the misrepresentation or omission and the purchase or sale of a security; (6) justifiable reliance upon the misrepresentation or omission; (7) economic loss; and (8) loss causation. *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008); MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 243–45 (5th ed. 2009).

5. *See generally* Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489, 491–501, 505–17 (1995) (outlining the approaches courts took to decide private securities actions). In fact, some assert that the very notion of a private right of action in securities fraud cases is the target of sustained judicial attack. In the recent *Stoneridge* case, Justice Stevens, joined by Justices Souter and Ginsburg in dissent, criticized "the Courts continuing campaign to render the private cause of action under § 10(b) toothless." *Stoneridge*, 522 U.S. at 175 (Stevens, J., dissenting). For further discussion of judicial interpretations narrowing the scope of the private right of action since its original recognition, see generally Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301, 1310–16 (2008).

6. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. §§ 77z-1 to -2, 78j-1, 78u-4 to -5 (2006)). Adopted in 1995, the PSLRA puts plaintiffs to a heightened pleading standard for scienter, provides special protections for forward-looking statements made by publicly-held companies, and imposes additional requirements with respect to securities class actions, among other requirements that generally disfavor plaintiffs. *Id.* The express purpose of the legislation was to act as "a check against abusive litigation by private parties." *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007).

7. A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 140 (2005). In 2007, complaints in these two circuits constituted over sixty percent of federal securities class action filings nationwide. PRICEWATERHOUSECOOPERS LLP, 2007 SECURITIES LITIGATION STUDY 21 (2008), http://10b5.pwc.com/PDF/2007%20SECURITY %20LIT%20STUDY%20W-LT.PDF. By contrast, the Fourth Circuit saw two percent of such filings. *Id.*

8. Pritchard & Sale, *supra* note 7, at 142.

9. *See, e.g.*, Gariety v. Grant Thornton, L.L.P., 368 F.3d 356, 365 (4th Cir. 2004) (stating that class certification issues require "rigorous analysis" (quoting Gen. Tel. Co. of the S.W. v. Falcon, 457 U.S. 147, 161 (1982)). Note, however, that the private right of action can extend to actions against control persons, directors and officers, and other professionals such as lawyers and accountants. *See generally* 4 BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD §§ 7:333–7:383 (2d ed. 2008) (describing scope of liability under securities fraud statutes).

With this background in focus, it appears that, particularly for securities plaintiffs in decisions handed down by the Fourth Circuit, the strike zone is very narrow indeed. Based on the authors' examination of private federal securities actions decided by the Fourth Circuit since 1995, defendants customarily and routinely have emerged victorious. This Article provides an empirical examination of these cases over that period, and it posits an explanation for this consequence stemming from the development of Fourth Circuit case law, beginning in 1995. Significantly, the Fourth Circuit experienced a marked increase in class action securities filings during this period, especially in the late nineties,[10] perhaps in part due to the growth of the high technology industry in Virginia and Maryland.[11] Thus, even as the volume of cases expanded over time, plaintiffs continued to enjoy only isolated successes—perhaps in large part due to the narrow strike zone recognized by that appellate court. A closer look at the data and the underlying cases supports this view.

II. RUNNING "THE NUMBERS":[12] SURVEY OF CASES SINCE 1995

The authors examined both published and unpublished appellate level decisions on federal securities cases handed down by the United States Court of Appeals for the Fourth Circuit[13] for the period

10. *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 943–44 (2003). For example, in 1997, just over one percent of nationwide securities class action suits were filed in the Fourth Circuit, but that figure rose to over five percent in 2000. *Id.*

11. *See id.* (noting that more research is required to confirm the correlation). Virginia and Maryland actively sought to develop their high technology markets during this time in various ways, including the adoption of legislation favorable to high technology firms. *See* Deborah Tussey, *UCITA, Copyright, and Capture*, 21 CARDOZO ARTS & ENT. L.J. 319, 360 (2003). For example, Fairfax County, Virginia, now claims over 6,200 technology firms, including industry leaders such as Northrop Grumman's Information Technology arm. Fairfax County Economic Development Authority, Industry Sectors in Fairfax County, http://www.fairfaxcountyeda.org/industry_sectors.htm (last visited Aug. 26, 2010); Northrop Grumman Information Systems, About Information Systems, http://www.is.northropgrumman.com/about/index.html (last visited Aug. 26, 2010).

12. Statistical measures (or a player's "numbers") are important in baseball. This is certainly so for pitchers, whose performance from game to game may be more difficult to predict than that of other positions—often because so many factors outside the player's control affect the results of each outing, such as the ability of batters to "crush" weak pitches and how well the fielders and basemen perform their tasks during the game. *See* Keith Woolner & Dayn Perry, *Why Are Pitchers So Unpredictable?*, *in* BASEBALL BETWEEN THE NUMBERS 48, 48–57 (Jonah Keri ed., 2006).

13. The Fourth Circuit includes Maryland, North Carolina, South Carolina, Virginia, and West Virginia. For general information about the court, see http://www.ca4.uscourts .gov/.

January 1, 1995 to January 31, 2009—a fourteen-year span.[14] The scope of examination focused exclusively on private actions by plaintiffs under the federal securities laws,[15] and it excluded criminal prosecutions instituted by the U.S. Department of Justice, civil enforcement actions brought by the Securities and Exchange Commission ("SEC"), as well as claims based on state securities laws (or "blue sky acts") and state common law.[16] This search produced a final array of thirty-seven cases.[17]

The array of cases reveals a pattern of particular difficulty for plaintiffs over the period. Of the thirty-seven cases surveyed, with near unanimity, defendants were victorious, either on the merits or due to procedural obstacles to plaintiffs.[18] In fact, nearly half of these cases were dismissed on Rule 12(b)(6) motions at the pleading stage.[19] None of the cases showed any clear win for the plaintiffs, and only two cases resulted in a mixed outcome or reduced recovery—including one instance where, although the plaintiffs successfully demonstrated liability, the amount of damages was held to be zero.[20] This pattern illustrates that plaintiffs in Fourth Circuit federal securities cases have thrown an unusually low number of "strikes" in

14. Methodology: A broad field search of Fourth Circuit decisions was conducted through Westlaw with the search command "securities exchange" or "federal /s securities & DA (AFT 1/1/1995)." After excluding ERISA actions, bankruptcy cases, and criminal and civil enforcement actions by the SEC, the final array of thirty-seven cases emerged. These results represent the authors' good-faith effort to locate all Fourth Circuit federal securities fraud cases within the scope of the survey period, but the authors cannot guarantee that one hundred percent of such cases have been located.

15. These cases primarily involved actions brought under sections 10(b), 14(a), and 20(a) of the Securities Exchange Act, as well as applicable Exchange Act rules thereunder.

16. Often, plaintiffs plead various state and common law claims, such as fraud, breach of contract, and negligence, in addition to federal securities claims. In such cases, only the dispositions of the federal securities claims have been considered.

17. *See infra* Table I.

18. *See id.*

19. *See id.* For example, the Fourth Circuit affirmed the dismissal of complaints in forty-six percent (seventeen of thirty-seven) of the cases surveyed. *See id.* Indeed, as Table I shows, defendants were victorious in nearly all cases, on grounds such as grants of motions to dismiss, summary judgment, and various procedural issues (such as running of the statute of limitations). *See id.* The Fourth Circuit itself has acknowledged that the bar for a securities fraud claim is particularly high. *See, e.g.*, Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 220 (4th Cir. 1994) ("At first blush, [these] principles may seem, as a matter of policy, to require too much of a plaintiff in a securities case.").

20. *See infra* Table I. In *Miller v. Asensio & Co.*, 364 F.3d 223 (4th Cir. 2004), the court of appeals affirmed a jury verdict for plaintiffs that awarded zero damages, declining to order a remand on the issue of damages. *Id.* at 234–35; *see infra* notes 301–03 and accompanying text.

the last fourteen years.[21] Accordingly, this Article provides a detailed analysis of some of the leading cases from this period, evidencing that

21. Interestingly, however, in a case decided shortly after the end of the survey period, the plaintiffs did manage to get one across the plate. In *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009), *cert. granted sub nom.* Janus Capital Group, Inc. v. First Derivative Traders, 78 U.S.L.W. 3271 (U.S. June 28, 2010), the court of appeals reversed the district court's dismissal of the complaint under Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to state a claim. *Id.* at 114–15. The class-action plaintiffs, certain shareholders of Janus Capital Group, Inc. ("JCG" or "Janus"), alleged that the defendants, JCG and its wholly-owned subsidiary, Janus Capital Management, LLC ("JCM"), violated section 10(b) by making misleading statements in prospectuses for a number of Janus mutual funds during the class period. *Id.* The plaintiffs also brought suit against JCG under the control-person provisions of section 20(a). *Id.* at 115.

The prospectuses at issue contained statements that the funds had adopted policies and measures to prevent a practice known as "market timing." *Id.* at 116. Market timing involves rapid trades made into and out of a mutual fund that exploit inefficiencies in the fund's valuation process to produce quick profits at the expense of long-term investors. *Id.* (citing *In re* Mut. Funds Inv. Litig., 529 F.3d 207, 211 (4th Cir. 2008)). The plaintiffs alleged that these statements were misleading because of the defendants' admissions in a separate suit brought by the New York Attorney General in 2003 that they had in fact, through secret agreements, expressly allowed certain hedge funds to engage in market timing in the funds. *Id.* at 117–18. The Attorney General's revelation of these secret trading pacts touched off massive withdrawals and redemptions from the funds that swept away $14 billion of assets under management by JCM in a few short months. *Id.* at 118.

The district court dismissed the plaintiffs' section 10(b) claims against both entities by ruling that, among other pleading defects, the complaint contained "no allegations that JCG actually made or prepared the prospectuses" or that any of the statements were directly attributable to JCG, and that the complaint failed to establish a nexus between JCM, as investment adviser for JCG, and the plaintiffs, as shareholders of JCG. *Id.* (citing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)). The district court also dismissed the section 20(a) control-person claim against JCG, based upon its finding that JCM had no primary liability under section 10(b). *Id.* Reversing, the court of appeals held that the plaintiffs had successfully plead all of the required elements to establish a claim under section 10(b) against JCM only, and that the plaintiffs had thus also established a control-person claim against JCG. *Id.* at 131.

In so doing, the court of appeals confronted the question of whether the "fraud-on-the-market" theory of reliance established by *Basic, Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988), requires direct attribution of the statement to the defendant. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 122 (citing *Cent. Bank of Denver*, 511 U.S. at 164). After surveying the approaches adopted by the Second, Ninth, Tenth, and Eleventh Circuits, the court of appeals adopted the standard that, in the limited context of the fraud-on-the-market theory, a plaintiff must prove "that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant" to demonstrate the element of reliance. *Id.* at 124. Under this test, the court of appeals found that, because the market recognizes the dominance that investment advisers typically exert over mutual funds, "interested investors would infer that JCM played a role in preparing or approving the content" of the prospectuses, and thus the statements regarding market timing were attributable to JCM. *Id.* at 127. By contrast, however, the court of appeals found that the statements were not attributable to JCG under this test, since the investing public would not so readily infer that the parent company that sponsors a family of funds would take an active role in drafting or approving statements issued by the individual the difficulty could lie in the exacting standards for securities actions that the Fourth Circuit has developed over time—standards that arguably go far beyond the strictures of the PSLRA. Indeed, in several cases, the Fourth Circuit's approach has been more restrictive toward plaintiffs than that of other circuits. Even in several notable cases that arose prior to the beginning of the survey period of this Article (1995), both in the context of private suits as well as government civil and criminal enforcement actions, the Fourth Circuit has historically carved a narrow "strike zone."

III. SIZING UP THE NARROW "STRIKE ZONE": BACKGROUND ON THE FOURTH CIRCUIT'S INTERPRETATION AND APPLICATION OF THE FEDERAL SECURITIES LAWS

A. *Private Actions*

Two leading cases decided prior to 1995, *Raab v. General Physics Corp.*[22] and *Hillson Partners Ltd. Partnership v. Adage, Inc.*,[23] illustrate the Fourth Circuit's stringent application of the materiality element in private suits, and they provide the foundation for the court's analysis in subsequent cases.[24] In both cases, the plaintiffs filed class action lawsuits against the companies and several of their officers under section 10(b) of the Securities Exchange Act ("the Exchange Act") for alleged misrepresentations contained in the respective companies' financial reports and press releases.[25] In each instance, the court of appeals affirmed dismissal of the complaint, reasoning that the statements at issue were not material as a matter of law.[26]

funds. *Id.* at 128. The court of appeals noted that this finding was consistent with the Supreme Court's ruling in *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), that deceptive acts that are not disclosed to the public are too remote to satisfy the element of reliance, since *Stoneridge* has no application to situations where statements were indisputably disseminated to the public. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 127 (citing *Stoneridge*, 552 U.S. at 161); *see also infra* note 315 (discussing *Stoneridge*). As noted above, the Supreme Court granted certiorari in this case on June 28, 2010. *Janus Capital Group*, 78 U.S.L.W. at 3271.

22. 4 F.3d 286 (4th Cir. 1993).

23. 42 F.3d 204 (4th Cir. 1994).

24. *See, e.g.*, Marsh Group v. Prime Retail, Inc., 46 F. App'x. 140, 146 (4th Cir. 2002) (noting that because of *Raab* and *Hillson*, the court was "constrained to find that the alleged misstatements in this case are immaterial and hence not actionable").

25. *Hillson*, 42 F.3d at 206–08; *Raab*, 4 F.3d at 288.

26. *Hillson*, 42 F.3d at 213–20; *Raab*, 4 F.3d at 290.

The alleged misrepresentations in *Raab* included a prediction that the company would enjoy an annual growth rate of ten to thirty percent for the next several years and a representation that a slowdown in awarding government contracts that had dampened the company's financial results was only "administrative" and "temporary," such that the results for the remainder of the fiscal year would be "in line" with analyst expectations.[27] Addressing the growth prediction, the court held that the statement was an example of a "soft" or "puffing" statement that, unless worded as a guarantee of performance, was too indefinite to be material or to constitute a fraud on the market—even though the company provided a discrete range of percentages.[28] In its treatment of materiality, the court expressly differentiated predictions of future events from expressions of opinion or belief about current conditions, which it noted stood "on a different footing."[29] Congress would later codify this very distinction in the PSLRA.[30]

With this distinction in mind, the court thereupon addressed the company's statement that, because of the "administrative" nature of the slowdown in the award of government contracts, "conditions in the 1st quarter are temporary and that results during the remainder of . . . 1992 should be in line with analysts' current projections."[31] Although the statement was clearly an expression of opinion or belief about current facts, the court focused on the term "temporary" to determine that the statement was sufficiently indefinite to render it not material.[32] In the words of the opinion, " '[t]emporary' is an indeterminate term: it could mean weeks, it could mean months, it could mean years."[33]

Depending on the surrounding circumstances, the term "temporary" may be indefinite standing alone. Nonetheless, the Fourth Circuit's definition of "temporary" is inconsistent with the term's commonly understood meaning.[34] Moreover, the Fourth

27. *Raab*, 4 F.3d at 287–88.

28. *Id.* at 289. Other courts have found statements that contained similar predictions of growth or return on investment in these ranges to be material. *See* Cohen v. Prudential-Bache Sec., Inc., 713 F. Supp. 653, 658 (S.D.N.Y. 1989) (holding a prediction of a "return of 20% to 30%" to be material) (citing Newman v. L.F. Rothschild, 662 F. Supp. 957, 959 (S.D.N.Y. 1987)).

29. *Raab*, 4 F.3d at 290.

30. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313–14 (2007).

31. *Raab*, 4 F.3d at 288.

32. *Id.* at 290.

33. *Id.*

34. The Fourth Circuit's reading is more expansive than the usual usage of the term, which denotes a transitory or short duration. *See* BLACK'S LAW DICTIONARY 1504 (8th

Circuit's analysis slights the context of the statement, which by its terms limits the scope of the term "temporary" to the first quarter of 1992. Indeed, the court overlooked the date of the announcement—March 30, 1992—only one day before the end of the first quarter.[35] Taken in context, this representation conveys the subject company's view that, in fact, the "temporary" slowdown in the award of government contracts had already passed. By ignoring the clear import of this language, the court's analysis bypassed an important inquiry, namely, the impact that this expression of opinion on current conditions had on a reasonable investor's decision-making processes.

In *Hillson Partners*, the Fourth Circuit expanded on the materiality rationale laid out in *Raab*. The central facts in *Hillson Partners* were similar, but with one exception: plaintiff-shareholders challenged a series of statements made by the company and its CEO at various points during the 1992 fiscal year concerning the company's anticipated financial results for that specific period.[36] For example, the company made predictions about full-year revenues and net income following the first, second, and third quarters, and it issued statements concerning full-year and fourth-quarter results in November and December 1992.[37] Relying on *Raab*, the court held that the statements made after the first, second, and third quarters were immaterial to the extent that they were predictions of future results, regardless of the fact that the scope of future events encompassed by the statements necessarily telescoped as the year progressed.[38] Flatly rejecting the proposition that an abbreviated time frame could alter the nature of materiality, the court opined that "[t]here is nothing in *Raab* ... that suggests a prediction of future growth ceases to be a prediction of future growth simply because it is

ed. 2004) (defining "temporary" as "[l]asting for a time only; existing or continuing for a limited (usu. short) time; transitory"). Similarly, "temporary" is synonymous with other terms such as "transient" that indicate a short-term condition. *See id.* at 1537 (defining "transient" as "[t]emporary; impermanent; passing away after a short time"). The common understanding of terms can be significant to determine the scope of federal securities regulation. *See, e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561, 574–76 (1995) (rejecting a "capacious" reading of the term "prospectus" as contemplated by the Securities Act) (citing BLACK'S LAW DICTIONARY 959 (2d ed. 1910)); Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1080 (9th Cir. 1999) (resorting to WEBSTERS THIRD NEW INTERNATIONAL DICTIONARY (3d ed. 1986) to help define the ordinary meaning of the word "any").

35. *See Raab*, 4 F.3d at 290–91.

36. Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 207–08 (4th Cir. 1994).

37. *Id.* at 207.

38. *See id.* at 213–14. As an example, the company issued statements predicting 1991 full-year financial results as early as May and as late as December of that year. *Id.*

made six weeks rather than six months in advance."[39] To support this proposition, the court embraced the use of the term "temporary" that was held not to be actionable in *Raab*, irrespective that this language referred to results of the quarter *then in progress*.[40]

Arguably taking this concept to an extreme, the Fourth Circuit held that the company's challenged statements made in November and mid-December (less than two weeks before the end of the quarter and fiscal year) were also in the nature of future predictions, instead of expressions of opinion or belief as to current events.[41] In addition, the court concluded that these two statements could not be material both under the "bespeaks caution" doctrine[42] and under a *Basic*-style[43] risk/magnitude analysis.[44]

A close reading of the language of the November and December statements aids in deciphering the court's approach toward application of these doctrines in this case. The November statement, released in the company's third quarter report, read: "With Fort Orange back operating at improved rates, Niagara Cold Drawn and RedGo Properties performing exceptionally well, Relm showing

39. *Id.* at 214.

40. *See id.* at 213; *Raab*, 4 F.3d at 288. In *Raab*, the company issued a press release on March 30 (only one day before the end of the quarter) stating its belief that "conditions in the 1st quarter are temporary." *Id.*

41. *Hillson Partners*, 42 F.3d at 214.

42. The "bespeaks caution" doctrine provides that when "an offering statement, such as a prospectus, accompanies statements of future forecasts, projections, and expectations with adequate cautionary language, those statements are not actionable as securities fraud." *In re* Donald J. Trump Casinos Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993). *See generally* MARC I. STEINBERG, SECURITIES REGULATION 441–51 (5th ed. 2008) (outlining parameters of the bespeaks caution doctrine); Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994) (examining limits of and rationale underlying the bespeaks caution doctrine through various applications by the courts); Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619 (1997) (comparing judicial and legislative approaches to the bespeaks caution doctrine).

43. In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1998), the Supreme Court defined materiality in terms of what a reasonable investor would consider important in making a particular voting or investment decision. *Id.* at 232. This analysis includes a balancing of the probability that the event will occur and the magnitude of its effect. *Id.* at 238–39; *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc) (opining that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity"), *cert. denied*, 394 U.S. 976 (1969). Importantly, misstated or omitted information does not have to be such that it would change the investor's decision; but, instead, there must be a substantial likelihood that a reasonable investor would view it "as having significantly altered the 'total mix' of information made available." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

44. *Hillson Partners*, 42 F.3d at 211–19.

significant improvements over 1990 and 1991 and reduced costs at Allister, we should have an excellent fourth quarter and see significant improvements during 1993."[45] The December statement appeared in the *Wall Street Journal*: "Adage, Inc. expects to have a better fourth quarter and year in sales and overall net income than a year ago, said Robert H. Cahill, president."[46]

The language of the two questioned statements reveals the truly expansive protection that the *Hillson Partners* court extended to ostensibly forward-looking corporate communications. First, although the November statement was forward-looking in the sense that it predicted fourth quarter results, it was issued at the mid-point of the quarter when at least half of the period's activity was already a present fact, while the December statement came a scant two weeks from the end of the quarter.[47] Further, the November prediction clearly relies on the effect of *past as well as current events* rather than assumptions about events in the remaining six weeks of the quarter. Under this broad application of the "bespeaks caution" doctrine, it appears that any forward-looking aspect contained in a communication can inoculate the entire statement from being deemed material.

This expansive approach stands in contrast to the positions adopted toward forward-looking statements in other circuits, even in the wake of the heightened requirements implemented by the PSLRA.[48] For example, the Eleventh Circuit found that a press release that predicted quarterly earnings issued on the last day of a quarter was a forward-looking statement—but only because two of five items that the company cited in a "laundry list" of contributing factors were assumptions rather than observed facts.[49] The court noted that statements based upon *observed facts*, such as the current rate of customer orders or input prices, were not forward-looking and only the presence of the two assumptions brought the statement within the safe harbor.[50] Similarly, the Third Circuit held that when projections are so related to representations about current facts that

45. *Id.* at 216.

46. *Id.* (quoting *Adage Expects Quarter and Year to Improve upon 1991 Results*, WALL ST. J., Dec. 15, 1992, at A7).

47. *Id.* at 215. The court noted in passing the timing of the announcements, but it considered timing alone to be inadequate to meet the pleading requirements of Federal Rule of Civil Procedure 9(b). *Id.*

48. *See, e.g.*, EP Medsystems, Inc. v. EchoCath, Inc., 235 F.3d 865, 873–75 (3d Cir. 2000); Harris v. Ivax Corp., 182 F.3d 799, 805–06 (11th Cir. 1999).

49. *Ivax*, 182 F.3d at 806.

50. *Id.*

the validity of the projections necessarily turns on those representations, they could not be found immaterial as a matter of law under the "bespeaks caution" doctrine.[51] In comparison to these cases, *Raab*, *Hillson Partners*, and their progeny illustrate the narrow "strike zone" employed by the Fourth Circuit in private securities laws actions.

B. Government Enforcement Actions

Although government civil and criminal enforcement actions are outside the scope of our empirical study of federal securities cases,[52]

51. *EchoCath*, 235 F.3d at 879; *see also* COMM. OF CONFERENCE, JOINT EXPLANATORY STATEMENT ON PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, H.R. REP. NO. 104-369, at 43–45 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 742–44 (crafting a broad safe harbor from private liability for forward-looking statements including codification of the "bespeaks caution" doctrine).

52. In the same vein, our empirical study focused exclusively on private federal securities law claims and excluded state securities law ("blue-sky" actions), as well as other state law claims, such as breaches of fiduciary duty, adjudicated in the federal courts. *See supra* notes 13–16 and accompanying text. Such state law claims may also give some indication of the Fourth Circuit's approach to interpreting the federal securities laws. Not surprisingly, the plaintiffs similarly appear to face significant obstacles to their claims based on state law. For example, in one recent case, the Fourth Circuit applied Delaware law to affirm the dismissal of a plaintiff's breach of fiduciary duty claims in relation to an allegedly unfair merger price because the plaintiff had opted to tender his shares for the offered price, which the court of appeals deemed to be acquiescence to the transaction. *See* Schwartz v. Blum, 309 F. App'x. 718, 718–20 (4th Cir. 2009). In that case, the Fourth Circuit declined to limit expansive language in a Delaware Supreme Court case which has been more narrowly construed by Delaware Court of Chancery decisions. *Id.* at 721 (stating that a shareholder who "'tendered his shares and accepted the merger consideration' has 'acquiesced in the transaction and cannot [subsequently] attack it'" (citing Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 848 (Del. 1987)) and declining to apply an interpretation of a lower court which held that "'a stockholder who casts a vote in favor of, or later accepts the consideration from, a merger effected by a controlling stockholder is not barred by the doctrine of acquiescence, or any other related equitable doctrine such as waiver, from challenging the fairness of the merger'" (quoting *In re* JCC Holding Co., 843 A.2d 713, 722–23 (Del. Ch. 2003))). *In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057, 1079 (Del. Ch. 2001) (interpreting the Delaware Supreme Court's decision in *Bershad* to preclude a shareholder from challenging the merger consideration only when such shareholder tenders her shares and affirmatively votes for ratification of the merger). Similarly, in two earlier cases arising under Virginia law, the Fourth Circuit affirmed the dismissal of a common law fraud claim in a stock price drop case on the basis that the plaintiff had failed to plead causation according to the standard articulated by the U.S. Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), and it granted summary judgment on a claim under the Virginia Securities Act for control-person liability on the part of two outside directors, finding that their conduct fell within an applicable statutory safe harbor. *See* Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 476–80 (4th Cir. 2006); Dellastatious v. Williams, 242 F.3d 191, 194–97 (4th Cir. 2001). For more discussion of the *Dura* pleading requirement for causation, see *infra* notes 304, 320 and accompanying text. In *Dellastatious*, because the Fourth Circuit held that the subject defendants met the safe harbor afforded by the Virginia Securities Act for control person

two notable enforcement cases also illustrate the Fourth Circuit's approach to securities fraud claims, and both ultimately played a role in defining the contours of liability for securities fraud. In the first of these, *United States v. Bryan*,[53] the Fourth Circuit rejected the misappropriation theory of insider trading liability,[54] thereby reversing criminal convictions under section 10(b) and Rule 10b-5.[55] Elton "Butch" Bryan, then the director of the West Virginia Lottery ("Lottery"), was convicted of securities fraud under these provisions for purchasing securities in companies transacting business with the Lottery on the basis of confidential, nonpublic information entrusted to him in his official capacity.[56] As director of the Lottery, Bryan was intimately involved in the negotiation and award of state contracts on behalf of the Lottery, including those required for a planned expansion of video lottery gaming in the state.[57] During 1991 and 1992, Bryan used nonpublic, confidential information to purchase shares in three companies that were bidding for contracts with the Lottery.[58] One such transaction was for the purchase of three hundred shares in the company, Video Lottery Consultants, occurring just after the Lottery's decision to award the firm an exclusive contract to supply video terminals.[59]

The Fourth Circuit reversed the conviction, reasoning that the language of section 10(b) as well as Supreme Court decisions interpreting the scope of that statute did not support the

liability, which is more restrictive than the good faith defense available under section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (2006), the court of appeals also granted summary judgment on the plaintiff's claims under federal securities law. *Dellastatious*, 242 F.3d at 194–97; *see infra* note 313 and Table I.

53. 58 F.3d 933 (4th Cir. 1995).

54. The misappropriation theory is distinguished from the "traditional" or "classical" theory of insider trading that prohibits insiders, such as executives or directors, from trading in securities of their own corporation on the basis of material, nonpublic information as a deceptive device within the scope of section 10(b) and Rule 10b-5. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980). By comparison, the misappropriation theory also extends section 10(b)/Rule 10b-5 liability to an actor who misappropriates confidential information for securities trading purposes in breach of a fiduciary duty or a relationship of trust and confidence owed to the source of the information. *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997); WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 5.4 (2d ed. 2005 & Supp. 2008).

55. *Bryan*, 58 F.3d at 944.

56. *Id.* at 937–39.

57. *Id.*

58. *Id.*

59. *Id.* at 939.

misappropriation theory of liability.[60] According to the Fourth Circuit, adoption of the misappropriation theory would impermissibly expand the scope of the statute to include "simple breaches of fiduciary duty" and violations of similar relationships.[61] Further, the court of appeals held that the language of section 10(b) requires a close nexus between deceptive conduct and the purchase or sale of a security and that the wronged party itself must be either a purchaser or seller of a security or "otherwise connected with or interested in the purchase or sale of securities."[62]

To reach this narrow conclusion, the court of appeals largely relied on the Supreme Court's statement in *Santa Fe Industries, Inc. v. Green*[63] that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception,"[64] and on the *Santa Fe* Court's definition of deception as "the [knowing] making of a material misrepresentation or the [knowing] nondisclosure of material information in violation of a duty to disclose."[65] The Fourth Circuit thereupon drew from the Supreme Court's rulings in *Chiarella v. United States*,[66] *Dirks v. SEC*,[67] and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[68] as support for the proposition that the anti-fraud provisions of section 10(b) and Rule 10b-5 only apply to breaches of duties toward purchasers or sellers of securities, or "at most," to investors or others "closely linked" to a securities transaction.[69] Because the misappropriation theory imposes liability based on deception of the

60. *Id.* at 946–49 (citing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); and Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

61. *Id.* at 945. Although it expressly rejected the misappropriation theory, the court conceded that Bryan's conduct "clearly constituted criminal activity" under that standard. *Id.*

62. *Id.* at 944.

63. 430 U.S. 462 (1977).

64. *Id.* at 473.

65. *Bryan*, 58 F.3d at 946 (citing *Santa Fe*, 430 U.S. at 470). *See generally* Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe*: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980) (discussing the *Santa Fe* decision).

66. 445 U.S. 222, 228–312 (1980) (holding that, absent a duty to disclose based on fiduciary duty or relationship of trust and confidence, trading on material nonpublic information is not actionable under section 10(b)).

67. 463 U.S. 646, 662 (1983) (holding that section 10(b) liability of tippers-tippees depends on "whether the insider [tipper] personally will benefit, directly or indirectly, from his disclosure [and that] [a]bsent some personal gain, there has been no breach of duty to stockholders [a]nd . . . no derivative breach [by the tippee]").

68. 511 U.S. 164, 190–91 (1994) (holding that aiding and abetting is not actionable in private section 10(b) actions).

69. *Bryan*, 58 F.3d at 946–48.

source of the information (a third party) that is unconnected to the subject securities transaction, the court of appeals held that the doctrine essentially rendered section 10(b)'s "in connection with"[70] requirement meaningless.[71] In rejecting this theory, the Fourth Circuit expressed its concern that the doctrine would inject further ambiguity into what the court termed the "already uncertain law governing fraudulent securities transactions."[72]

Subsequently, the Supreme Court disagreed and expressly upheld the validity of the misappropriation theory in *United States v. O'Hagan*.[73] In its decision, the Court addressed the concerns raised by the Fourth Circuit in *Bryan*. As a starting point, *O'Hagan* confirmed that the misappropriation theory comports with the requirement of deceptive conduct proscribed by section 10(b), observing that misappropriation necessarily "involves feigning fidelity to the source of [the] information."[74] Under this analysis, the "in connection with" requirement is met because the fraud is not ultimately complete until

70. 15 U.S.C. § 78j(b) (2006). The requisite connection between a disclosure deficiency and the purchase or sale of a security is an essential element of an action under this provision. *See supra* note 4.

71. *See Bryan*, 58 F.3d at 949–50 (stating that the misappropriation theory "effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived, allowing conviction not only where the 'defrauded' person has no connection with a securities transaction, but where no investor or market participant has been deceived").

72. *Id.* at 950–51.

73. 521 U.S. 642, 653–55 (1997). The defendant in this case, James O'Hagan, was an attorney and partner in the law firm of Dorsey & Whitney at a time when the firm was hired to represent a British purchaser as local counsel in a prospective tender offer for the Pillsbury Company. *Id* at 647. Although the project required that both the purchaser and Dorsey & Whitney take precautions to keep the contemplated tender offer secret, O'Hagan began purchasing call options on Pillsbury stock, eventually becoming the largest individual holder of the company's unexpired options. *Id.* When the tender offer was ultimately announced, O'Hagan netted a profit of more than $4.3 million. *Id.* at 648. For more on the impact of *O'Hagan* on securities regulation, see generally BROMBERG & LOWENFELS, *supra* note 9, at § 6:500. Although the *O'Hagan* case arose in the Eighth Circuit, the Supreme Court noted that the court of appeals in the case at bar relied upon the ruling in *Bryan* to reject the misappropriation theory. *O'Hagan*, 521 U.S. at 649–50.

74. *O'Hagan*, 521 U.S. at 655 (citing Santa Fe Indus. v. Green, 430 U.S. 462, 477–78 (1977)). Thus, if a fiduciary informs the source of the intent to trade on the information, section 10(b) liability normally does not attach; however, the fiduciary may still be liable for a state law breach of the duty of loyalty or a comparable obligation. *Id.*; *see also* Sandberg v. Virginia Bankshares, Inc., 979 F.2d 332, 342–48 (4th Cir. 1992) (holding corporate directors liable for breaches of fiduciary duties under state law although plaintiffs failed to prove causation under federal securities claims); Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1050–51 (11th Cir. 1987) (holding broker liable for breach of fiduciary duty even though section 10(b) liability could not be established because reliance was not established). For the advantages and disadvantages of state securities law and common law claims, see generally STEINBERG, *supra* note 4, at 303–11.

the actor uses the confidential information to purchase or sell securities—thus bringing the fraud within the ambit of section 10(b).[75]

Going further, the Supreme Court addressed in detail the arguments raised by the Fourth Circuit in reliance on *Chiarella*, *Dirks*, and *Central Bank of Denver*. First, the Court noted that *Chiarella* expressly left open the question of the validity of the misappropriation theory,[76] as did the *Dirks* decision, where the source of the information had no expectation that it would be kept in confidence.[77] Lastly, *Central Bank* likewise did not foreclose the misappropriation theory, since the language of that case focused on the scope of liability in section 10(b) private actions for secondary actors.[78] Although rejecting the imposition of aiding and abetting liability under section 10(b), the *Central Bank* Court also made clear that secondary actors may be held primarily liable under that statute.[79] At no point in its decision did the *Central Bank* Court opine that section 10(b) encompasses only that deceptive conduct on which market participants rely. Hence, the misappropriation of confidential, material information in breach of a duty owed to the source of the information was held by the *O'Hagan* Court to come within the ambit of section 10(b).[80] This explicit Supreme Court adoption of the misappropriation theory to resolve the split of authority among the federal circuits thus overruled *Bryan*.[81]

The second of these two cases, *SEC v. Zandford*,[82] turned on section 10(b)'s "in connection with" the purchase or sale of a security requirement.[83] This case involved an action brought by the SEC against Charles Zandford, a securities broker, following his conviction

75. *O'Hagan*, 521 U.S. at 655–56.

76. *Id.* at 650 n.4, 661. The *Chiarella* Court did not address this issue because it had not been presented to the jury in that case. *See* Chiarella v. United States, 445 U.S. 222, 235–36 (1980).

77. *O'Hagan*, 521 U.S. at 663; *see* Dirks v. SEC, 463 U.S. 646, 665–67 (1983).

78. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 172–92 (1994).

79. *O'Hagan*, 521 U.S. at 664. To establish liability for secondary actors, however, plaintiffs must satisfy all of the elements of a federal securities fraud violation just as for a primary actor, since liability under these provisions does not extend to aiding and abetting. *Cent. Bank of Denver*, 511 U.S. at 191; *see also* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) (stating that "[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for liability").

80. *O'Hagan*, 521 U.S. at 665–66; *see* WANG & STEINBERG, *supra* note 54, § 5.4 (discussing *O'Hagan* and lower court cases applying the misappropriation theory).

81. *O'Hagan*, 521 U.S. at 650; *see supra* notes 53–72 and accompanying text (discussing *Bryan*).

82. 238 F.3d 559 (4th Cir. 2001), *rev'd*, 535 U.S. 813 (2002).

83. *Zandford*, 238 F.3d at 563.

on thirteen counts of wire fraud for misappropriating $343,000 of funds from two of his clients for his own use.[84] The clients, William Wood and his daughter, Diane Wood Okstulski,[85] opened a joint investment account with Zandford in which they placed over $400,000.[86] Ultimately, the clients were left with nothing.[87]

With the directive to invest the funds conservatively, the clients granted Zandford discretion to manage the account and power of attorney to buy and sell securities without their prior approval.[88] Unbeknownst to his clients, Zandford systematically generated money in the account by selling shares of mutual funds, and he then withdrew the proceeds for his own use by wire transfer and by checks drawn on the account payable to Zandford himself.[89] In an SEC enforcement action based on this misconduct, the district court granted summary judgment to the Commission on counts alleging violations of section 17(a) of the Securities Act,[90] section 10(b) of the Exchange Act, and Rule 10b-5.[91]

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84. *Id.* at 561. Zandford was ultimately sentenced to fifty-two months in prison and ordered to pay restitution after his conviction was affirmed in *United States v. Zandford*, 110 F.3d 62 (4th Cir. 1997). *Id.*

85. At this time, Wood was elderly and in poor health, and Okstulski suffered from both mental disability and a multiple personality disorder. *Zandford*, 238 F.3d at 561. The SEC complaint showed that the investment goals for the account were "safety of principal and income." *Zandford*, 535 U.S. at 815.

86. *Zandford*, 238 F.3d at 561.

87. *Zandford*, 535 U.S. at 815. Wood died shortly thereafter in 1991. *Id.*

88. *Id.*

89. *Id.* at 815–16. A routine examination by the National Association of Securities Dealers ("NASD") initially uncovered Zandford's misappropriation of the funds. *Id.* at 815. The NASD was originally a self-regulatory body responsible for, among other things, overseeing the operation of broker-dealers, and the administration of licensing accreditations such as the Series 7 examination. In 2007, the NASD merged with the enforcement agency of the New York Stock Exchange, NYSE Regulation, Inc., to form the Financial Industry Regulatory Authority, also known as FINRA. *See generally* William B. Little, *Fairness is in the Eyes of the Beholder*, 60 BAYLOR L. REV. 73, 131–35 (2008) (discussing the logistical challenges behind the merger). General information about FINRA may also be found at its website. Financial Industry Regulatory Authority, http://www.finra.org/index.htm (last visited Aug. 24, 2010).

90. 15 U.S.C. § 77q (2006). This provision forbids, in the offer or sale of any security: (1) "any device, scheme, or artifice to defraud"; (2) any material misrepresentation or half-truth used to obtain money or property; and (3) "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." *Id.* Unlike under section 10(b), the courts overwhelmingly have held that there is no private right of action under section 17(a). *See, e.g.*, Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990); Newcome v. Esrey, 862 F.2d 1099, 1102–07 (4th Cir. 1988); Landry v. All Am. Assurance Co., 688 F.2d 381, 389–91 (5th Cir. 1982). Accordingly, the provision is exclusively a tool for SEC civil enforcement actions and federal criminal prosecutions. *See, e.g.*, United States v. Naftalin, 441 U.S. 768, 771–76 (1979). Further, under sections 17(a)(2) and (a)(3), scienter is not a required element and, thus, a showing of negligence is

The Fourth Circuit reversed, ruling that Zandford's conduct was "not sufficiently connected to a securities transaction to merit liability" under these provisions.[92] Drawing on Second Circuit precedent, the Fourth Circuit held that a fraud must be "integral to the plaintiff's purchase or sale of the security,"[93] while in this case, Zandford's sales of the Woods' securities were only "incidental" to his fraudulent scheme.[94] According to the court, the heart of the fraud instead consisted of absconding with the funds, and the sales of shares were simply conducted in "a routine and customary fashion."[95] In this analysis, the only connection to the purchase or sale of a security was that the funds happened to be "converted from a securities investment account,"[96] and the scheme itself more accurately resembled a state law tort of conversion.[97]

Narrowly interpreting the Supreme Court's decision in *O'Hagan* to apply only in cases where the misappropriated confidential information had "independent value,"[98] the Fourth Circuit determined that *O'Hagan* did not apply in this context.[99] Here, the court of appeals relied on the discussion in *O'Hagan* that one aspect of liability under the misappropriation theory lay in the particularized nature of information about the subject security—particularized

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sufficient to establish a violation in SEC enforcement actions. *See* Aaron v. SEC, 446 U.S. 680, 696–97 (1980). For further discussion, see generally Marc I. Steinberg, *Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GEO. L.J. 163 (1979).

91. *Zandford*, 238 F.3d at 561–62.

92. *Id.* at 566.

93. *Id.* at 564 (quoting Flickinger v. Harold C. Brown & Co., 947 F.2d 595, 598 (2d Cir. 1991)) (internal quotation marks omitted).

94. *Id.* (citing Hunt v. Robinson, 852 F.2d 786, 787 (4th Cir. 1988)) (holding that fraud was only incidentally related to the purchase or sale of securities where the defendant fraudulently refused to convey shares due under an employment contract).

95. *Id.*

96. *Id.* at 566 (quoting Smith v. Chicago Corp., 566 F. Supp. 66, 70 (N.D. Ill. 1983)). In *Smith v. Chicago Corp.*, an account executive similarly withdrew funds from two customers' securities accounts for his own use, after assuring the customers that he would follow their instructions to purchase certain securities. Smith v. Chicago Corp., 566 F. Supp. 66, 68 (N.D. Ill. 1983). Significantly, however, the account executive did not liquidate any shares to generate the stolen funds, and he only withdrew cash that the customers had placed in the accounts for the purpose of purchasing securities. *Id.* Thus, this fraud never implicated the actual purchase or sale of a security. *Id.* at 70.

97. *Zandford*, 238 F.3d at 566 (reasoning that the proceeds "might as well have come from the unlawful sale of a car which the Woods had entrusted to Zandford's care").

98. *Id.* at 565.

99. *Id.* On appeal, the Supreme Court disagreed with this narrow interpretation. *SEC v. Zandford*, 535 U.S. 813, 818 (2002). The Court nonetheless stated that, even as construed by the Fourth Circuit, "the Woods' securities did not have value for [Zandford] apart from their use in a securities transaction." *Id.* at 824–25; *see infra* text accompanying note 108.

information that, unlike money, had no real value outside of the context of a purchase or sale of such security.[100] In particular, the court of appeals cited the hypothetical noted by the *O'Hagan* Court that the misappropriation theory would *not* apply where a defendant defrauded a bank or embezzled money from a third party and thereafter used the proceeds to purchase securities.[101] Because the Fourth Circuit viewed Zandford's scheme as simply the reverse of this hypothetical, it reasoned that the securities anti-fraud provisions did not apply. Echoing the tenor of its earlier decision in *Bryan*, the court of appeals declined "to stretch the language of [these] provisions to encompass every conversion or theft that happens to involve securities."[102]

Once again, the Supreme Court, in a unanimous decision, disagreed with and reversed the holding that neither section 10(b) nor *O'Hagan* was to be read in such a limited fashion.[103] Instead, observing that the fundamental objectives of the federal securities laws are to effectuate full disclosure and to ensure a higher level of ethics in the securities industry, the Court held that the anti-fraud language of section 10(b) should be "construed not technically and restrictively, but flexibly to effectuate its remedial purposes."[104] Consistent with these objectives, the SEC's "broad" reading of section 10(b)'s "in connection with" clause to encompass the conduct of a broker who accepts payment for securities with no intent to deliver them, or who liquidates customer securities intending to misappropriate the proceeds, was reasonable and entitled to judicial deference.[105] Under this approach, the very mechanics of the plot

100. *Zandford*, 238 F.3d at 565.

101. *Id.*; *see* United States v. O'Hagan, 521 U.S. 642, 656–57 (1997) (noting that because of the fungible nature of cash, which "can buy, if not anything, then at least many things," the purchase of securities with misappropriated funds is "sufficiently detached" from the misappropriation itself to place the transaction beyond the reach of section 10(b) liability).

102. *Zandford*, 238 F.3d at 566.

103. Zandford, 535 U.S. at 813, 819, 824.

104. *Id.* at 819 (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972)) (internal quotation marks omitted).

105. *Id.* (citing United States v. Mead Corp., 533 U.S. 218, 229–30 (2001)). *Mead*, like *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), governs the level of deference that courts accord to statutory interpretations made by administrative agencies such as the SEC. The *Chevron* standard, under which a court will not review an administrative interpretation that is reasonable, is appropriate where Congress has explicitly or implicitly delegated interpretive authority to the agency. *Chevron*, 467 U.S. at 843–44; *see* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Services., 545 U.S. 967, 982–83 (2005) (stating that where an ambiguous statute is delegated to an administrative agency for enforcement, such agency's construction is entitled to judicial deference under

illustrate the direct correlation to a securities transaction: a series of undisclosed, unauthorized sales of securities intended only to further the fraud.[106] In fact, the fraud, and thus the violation of section 10(b), is complete once the security is sold; the subsequent misappropriation of the proceeds is simply persuasive evidence of intent and not an independent element of the offense.[107]

This focus on the connection between intent and sale, rather than on the proceeds of the sale, adhered to *O'Hagan*. The *Zandford* Court explicitly stated that, in spite of the bank fraud/embezzlement hypothetical relied upon by the court of appeals, *O'Hagan* did not introduce a new requirement that the subject of a fraud have "independent value" to the perpetrator outside of a securities transaction, but even if it did, such an element would be satisfied here because the subject of the fraud—the securities, *not the proceeds*—had no value to either the Woods or Zandford apart from their use in a securities transaction.[108]

Bryan and *Zandford* thus display a more narrow view of the securities fraud provisions than the Supreme Court was willing to embrace, yet both cases were obviously influential in developing the scope of these statutes. Consistently, in the context of private actions, the Fourth Circuit likewise has narrowed the "strike zone" for plaintiffs in important respects, as a review of several cases from the survey period will show.

Chevron, even when the courts previously have interpreted the subject statute differently from such agency). Where such express authority is lacking, however, deference may still be appropriate for certain statutory interpretations. Under the lesser *Mead* standard, the courts must afford lesser deference to an agency interpretation based on "the 'specialized experience and broader investigations and information' available to the agency, and given the value of uniformity in its administrative and judicial understandings of what a national law requires." *Mead*, 533 U.S. at 235 (quoting Skidmore v. Swift & Co., 323 U.S. 134, 139 (1944)); *see* Bragdon v. Abbott, 524 U.S. 624, 642 (1998) (stating that well-reasoned views of subject agency implementing a statute provide proper guidance for courts). *See generally* Patrick M. Garry, *Accommodating the Administrative State: The Interrelationship Between the* Chevron *and Nondelegation Doctrines*, 38 ARIZ. ST. L.J. 921 (2006) (arguing that the *Chevron* doctrine is necessary to give effect to vague and generalized statutory provisions).

106. *Zandford*, 535 U.S. at 824.

107. *Id.*

108. *Id.* at 824–25.

IV. A VIEW OF THE NARROW "STRIKE ZONE" FROM THE MOUND:[109] SELECTED CASES FROM THE SURVEY PERIOD

Drawing on the foundation of the cases discussed above, particularly *Raab* and *Hillson Partners*,[110] several cases from the survey period provide a flavor for the Fourth Circuit's continuing approach to aspects of the elements of securities fraud claims such as materiality, scienter, and causation. Notably, significant developments occurred during this time frame, including congressional enactment of the PSLRA and Supreme Court decisions in prominent cases such as *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta. Inc.*[111] and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[112] The following discussion focuses on Fourth Circuit interpretations that, while anticipating these developments, further confined the parameters of the already narrow "strike zone."

A. *Materiality*

Section 10(b) and Rule 10b-5 only provide liability for *material* misstatements, half-truths, or omissions.[113] Thus, to establish a claim, a securities fraud plaintiff must not only demonstrate a disclosure deficiency, but he must also show that such lack of accurate disclosure is objectively material. As interpreted by the Supreme Court, the term "material" signifies that a reasonable investor would consider the information important when making an investment (or voting) decision, or stated somewhat differently, that a substantial likelihood exists that accurate disclosure of the subject information would alter the total mix of information available at the time.[114] Because this determination must take into account many different factors as well as their relative significance, it is normally a question of fact for a jury.[115] Nonetheless, when materiality or lack thereof is "so obvious that reasonable minds [could] not differ," the issue may be decided as

109. The pitching mound, where the pitcher's plate or "pitching rubber" is located, is a circle eighteen feet in diameter, with its center placed fifty-nine feet from the back of home plate. PLAYING RULES COMM., *supra* note 1, at 1-3 . The mound area rises in a gradual slope from the edges of the circle to a height that places the pitcher's plate ten inches above the level of home plate. *Id.*; *see supra* note 2.

110. *See supra* notes 22–51 and accompanying text.

111. 552 U.S. 148 (2008).

112. 551 U.S. 308 (2007).

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

114. Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1998); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see supra* note 43.

115. *See TSC Indus.*, 426 U.S. at 450.

a matter of law.[116] This standard accordingly provides courts with a measure of discretion toward the assessment of materiality, and it is perhaps one reason for the varying "strike zone" among the circuit courts for securities claims based on how stringently the standard is applied.

1. *Greenhouse v. MCG Capital Corp.*

Greenhouse v. MCG Capital Corp.[117] provides some insight into the Fourth Circuit's treatment of materiality.[118] In this case, shareholders instituted a section 10(b) claim (as well as a claim under section 11 of the Securities Act[119]) after the company's CEO, Bryan Mitchell, revealed that he had lied about receiving an undergraduate degree in economics from Syracuse University, and he had allowed the company to include this misrepresentation in filings with the SEC.[120] The district court dismissed the complaint on the finding that Mitchell's educational background was immaterial as a matter of law, and the Fourth Circuit affirmed, apparently approving of the district court's conclusion that a plaintiff "cannot use the credibility and integrity problems that result from a false statement to bootstrap an otherwise immaterial false statement into creating a basis for a securities fraud action."[121]

The Fourth Circuit's analysis of materiality focused on the bare fact of Mitchell's educational background, standing alone, to conclude that his failure to obtain a degree did not alter the "total mix" of information available to investors.[122] This holding was based on the relative strength of other information about the company's leadership provided in public statements and filings, such as Mitchell's years of

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116. Provenz v. Miller, 102 F.3d 1478, 1489 (9th Cir. 1996) (quoting *TSC Indus.*, 426 U.S. at 450) (alteration in original).

117. 392 F.3d 650 (4th Cir. 2004).

118. *Id.* at 658.

119. 15 U.S.C. § 77k (2006). Section 11 provides a private right of action for damages on behalf of purchasers who acquired their securities pursuant to a Securities Act registration statement that contains a materially false or misleading statement. *Id.* Parties subject to liability under section 11 include the issuer, directors, signatories of the registration statement, underwriters, and certain experts, such as accountants and engineers. *Id.* A due diligence defense may be invoked by the subject parties, except by the issuer. *Id.*; *see, e.g.*, *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 621 (9th Cir. 1994); *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 656–59 (S.D.N.Y. 2004); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 652, 682–703 (S.D.N.Y. 1968). For further discussion, see STEINBERG, *supra* note 4, at 205–26.

120. *Greenhouse*, 392 F.3d at 653–54. In fact, Mitchell did attend Syracuse University, where he studied economics, but left before obtaining a degree. *Id.*

121. *Id.* at 655.

122. *Id.* at 658–59.

successful experience and the similar track records of other members of the board of directors and management.[123] This "large body of information" outweighed the value of "what Mitchell did (or, as the case may be, did not do) during what would have been his fourth year at Syracuse."[124] Importantly, this finding excluded any careful assessment of the misrepresentation on the overall credibility of the company or its management. Since any knowingly false statement implicates the integrity of management to some extent, the court reasoned that consideration of these factors would "simply [read] materiality out of the statute" and could render all misrepresentations by senior management actionable, no matter how trivial.[125]

Few published cases involving misrepresentation of executive academic credentials existed at the time of the *Greenhouse* decision,[126] but similar high-profile incidents in the years following demonstrate that corporate stakeholders and investors often view such matters as anything but trivial, and for very good reason. In 2006, the CEO of RadioShack, David J. Edmondson, was ultimately forced to resign after he revealed that he had lied about receiving two college degrees.[127] Significantly, RadioShack stock dropped twelve percent in the week that investors received this news.[128] Only a year

123. *Id.* at 658.

124. *Id.* The court also pointed to quantitative (as compared to qualitative) factors, including "the years of MCG's earnings statements as a private company; the firm's debt/equity ratio; the general costs of capital and macroeconomic trends; the strength of MCG's potential competitors; etc." *Id.*

125. *Id.* at 660. The court listed misrepresentations by a CEO about his/her marital fidelity and golf handicap as possible examples. *Id.*

126. *Id.* at 657. *See* SEC v. Physicians Guardian Unit Inv. Trust, 72 F. Supp. 2d 1342, 1344–51 (M.D. Fla. 1999) (holding that a complaint alleging, among other violations, misrepresentation that principal held a law degree from Boston University School of Law adequately plead elements of federal securities fraud to survive a Rule 12(b)(6) motion to dismiss); New Equity Sec. Holders Comm. for Golden Gulf, Ltd. v. Phillips, 97 B.R. 492, 496–97 (E.D. Ark. 1989) (finding misrepresentation in offering memorandum that principal had a college degree in business administration from the University of Arkansas was not material); SEC v. Suter, No. 81 C 3865, 1983 WL 1287, at *3, 19–21 (N.D. Ill. 1983) (granting injunction after a hearing where the court determined as a finding of fact that defendants, among other violations, misrepresented that their investment adviser held a Masters in Business Administration from DePaul University).

127. Floyd Norris, *RadioShack Chief Resigns After Lying*, N.Y. TIMES, Feb. 21, 2006, at C1.

128. *Id.* In its 2004 annual filing with the SEC, in which it announced Edmondson's imminent appointment as CEO, RadioShack made no disclosure of Edmondson's educational background. *See* RadioShack Corp., Annual Report (Form 10-K), at 10 (Mar. 16, 2005). In a press release following the announcement of Edmondson's resignation, RadioShack stated that the board of directors was aware of "some, but definitely not all" of the issues surrounding its former CEO's resume. RadioShack Corp., Current Report (Form 8-K), at Exhibit 99.1 (Feb. 21, 2006).

later, Patrick Imbardelli, the chief executive of InterContinental Hotels Group's Asia Pacific region, was ousted when an investigation ahead of his appointment to the board of directors uncovered that none of the three degrees he claimed to hold were in fact valid.[129] A spokesman for the company noted that even Imbardelli's proven record of professional accomplishments could not overcome the impact of this deceit: "With something like this, the fundamental basis of trust is undermined."[130] Certainly such concerns extend outside the traditional corporate world, even to the "gridiron."[131] Notably, George O'Leary was forced to resign his position as head coach of the Notre Dame football team less than one week after being hired, after it came to light that his claims that he held a master's degree and that he had lettered in three years of college football at the University of New Hampshire were false.[132] Notre Dame athletic director Kevin White said of the decision: "I understand that these inaccuracies represent a very human failing; nonetheless, they constitute a breach of trust that makes it impossible for us to go forward with our relationship."[133]

The Fourth Circuit's decision in *Greenhouse* thus minimizes the significance of qualitative materiality, a concept that has enjoyed long-standing judicial acceptance.[134] As the SEC stated nearly a half-

129. Dominic Walsh, *Hotels Boss Quits Over Fake Qualifications*, TIMES (London), June 15, 2007, at 59.

130. *Id.*

131. The term "gridiron" to describe American football apparently arose from the resemblance of the pattern of hash marks on the playing field to "gridiron" grills used to cook meat or fish over open flames, and the term was first used in print in 1897 in a story in the *Boston Herald*. MORRIS DICTIONARY OF WORD AND PHRASE ORIGINS 261 (William & Mary Morris eds., Harper & Row 1971) (1962). For a discussion of the emergence of "gridiron" football from the sports that would eventually become soccer and rugby, see WANGERIN, *supra* note 3, at 19–23.

132. Andrew Bagnato, *Hasty Hire White's Undoing*, CHI. TRIB., Dec. 15, 2001, at N1. For a detailed history of O'Leary's career and the events leading up to his resignation from Notre Dame, see Gary Smith, *Lying In Wait: As George O'Leary Climbed the Coaching Ladder to His Dream Job at Notre Dame, a Dirty Secret Was Lurking in His Resume. But Did He Pay Too High a Price for a Few Lies?*, SPORTS ILLUSTRATED, Apr. 8, 2002, at 70–89.

133. Bagnato, *supra* note 132. Significantly, whether O'Leary had lettered in football or obtained a master's degree had not been an issue in Notre Dame's decision to hire him as head coach, but his falsifying of academic credentials was considered "a death knell." Smith, *supra* note 132, at 87.

134. *See, e.g.*, Maldonado v. Flynn, 597 F.2d 789, 797–98 (2d Cir. 1979); Bertoglio v. Texas Int'l Co., 488 F. Supp. 630, 644–55 (D. Del. 1980); SEC v. Joseph Schlitz Brewing Co., 452 F. Supp. 824, 830 (E.D. Wis. 1978); *cf.* Ganino v. Citizens Utils. Co., 228 F.3d 154, 162–65 (2d Cir. 2000) (applying qualitative economic materiality and rejecting the exclusive use of numerical benchmarks to assess materiality); *infra* note 175.

century ago, "[e]valuation of the quality of management—to whatever extent it is possible—is an essential ingredient of informed investment decision[s]."[135] Expanding on this concept, the Commission by rule requires *affirmative* disclosure of certain qualitative information in SEC filings made by publicly-held companies, including management's business experience.[136] Here, although the specific information disclosed is not called for by SEC rule,[137] publicly-held companies frequently provide the educational background of the CEO and other high-level corporate officers.[138] This prevalent practice points to the information's relevance to the investing public. To hold that a CEO's outright lie regarding his educational credentials is not material as a matter of law contravenes accepted norms of corporate governance.[139]

In addition to such obvious concerns over credibility, there is an increasing realization that cases like these indicate a fundamental weakness in corporate controls and screening processes that could create exposure to regulatory actions and other legal claims such as

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135. *In re* Franchard Corp., 42 S.E.C. 163, 170 (1964); *see* Ralph C. Ferrara, Richard M. Starr, & Marc I. Steinberg, *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555, 555 (1981) (discussing qualitatively material information that "reflects on the quality of corporate management").

136. Directors, Executive Officers, Promoters and Control Persons, 17 C.F.R. § 229.401(e)(1) (2009) ("Briefly describe the business experience during the past five years of each director, executive officer, person nominated or chosen to become a director or executive officer, and each person named in answer to paragraph (c) of Item 401, including: each person's principal occupations and employment during the past five years; the name and principal business of any corporation or other organization in which such occupations and employment were carried on; and whether such corporation or organization is a parent, subsidiary or other affiliate of the registrant."); *see* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 1.09 (2009).

137. Item 401(e) contains a five-year look-back period. 17 C.F.R. § 229.401(e)(1). Since Mitchell's biographical information was contained in a prospectus issued in 2001, the required look-back period began in 1997, although MCG included disclosure of Mitchell's professional history back to 1988. *See* Greenhouse v. MCG Capital Corp., 392 F.3d 650, 653–54 (4th Cir. 2004).

138. *See, e.g.*, Google, Inc., Annual Report (Form 10-K), at 97 (Feb. 13, 2009); Acura Pharm., Inc., Annual Report (Form 10-K), at 45 (Mar. 2, 2009); Dell, Inc., Annual Report (Form 10-K), at 9–11 (Mar. 31, 2008).

139. *See* COMM. ON CORP. LAWS, AM. BAR ASS'N., CORPORATE DIRECTOR'S GUIDEBOOK 30 (5th ed. 2007) (stating that in the disclosure process a subject corporation should have procedures that "are reasonably designed to produce accurate and complete public disclosures" and that "[m]any public companies have established internal disclosure committees composed of managers who have specific responsibility for the company's SEC filings and other public financial disclosures"). *See generally* Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?*, 39 LOY. U. CHI. L.J. 595, 608–10 (2008) (discussing a principles-based compliance regime for disclosure that promotes substance over form, rather than "simply checking off items on an articulated checklist").

negligent hiring and retention.[140] Taken together, these issues certainly cast doubt on the relative ease with which the Fourth Circuit discounted the materiality of the deliberate falsehood made in *Greenhouse*.

2. *Longman v. Food Lion, Inc.*

Longman v. Food Lion, Inc.[141] illustrates the Fourth Circuit's approach to materiality of alleged misrepresentations as well as omitted facts in securities actions.[142] Here, the court of appeals held that the subject corporation's alleged failure to disclose violations of federal labor laws and a pattern of unsanitary food handling practices were not material. The court reasoned that the labor violations were already publicly known and that the level of unsanitary food practices was not of sufficient magnitude to affect the price of Food Lion's stock.[143]

In *Food Lion*, shareholders brought a class action suit shortly after a televised investigative report about Food Lion that precipitated a sharp decline in the company's stock.[144] The report detailed supposedly widespread labor and sanitation abuses in Food Lion stores.[145] The plaintiffs claimed that the company's failure to disclose these practices inflated stock prices during the class period.[146]

During the class period, Food Lion became the target of a boycott by the United Food and Commercial Workers Union ("UFCW") that stemmed from the company's resistance to efforts to unionize its workers.[147] The UFCW eventually filed a formal complaint with the Department of Labor that alleged a widespread pattern of labor abuses because of Food Lion's tacit encouragement of off-the-clock work hours.[148] This filing sparked a series of dueling press releases from the UFCW and Food Lion, with accusations on one side that over one-third of the grocery chain's profits derived

140. Susan Gardner et al., *Does Your Background Checker Put You in Jeopardy? A Case for Best Practices and Due Diligence*, 11 J. LEGAL, ETHICAL & REG. ISSUES 111, 114–16 (2008).
141. 197 F.3d 675 (4th Cir.1999).
142. *Id.* at 675–88.
143. *Id.* at 684–86.
144. *Id.* at 677.
145. *Id.*
146. *Id.* at 684–86. The class period covered a roughly three-year period from the date that Food Lion filed its 1989 annual report until the date of the television report. *Id.*
147. *Id.* at 678.
148. *Id.* at 678–79.

from illegal labor[149] and heated denials by the company on the other.[150] Food Lion announced that it would conduct a full investigation of the allegations contained in the federal labor complaint, but it simultaneously asserted that these claims constituted no more than a pattern of harassment by the union.[151] The company's annual reports during this time did not acknowledge any prevalent labor or sanitation problems in Food Lion stores,[152] and its 1991 report issued in June 1992 stated that it "believ[ed] that Food Lion's Extra Low Prices and its clean and conveniently located stores are especially well suited to the demands of our customers."[153] A form 10-Q filed with the SEC in July 1992 confirmed that an investigation of the labor charges was ongoing, but that in the opinion of the company, it had "meritorious defenses to the allegations[, that Food Lion] intend[ed] to defend the allegations vigorously and any liability [would] not have a material adverse effect"[154] on its financial results or operations.[155]

Then, on November 5, 1992, American Broadcasting Company ("ABC") televised an edition of PrimeTime Live with an exposé on violations of labor laws and food sanitation standards at Food Lion stores that featured interviews with current and former Food Lion employees as well as hidden-camera footage that focused on three of Food Lion's stores.[156] Several employees gave harrowing accounts of

149. *Id.* The UFCW press release claimed that Food Lion might owe almost $200 million in back wages because of unpaid hours, and it further asserted that the grocery chain's liability for these violations could be "as high as $388 million." *Id.* at 679.

150. *Id.*

151. *Id.*

152. *Id.* at 679–80.

153. *Id.* at 679. A similar statement appeared in Food Lion's 1989 annual report: "[W]e will continue to pay close attention to service levels and cleanliness in our stores and believe we will achieve high marks from customers in these areas." *Id.* at 678.

154. *Id.* at 680. Several months after the close of the class period, Food Lion eventually entered into a settlement agreement with the Department of Labor concerning these allegations and other charges that the company routinely violated child labor laws by allowing or encouraging minors to operate meat-cutting and paper-box bailing devices. *Id.* Under the terms of the settlement, Food Lion admitted no wrongdoing, but it agreed to pay amounts representing back wages and penalties of $16.2 million. *Id.* These charges amounted to a cost to shareholders of approximately two cents per share, which experts from both the plaintiffs and defendants in the case agreed was not material to earnings. *Id.* at 685.

155. *Id.* at 680.

156. *Id.* These investigative techniques, which included ABC journalists obtaining employment at Food Lion stores to obtain access and opportunities to film secretly, led to a lawsuit by Food Lion against ABC, alleging trespass and fraud that involved serious questions about journalistic ethics and the extent of First Amendment protections. Food Lion, Inc. v. Capital Cities/ABC, Inc., 194 F.3d 505, 510–11 (4th Cir. 1999). For more

various unsanitary food practices that allowed the grocery chain to sell out-of-date or even spoiled food,[157] and many claimed that employees were required to work extra hours off the clock because of Food Lion's scheduling system and overtime policies.[158] In addition to employee interviews, ABC's hidden camera video captured some of this conduct directly on film.[159] Shareholders soon filed suit when Food Lion's stock price dropped sharply on the day after the broadcast.[160]

The Fourth Circuit affirmed a grant of summary judgment for Food Lion.[161] As to the alleged labor violations, the court held that because information about the practices described in the television broadcast was already publicly available,[162] disclosure of such practices on PrimeTime Live was not material to Food Lion's earnings or its stock price.[163] Even though the company publicly denied the allegations, the court placed significant weight on Food Lion's statement that it would conduct an investigation to conclude whether "[t]he market had a full opportunity to evaluate these claims and to reflect their risk in the market price for Food Lion stock."[164] In

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discussion on the outcome of this case and of conflicts between journalistic freedoms and possible tortious conduct by news gatherers, see James A. Albert, *The Liability of the Press for Trespass and Invasion of Privacy in Gathering the News—A Call for the Recognition of a Newsgathering Tort Privilege*, 45 N.Y.L. SCH. L. REV. 331, 333–39 (2002).

157. *Food Lion*, 197 F.3d at 680. These practices included altering expiration dates to extend shelf life, bleaching meat and fish to remove odor, and mixing rotten pork with fresh pork to sell as fresh sausage. *Id.*

158. *Id.* at 678. The report alleged that while Food Lion offered wages and benefits superior to competitors, its time management policy, called Effective Scheduling, forced workers in practice to work extra, uncompensated hours to complete scheduled tasks, or they risked losing their jobs. *Id.*

159. *Id.* at 680.

160. *Id.* at 680–81 (stating that "[t]he day after the broadcast, Food Lion's Class A stock fell from $9.25 per share to $8.25 per share, and its Class B stock fell from $10.00 per share to $8.625 per share").

161. *Id.* at 677.

162. *Id.* at 684. Here the court relied on *Hillson Partners* for the proposition that the securities laws do not require disclosure of information that is "already in the public domain." *Id.* In that case, however, the information at issue—the ongoing financial difficulties of a subsidiary—had been disclosed by the issuer in annual reports and SEC filings, and its veracity was not disputed by any party. *See* Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 212–13 (4th Cir. 1994).

163. *Food Lion*, 197 F.3d at 685.

164. *Id.* Notably, the court here relied on *Raab* for the proposition that the market has internalized all publicly available information. *See* Raab v. Gen. Physics Corp., 4 F.3d 286, 289 (4th Cir. 1993) (discussing that such a presumption is encompassed in the fraud-on-the-market theory of reliance). *See generally* Basic, Inc. v. Levinson, 485 U.S. 224, 241–47 (1988) (approving the use of the fraud-on-the-market theory to create a rebuttable presumption of reliance in section 10(b) class actions for securities traded on an efficient market).

the view of the court, the television program added no new information to inform the market but instead only repeated earlier accusations through the experiences of individual employees.[165] The court pointed to the small effect on earnings per share of the company's eventual settlement of its labor claims with the Department of Justice to support the conclusion that this information was not material, as well as the fact that the price of Food Lion's stock did not drop following announcement of the settlement.[166]

Similarly, the Fourth Circuit opined that the "day-to-day" conditions of Food Lion's stores and the "existence of various sanitation problems that were revealed from time to time" were not material to the price of the company's stock, and it further noted that the statements the company made about the cleanliness of its stores in its annual reports were not sufficient to support reliance.[167] The court ruled that, even considering the contents of the PrimeTime Live broadcast,[168] the plaintiffs had not shown that there were widespread problems with sanitation, or further, that Food Lion was aware of these conditions.[169] The court of appeals agreed with the reasoning of the district court that because the investigative report focused on only three of Food Lion's 1,000 stores and interviewed a total of seventy former and current employees, the conditions that it depicted did not indicate a sufficiently pervasive problem to be material.[170] Finally, the statements made about the cleanliness of Food Lion's stores in the company's annual reports were found to be no more than soft, puffing statements upon which investors were not entitled to rely.[171]

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165. *Food Lion*, 197 F.3d at 685.

166. *Id.*

167. *Id.* at 686; *see Raab*, 4 F.3d at 289 & n.1 (discussing "commonplace commercial puffery").

168. *Food Lion*, 197 F. 3d at 685. The court of appeals, like the district court, noted that most of the PrimeTime Live broadcast was inadmissible hearsay, as none of the persons who spoke were under oath or subject to cross-examination. *Id.* The Federal Rules of Evidence exclude prior statements from witnesses who are unavailable to testify at trial from the general prohibition on hearsay in certain limited circumstances, but presumably none of those exceptions applied in this case. *See* FED. R. EVID. 804(b).

169. *Food Lion*, 197 F.3d at 686.

170. *Id.*

171. *Id.* With respect to the concept of puffery, see *Raab*, 4 F.3d at 289–90; Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1699 (1998) (asserting that "the courts have significantly expanded the scope of a powerful defense to dismiss potentially meritorious securities fraud actions").

As the dissent in *Food Lion* noted, the majority relied heavily on both *Hillson Partners* and *Raab* to analyze materiality,[172] and thus, this case illustrates the effect of these two cases to help define the "strike zone" plaintiffs in securities cases in the Fourth Circuit must face. The dissent was also likely correct, however, that *Hillson Partners* and *Raab* should not have governed here, because the majority overlooked the requirement of *Basic* that the source of market information be credible to affect a materiality analysis.[173] Here, the market only had access to information about Food Lion's labor problems from a source that was admittedly antagonistic to the company, and only in the form of allegations that the company strongly denied. Under this analysis, the PrimeTime Live exposé did in fact inject new, material information into the marketplace by providing independent corroboration of the already-known, but hotly disputed, allegations. The observation of the court that no stock drop occurred after the announcement that Food Lion had settled the allegations with the Department of Labor also supports, rather than undercuts, this conclusion; because the market had already assimilated the effect of the allegations following the television broadcast, no further adjustment necessarily would be expected. As the dissent asserted, an issue of fact regarding the materiality of Food Lion's omissions and representations existed that should have precluded the grant of summary judgment.[174]

Although the dissent considered only the labor violations, this same argument applies with similar force to the materiality of unsanitary conditions in Food Lion stores. Here, again, the majority declined to adequately address how a reasonable investor would view the allegations in the PrimeTime Live exposé and their effect on the total mix of information available. Rather, the court largely engaged in a premature quantitative analysis based on the number of stores and employees featured in the investigative report. A proper analysis of materiality under *Basic*, however, does not rest solely upon

172. *Food Lion*, 197 F.3d at 687 (Murnaghan, J., dissenting); *see supra* notes 22–51 and accompanying text (discussing *Hillson Partners* and *Raab*).

173. *Food Lion*, 197 F.3d at 687 (citing *Raab*, 4 F.3d at 289) (quoting *In re* Apple Sec. Litig., 886 F.2d 1109, 1115 (9th Cir. 1989)). "The investing public justifiably places heavy reliance on the statements and opinions of corporate insiders. In order to avoid [federal securities fraud] liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counter-balance any misleading impression created by the insider's one-sided representations." *In re* Apple Sec. Litig., 886 F.2d at 1116 (citing Basic, Inc. v. Levinson, 485 U.S. 224, 248–49 (1988)).

174. *Food Lion*, 197 F.3d at 687–88.

quantitative factors but also upon the qualitative force of the information from the point of view of a reasonable investor.[175]

Pursuant to a qualitative economic approach, investigative techniques utilized by a reputable source evidencing that tainted food was sold to the consuming public smacks of impropriety. To opine that such allegations as a matter of law are immaterial cannot be reconciled with the public concern for sanitary food practices. Indeed, the recent scandals involving outbreaks of salmonella resulting from unsanitary food practices by manufacturers highlight this concern.[176] Notably, the ability of the food service industry to police itself has been called into serious doubt in congressional hearings on these outbreaks: for example, federal inspectors sent to examine two peanut processing plants that were a source of salmonella contamination found dead mice and roaches, mold in the ceilings and walls, and rain water dripping into food processing areas—even though a previous inspector hired by one of the plants had reported no rodent problems and had given the facility a "superior" rating for its processing functions.[177] Hence, the potential adverse economic impact upon the price of the subject company's stock price due to such unsafe conditions is clear. Accordingly, given the nature of the

175. *See, e.g.*, Ganino v. Citizens Utilities. Co., 228 F.3d 154, 162–65 (2d Cir. 2000) (noting that qualitative factors can render relatively small quantitative changes in revenue material); *see also* SEC Staff Accounting Bulletin ("SAB") No. 99, 64 Fed. Reg. 45,150, 45,152 (Aug. 19, 1999) (codified at 17 C.F.R. pt. 211). SAB 99 sets forth a non-exhaustive list of qualitative factors that affect the materiality of quantitative measures, including the inherent precision or imprecision of the measurement and whether a misstatement masks other changes or trends, or conceals a failure to meet analyst expectations. SEC Staff Accounting Bulletin No. 99, *supra*. SEC SABs do not carry the force of law as do rules promulgated by the Commission pursuant to its rulemaking authority, but courts nonetheless consider SABs to be persuasive authority and afford a level of deference to these administrative provisions. *Ganino*, 228 F.3d at 163–64 (citing Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944)). *See generally* Paul A. Dame, *Stare Decicis,* Chevron, *and* Skidmore*: Do Administrative Agencies Have the Power to Overrule Courts?*, 44 WM. & MARY L. REV. 405 (2003) (discussing the levels of deference afforded to administrative interpretations and the role of administrative expertise in the judicial framework); *supra* note 105 and accompanying text (discussing the *Mead* and *Chevron* standards for deference to administrative interpretations).

176. *See, e.g.*, Gardiner Harris & Andrew Martin, *House Panel Questions Industry on Food Safety*, N.Y. TIMES, Mar. 20, 2009, at A18.

177. *The Salmonella Outbreak: The Role of Industry in Protecting the Nation's Food Supply: Hearing Before the Subcomm. on Oversight and Investigations and the H. Comm. on Energy & Commerce*, 111th Cong. 1–3 (2009) (statement of Rep. Bart Stupak, Chairman, H. Subcomm. on Oversight and Investigations). Representative Stupak highlights the fact that the previous auditor, employed by a private firm selected and paid by the company who owned the plant, gave advance notice of the audit in an email to the plant manager with the words " '[y]ou lucky guy. I am your . . . auditor. So we need to get your plant set up for any audit.' " *Id.* at 2.

allegations and the direct documentary evidence of Food Lion's allegedly unsanitary food practices, it may be concluded that reasonable minds would differ about their importance to investors, thereby precluding a grant of summary judgment.

Taken together, *Greenhouse* and *Food Lion* display a particularly narrow view of materiality that some assert is justified as an exercise of the court's duty to "screen out" meritless claims and promote judicial economy.[178] While one may question the particular analytical steps employed to determine materiality in these two cases, these processes demonstrate the nature of difficulties that securities plaintiffs have faced in bringing claims in the Fourth Circuit over the past several years.

B. Scienter

Along with the requirement of materiality, section 10(b) also demands a showing that the defendant acted with a specified level of scienter, meaning with "a mental state embracing intent to deceive, manipulate, or defraud."[179] As the following cases illustrate, over time this standard has come to embrace not just willful conduct but, in certain contexts, recklessness as well.[180] In addition to the recognition

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178. *See, e.g.*, Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 220 (4th Cir. 1994) (opining that the high bar required to adequately plead and establish the elements of federal securities fraud are appropriate to prevent a proliferation of securities litigation); Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993) (same); *see also* R. Gregory Roussel, Note, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049, 1084 (1998) (discussing immateriality of "corporate puffery" statements and asserting that according judicial protection to such statements is "a useful way to effectively, yet fairly, screen investor strike suits"). Arguably, another example of the Fourth Circuit's "narrow strike zone" is *Phillips v. LCI International, Inc.*, 190 F.3d 609 (4th Cir. 1999). There, the court of appeals held that the CEO's statement that the company was "not for sale" when preliminary negotiations had allegedly already commenced was not material in light of the totality of information available to investors at the time. *Id.* at 615–20; *see infra* note 196. *Phillips* has been viewed as a restrictive application of the Supreme Court's probability/magnitude test of materiality set forth in *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988). *See, e.g.*, STEINBERG, *supra* note 4, at 338 n.19; *see also infra* text accompanying notes 183–204 (discussing *Phillips* in connection with the element of scienter).

179. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 (2007) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)). *See generally* STEINBERG, *supra* note 4, at 251–54 (discussing requisite level of intent and pleading requirements).

180. *See, e.g.*, Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 344 (4th Cir. 2003). As *Ottman* illustrates, however, instances of conduct that depart so extremely from the ordinary level of care so as to constitute recklessness are relatively rare. *See id. But see In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1246–47 (3d Cir. 1989) (holding that a jury could reasonably find that the partnership's equal basis statements constituted "recklessness"). Further, under the PSLRA, forward-looking statements receive extended protection: when accompanied by meaningful, cautionary "safe harbor" language, state of

of recklessness as a basis for scienter, two other significant events helped to define the contours of this element during the survey period—the passage of the PSLRA in 1995 and the Supreme Court's decision in *Tellabs* in 2007. Pursuant to the PSLRA, plaintiffs must meet a heightened pleading standard with respect to scienter, in that the facts plead must give rise "to a strong inference that the defendant acted with the required state of mind."[181] Further, under the *Tellabs* standard, this "strong inference" must be both "cogent and at least as compelling as any opposing inference of nonfraudulent intent."[182] The cases below provide some insight into how the Fourth Circuit has integrated these new standards into its existing body of case law, which in some instances had already incorporated a markedly similar approach toward the element of scienter in securities fraud cases.

1. *Phillips v. LCI International, Inc.*

In *Phillips v. LCI International, Inc.*,[183] a pre-*Tellabs* case, the court of appeals first confronted recklessness as a basis for scienter by considering the test adopted earlier by the Second Circuit.[184] Here, the securities fraud claims focused on alleged misstatements made in the context of the 1998 merger between telecommunications firms

mind becomes wholly irrelevant, and when unaccompanied by such language, the required level of scienter is actual knowledge that the statements are false or misleading. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 102, 109 Stat. 737, 750 (1995) (codified at 15 U.S.C. § 78u-5(c) (2006)); *see, e.g.*, *In re* Compuware Sec. Litig., 301 F. Supp. 2d 672, 683 (E.D. Mich. 2004).

181. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 747 (1995) (codified at 15 U.S.C. § 78u-4(b)(2) (2006)); *cf.* FED. R. CIV. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.").

182. *Tellabs*, 551 U.S. at 314. The *Tellabs* decision resolved a split of authority among the circuit courts as to the standard to apply to weigh competing inferences. *Id.* at 322. For example, the Sixth Circuit and Ninth Circuits had adopted more stringent tests that required the inference of culpable intent to be the most plausible of competing inferences, while the Seventh Circuit had rejected weighing inferences altogether. *See id.* at 317–18; *In re* Silicon Graphics Sec. Litig., 183 F.3d 970, 978–79 (9th Cir. 1999) (opining that legislative history indicated that "Congress intended for the PSLRA to raise the pleading standard even beyond the most stringent existing standard").

183. 190 F.3d 609 (4th Cir. 1999).

184. *Id.* at 620 (citing *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268–69 (2d Cir. 1993)). Under the Second Circuit standard, plaintiffs can establish scienter by pleading facts establishing either: (1) a motive and opportunity to commit fraud; or (2) circumstantial evidence of recklessness or intentional conduct. *Id.*

LCI International ("LCI") and Qwest.[185] The precise statement at issue was the remark by LCI chief executive H. Brian Thompson that LCI was "not a company that's for sale," made at a time when preliminary discussions about a possible merger between LCI and Qwest allegedly had in fact already begun.[186]

Thompson made this statement on February 17, 1998, in the course of an interview about LCI's just-released quarterly earnings.[187] Less than a month later, however, LCI and Qwest publicly announced that they would merge, allegedly as the result of discussions that began in October 1997, when the chief executive officer of Qwest approached Thompson at a trade convention.[188] On the basis of this initial discussion, officers of the two companies began meeting at the end of October, and they had reached an agreement to begin reciprocal due diligence by late November.[189] In December, Qwest made an offer of thirty-six dollars a share for LCI's stock, but it received a letter in return from LCI that stated that the company "was not for sale," but nonetheless indicated that its board of directors would consider a sale at a price substantially higher than that proposed.[190]

On February 19, 1998, two days after Thompson made his public remarks during the interview, LCI received another offer from Qwest for forty dollars a share.[191] After two weeks of due diligence and negotiations, the companies finally arrived at a price of forty-two dollars a share, and they announced the deal on March 9.[192] The plaintiffs, LCI shareholders that sold their stock between February 17 and March 9, brought suit roughly a month after the announcement of the merger.[193]

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185. *Id.* at 611–12. During this time period, the telecommunications industry was undergoing a period of rapid consolidation through a series of mergers and acquisitions among the leading companies in the field. *See* Kathy Bergen, *Pay-TV Faces Diminishing Returns—Merger Would Whittle Choices*, CHI. TRIB., Nov. 1, 2001, at N1 (discussing consolidation of telecommunications industry following deregulation in 1996); *infra* note 196.

186. *Phillips*, 190 F.3d at 612.

187. *Id.*

188. *Id.* at 613.

189. *Id.* at 612.

190. *Id.*

191. *Id.*

192. *Id.* at 612–13. On the day that the deal was made public, Thompson appeared on CNN Moneyline with Lou Dobbs, where he responded to the question of how long LCI and Qwest had been discussing a merger: "[t]alking to each other? It goes way back, but really in earnest for the last three or four weeks." *Id.* at 613.

193. *Id.*

The Fourth Circuit first considered the varying approaches to pleading scienter that the circuit courts had developed in the wake of the PSLRA, but it ultimately declined to adopt any one standard since, in its analysis, the plaintiffs had failed to meet even the most lenient of the competing tests under the PSLRA—that developed by the Second Circuit.[194] Under that test, scienter could be established by alleging specific facts to show that either: (1) the defendants had engaged in conscious or reckless conduct; or (2) the defendants had both a motive and an opportunity to commit fraud.[195] As to the first prong, the court held that because the plaintiffs had failed to plead facts showing that Thompson's statements were materially false,[196] no strong inference of conscious or reckless behavior could be drawn.[197] Similarly, the court found that the plaintiffs' claim, that Thompson's personal incentive was to artificially depress the price of LCI stock, was too speculative to establish "motive and opportunity" under the alternative prong of the Second Circuit test.[198] The court of appeals held that allegations that an executive took certain actions to preserve a corporate position, standing alone, could not establish motive, nor could a claim that executives were motivated by increased compensation absent a showing of insider trading or sales of personal stock.[199] Since the plaintiffs could only demonstrate incentives that existed in virtually every merger, the court held that the complaint did not raise the required "strong inference" of scienter.[200]

Here, the court of appeals' analysis likely served the purpose of the PSLRA to curtail suits based upon weak inferences or attenuated theories of misconduct. Under the plaintiffs' characterization of the events of the LCI/Qwest merger, Thompson not only made his public statements that the company was "not for sale" to depress the price of

194. *Id.* at 621; *see supra* note 182.

195. *Phillips*, 190 F.3d at 620.

196. *Id.* at 618–20. Because the state of the telecommunications industry was in a period of rapid consolidation and because the statement was made in the context of a release discussing almost-record profits and stock price for LCI, the court of appeals concluded that Thompson's remark could not be considered to have a substantial likelihood of altering the total mix of information available to a reasonable investor at the time. *Id.*; *see supra* note 43 (discussing the materiality standard).

197. *Phillips*, 190 F.3d at 621.

198. *Id.*

199. *Id.* at 622.

200. *Id.* "To support a claim of motive based on the benefit a defendant derives from an increase in the value of his holdings, a plaintiff must demonstrate some sale of 'personally-held stock' or 'insider trading' by the defendant." *Id.* (citing Stevelman v. Alias Research, Inc., 174 F.3d 79, 85 (2d Cir. 1999); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1312 (C.D. Cal. 1996)).

LCI's stock to encourage the merger, but he also deployed his own vote *against* the merger—on the supposition that Qwest wanted to be able to announce unanimous board support—as a strategy to exact more favorable terms from Qwest for himself personally.[201] As the court noted, the suggestion of fraud displayed in this account would require the court to string together several speculative inferences to attribute a culpable motive to Thompson's actions.[202] From that perspective, *Phillips* is an apt example of the PSLRA's "strong inference" requirement appropriately used to balance the competing interests of issuers and investors in securities fraud actions.[203]

Going further, however, *Phillips* employed almost precisely the standard that would be articulated by the Supreme Court in *Tellabs* almost ten years later. Clearly the court of appeals did not find the theory of scienter alleged by the plaintiffs to be cogent, in that it required multiple inferential steps, nor did it find that the inferences of fraudulent intent were as plausible on the whole as competing inferences of non-culpability. In this regard, *Phillips* serves as another example of the Fourth Circuit as an "early adopter" of a significant interpretation of the securities fraud provisions.[204]

2. *Ottman v. Hanger Orthopedic Group, Inc.*

In *Ottman v. Hanger Orthopedic Group, Inc.*,[205] the court followed *Phillips* and explicitly recognized recklessness as a basis to establish scienter in a securities fraud claim.[206] The plaintiffs in this case were investors who brought claims against the company, Hanger Orthopedic Group, Inc. ("Hanger"), and two of its officers for alleged oral and written misstatements made during conference calls with

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201. *Id.* at 621–22.

202. *Id.* at 623.

203. *Id.* at 620–24. *See, e.g.*, Cozzarelli v. Inspire Pharm., Inc., 549 F.3d 618, 624 (4th Cir. 2008) (holding that the PSLRA, in conjunction with *Tellabs*, balances concerns of plaintiffs and defendants by screening meritless claims from valid claims early in litigation); *infra* text accompanying notes 230–66 (discussing *Cozzarelli*); *see also* Rose, *supra* note 5, at 1335–37, 1349 (describing the PSLRA's heightened pleading requirements as part of a "narrowing" approach to federal securities litigation reform that balances risks of dismissing suits with "technical" merit with harms of over-deterrence in domestic capital markets). *But see* Christopher M. Fairman, *Heightened Pleading*, 81 TEX. L. REV. 551, 607–11 (2003) (asserting that the PSLRA heightened pleading standard for scienter is inherently unworkable and suggesting procedural alternatives, such as limited discovery, to protect interests of plaintiffs and defendants).

204. *See supra* text accompanying notes 27–30 and 41–61 (discussing the court's treatment of the materiality of forward-looking statements in advance of the express protections granted to such statements by the PSLRA).

205. 353 F.3d 338 (4th Cir. 2003).

206. *Id.* at 344.

investors and analysts and in press releases discussing quarterly revenues.[207]

In particular, these statements concerned problems Hanger had encountered following the acquisition of a new subsidiary, NovaCare Orthotics & Prosthetics ("NovaCare").[208] Both Hanger and NovaCare were providers of orthotic and prosthetic devices to patients with artificial limbs whose profitability depended on certified practitioners qualified to fit these devices for their customers.[209] Following the acquisition, which occurred during the third quarter of 1999, a number of NovaCare practitioners decided to leave the company.[210] On November 8, 1999, Hanger executives issued a press release with third quarter earnings and participated in a conference call to discuss the results.[211] In the conference call, a Hanger executive stated that "approximately" ten practitioners had left NovaCare before the acquisition and "about" another ten afterward, for a total loss of $8 million in revenue.[212] Another executive stated that this loss did not constitute a "major defection" and that it was "certainly not any kind of a trend that we see."[213]

In a January 7, 2000, conference call, however, a Hanger executive made statements that indicated that the number of post-acquisition practitioner resignations was not ten but rather eighteen or nineteen, and he further revealed that another seven practitioners had resigned in December alone.[214] Later in the call, the executive stated that this number of defections, while small relative to the total number of Hanger practitioners, had "inflicted serious damage."[215]

207. *Id.* at 342.

208. *Id.* at 346.

209. *Id.* at 341. Before being acquired by Hanger, NovaCare itself had acquired over ninety other orthopedic and prosthetic ("O & P") businesses since 1992. Hanger Orthopedic Group, Inc., Annual Report (Form 10-K), at 1 (Mar. 30, 2000). With its purchase of NovaCare, Hanger became "the leading provider of O&P patient-care services in the United States." *Id.*

210. *Ottman*, 353 F.3d at 346.

211. *Id.* at 341.

212. *Id.* at 346.

213. *Id.* Notably, Hanger viewed its ability to successfully integrate acquired businesses and operations as one of its "competitive strengths." *See* Hanger Orthopedic Group, Inc., Annual Report (Form 10-K), at 2 (Mar. 30, 2000).

214. *Ottman*, 353 F.3d at 347.

215. *Id.* As of December 31, 1999, Hanger employed "approximately 962 practitioners" in forty-one states and the District of Columbia. Hanger Orthopedic Group, Inc., Annual Report (Form 10-K), at 1 (Mar. 30, 2000). The acquisition of NovaCare apparently marked the beginning of a period of slower growth for the company since, by comparison, in its most recent annual filing, the company reported that it employed "in excess of 1,000

This was in part due to the fact that a single NovaCare practitioner's referral business could represent half a million dollars in revenue to Hanger, with a similar impact on income.[216] Based on these revelations, plaintiffs brought suit for securities fraud violations.[217] The Fourth Circuit affirmed the district court's dismissal of the complaint.[218]

The plaintiffs claimed that the November 1999 misstatement of the number of post-acquisition practitioner resignations as ten instead of eighteen or nineteen was a material misrepresentation that understated the effect of these defections on Hanger's future performance.[219] Hanger contended that any misstatement of the number of practitioners who had left could not be material because the company had accurately disclosed the impact of those losses on revenues.[220] The Fourth Circuit ultimately agreed with the plaintiffs that Hanger's statements about practitioner losses could cause a reasonable investor to underestimate the effect on Hanger's financial condition because the effects on revenues and earnings from the additional practitioner resignations could well have been felt primarily in future quarters.[221] Thus, the court of appeals ruled that plaintiffs had adequately plead materiality.[222]

The court of appeals disagreed, however, that the complaint established the requisite level of scienter because the facts plead were "more consistent with negligence than with recklessness or intent."[223] The plaintiffs' inference of scienter rested on the grounds that Hanger considered practitioner retention to be the driving factor for revenue

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revenue-generating O&P practitioners" in forty-five states and the District of Columbia. *See* Hanger Orthopedic Group, Inc., Annual Report (Form 10-K), at 3 (Mar. 03, 2010).

216. *Ottman*, 353 F.3d at 347.

217. *Id.* at 342.

218. *Id.* at 352–53.

219. *Id.* at 347. During the November conference call, Hanger disclosed that the loss in revenue during the third quarter from practitioner losses was approximately $8 million. *Id.* Total revenue for that quarter was approximately $125 million. *Id.* at 341, 346.

220. *Id.* at 347.

221. *Id.* at 347–48. In its year-end results for 1999, Hanger reported that net sales revenues almost doubled from the previous year, from $188 million to $347 million, which the company attributed primarily to the acquisition of Novacare. Hanger Orthopedic Group, Inc., Annual Report (Form 10-K), at 21, 23 (Mar. 30, 2000). Thus, future changes in Novacare's revenues would have an accordingly significant impact on Hanger's performance. *See id.*

222. *Ottman*, 353 F.3d at 349.

223. *Id.* at 348. Here, the court of appeals appears to adopt a *Tellabs*-style approach to the scienter standard that culpable inferences must be at least as compelling as competing inferences. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007); *supra* note 182 and accompanying text.

growth, that the company had tracked retention numbers month by month, and that it had clearly recognized a negative trend by the time of the first conference call.[224] Although the Fourth Circuit conceded that these claims gave "some indication" that Hanger stated the number of departures recklessly,[225] it ultimately held that these factors were outweighed by an inference of "mere" negligence because: (1) Hanger couched its statements in rough terms rather than precise figures; (2) the number of resignations was small relative to the total number of practitioners nationwide, lending credence to the possibility that the company simply miscounted; (3) Hanger had disclosed at least some of the negative effects on revenues and earnings from the losses; (4) there were no allegations of a long-term or continuing conspiracy to hide the level of resignations; (5) plaintiffs had not alleged any personal motivations by Hanger executives to misstate the figures;[226] and (6) Hanger plausibly explained in its November statement that it believed that no significant trend of resignations existed.[227]

In its discussion of the requisite pleading standards to establish scienter, the Fourth Circuit not only expressly accepted the prevalent standard of "recklessness"[228] as a basis for the requisite mental state, but it further adopted what it termed a "flexible, case-specific" approach to determine if the facts plead collectively raised a strong inference of culpability, thus rejecting the more lenient motive/opportunity standard espoused by the Second Circuit.[229] Interestingly, this standard again foreshadows the *Tellabs* standard in

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224. *Ottman*, 353 F.3d at 348.

225. *Id.* Here, the Fourth Circuit relied on its earlier decision in *Phillips*. "In *Phillips*, we defined 'recklessness' as 'an act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.' " *Id.* at 343 (quoting Phillips v. LCI Int'l, Inc., 190 F.3d 609, 621 (4th Cir. 1999)). This standard is consistent with that adopted by other federal appellate courts. *See, e.g.*, *In re* Ikon Office Solutions, Inc. Sec. Litig., 277 F.3d 658, 667 (3d Cir. 2002); Nathenson v. Zonagen, Inc., 267 F.3d 400, 408 (5th Cir. 2001); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039–40 (7th Cir. 1977).

226. *Ottman*, 353 F.3d at 348. Again citing *Phillips*, the court of appeals opined that personal motivation in this context includes conduct such as sales of executives' personal stock, but it does not include "generalized corporate motives." *Id.* at 348 n.7.

227. *Id.* at 348.

228. In doing so, the Fourth Circuit reiterated the definition of recklessness expressed earlier in *Phillips*: " '[A]n act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.' " *Id.* at 343 (quoting *Phillips*, 190 F.3d at 621); *see* cases cited *supra* note 225.

229. *Ottman*, 353 F.3d at 345.

that the court of appeals was persuaded that the facts plead more plausibly supported negligence than recklessness. While *Ottman* presents a closer case than *Phillips* and reasonable minds may disagree with the court's holding, particularly due to the fact that the statements at issue here were demonstrably false and concerned an issue that the defendants obviously tracked closely, the decision in *Ottman* illustrates the Fourth Circuit's reliance on the federal pleading requirements to stifle what the court perceives as the invocation of section 10(b) litigation directed toward simple negligence or inadvertent misstatement by alleged wrongdoers.

3. *Cozzarelli v. Inspire Pharmaceuticals, Inc.*

In *Cozzarelli v. Inspire Pharmaceuticals, Inc.*,[230] the Fourth Circuit, in determining whether the subject pleadings established a "strong inference" of scienter, affirmed dismissal of securities fraud claims in light of the *Tellabs* decision.[231] The defendant, Inspire Pharmaceuticals, Inc. ("Inspire"), developed prescription drugs for the treatment of various eye, lung, and sinus diseases, including in particular the drug diquafosol tetrasodium ("diquafosol"),[232] designed to prevent and repair long-term corneal damage from dry eye disease. Plaintiffs brought a class action suit against Inspire after the company announced in early February 2005 that diquafosol had failed to meet an expected level of success in a series of testing to obtain approval from the Food and Drug Administration ("FDA") to market the drug.[233] This announcement precipitated a forty-five percent drop in Inspire's stock price.[234]

In June 2004, as a final step to gain FDA approval, Inspire began a series of trials labeled Study 109 that were intended to replicate the results of a prior series of tests, Study 105, for a specific endpoint objective.[235] Inspire made "a handful of public comments" about Study 109 in prospectuses for stock offerings that stated that Inspire had a "clear understanding of the FDA's additional requirement" to

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230. 549 F.3d 618 (4th Cir. 2008).

231. *Id.* at 620–21.

232. *Id.* at 621. Inspire is continuing the development of this drug under the trade name Prolacria. Inspire Pharmaceuticals, Inc., Prolacria—Inspire Pharmaceuticals, http://www.inspirepharm.com/r_and_d/prolacria.php (last visited May 9, 2010). In January 2010, the company announced the failure of a new series of trials with a specified endpoint of corneal clearing. *Id.*; *see infra* note 237 (discussing corneal clearing versus corneal staining as an objective endpoint for study).

233. *Cozzarelli*, 549 F.3d at 622.

234. *Id.*

235. *Id.*

approve the drug, and it referred to Study 109 as a "confirmatory" trial.[236] In addition, Christy Shaffer, Inspire's chief executive officer, made statements in conference calls with investors and analysts that led some stock analysts to speculate about the endpoint objective[237] of Study 109 and whether trials would likely meet that objective.[238] Nonetheless, claiming competitive reasons, Inspire never publicly confirmed the specific endpoint of the trial.[239] While Study 109 was in progress, Shaffer and two Inspire directors sold shares of company stock ranging from three to thirteen percent of their respective holdings.[240] Unfortunately for Inspire, Study 109 showed that diquafosol failed to meet the required level of success.[241] A week after the announcement of the test results and the resulting drop in Inspire's stock price, plaintiffs filed suit.[242]

Like *Phillips* and *Ottman*, *Cozzarelli* illustrates the Fourth Circuit's application of the PSLRA's stringent pleading requirements, supported by *Tellabs*, to "screen out" a claim that the court of appeals deems to be relatively weak. The court of appeals affirmed dismissal based on the plaintiffs' failure to adequately plead scienter; the inference of fraudulent intent raised in the complaint was not as compelling as an inference of innocent conduct.[243] The claims of scienter relied primarily on the personal and corporate financial motivations that Inspire's CEO had to mislead analysts and investors about the particular endpoint of Study 109, buttressed by the stock

236. *Id.*

237. The specific endpoint of Study 109 was to replicate the level of "corneal staining" that the drug had achieved in Study 105. *Id.* at 621. Corneal staining is a procedure used to measure damage to the cornea on a scale from zero to five, with a score of zero signifying a positive result known as "corneal clearing." *Id.* Thus, an endpoint objective of corneal clearing—as analysts openly speculated—would indicate that diquafosol was a more effective treatment for damage to the cornea than would an endpoint of achieving only a lower level of corneal staining. *See id.*

238. *Id.* at 622.

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.* Inspire's stock price dropped from $16 per share to $8.88 on the announcement that diquafosol had failed to replicate the corneal staining results of Study 105—a forty-five percent decline. *Id.* Similarly, two years earlier, Inspire had enjoyed a forty percent increase in the price of its stock on the news that diquafosol had achieved the primary endpoint of corneal staining in that study. Michael Dunn, *Inspire Pharmaceutical Climbing on Positive Dry Eye Results*, THE STREET, June 18, 2002, http://www.thestreet.com/tech/marketmovers/10027764.html.

243. *Cozzarelli*, 549 F.3d at 626 (concluding that "no strong inference of scienter exists because the inference that defendants acted with the nonfraudulent intent to protect their competitive advantage is more powerful and compelling than the inference that defendants acted with an intent to deceive").

sales by the CEO and other insiders.[244] Applying the Supreme Court's instruction in *Tellabs* to look at the facts as a whole, including documents incorporated by reference in the complaint, the Fourth Circuit reasoned that analyst reports—when read in their entirety, rather than simply portions quoted in the complaint—corroborated Inspire's legitimate business reasons for not disclosing the precise endpoint to be achieved by Study 109.[245] As the court observed, while analysts did opine regarding the endpoint for Study 109 (that the endpoint was to achieve corneal clearing), these opinions were expressly noted as based only on "assumption" and "belief."[246] The analyst reports further indicated that Inspire had expended substantial time and resources to determine what endpoint was required to gain FDA approval, and it did not want to divulge that valuable information to competitors.[247] Thus, the Fourth Circuit concluded that the inference that Inspire's statements were motivated by a legitimate business concern was "more powerful and compelling" than that of an intent to deceive the investing marketplace.[248]

Turning to the CEO's alleged motivations to raise capital for the company and increase her personal compensation (that was tied to the performance of the company and diquafosol), the court relied on *Ottman* for the proposition that these incentives exist in every company, "thus add[ing] little to an inference of fraud."[249] Similarly, the stock sales by executives were deemed neither "unusual or suspicious," and thereby did not lend any weight to an inference of culpable intent.[250] The court found the levels of sales—from three to thirteen percent of holdings—"modest to *de minimis*," and it noted that, while Study 109 was ongoing, each of the executives actually increased their total holdings in Inspire.[251] Further, two of the three executives resigned "around the time" of their stock sales, "indicating that their departures, rather than an intent to defraud, may have prompted them to sell their stock."[252] The court found that these facts,

244. *Id.* at 625.
245. *See id.*
246. *Id.* at 626.
247. *Id.*
248. *Id.*
249. *Id.* at 627 (citing Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 352 (4th Cir. 2003)).
250. *Id.* (quoting *In re* PEC Solutions, Inc. Sec. Litig., 418 F.3d 379, 390 (4th Cir. 2005)).
251. *Id.* at 628.
252. *Id.*

taken together, did not support an inference that the executives intended to dump their shares at an artificially inflated stock price.[253]

Interestingly, the Fourth Circuit observed that the plaintiffs had failed to allege the existence of any Inspire internal documents that supported an inference of scienter.[254] As the court recognized, however, such "smoking-gun[s]" are not required by *Tellabs*.[255] Unfortunately, as the Fourth Circuit declined to point out, such internal documents normally are obtained pursuant to the discovery process, to which a plaintiff under the PSLRA is entitled to invoke only after successfully fending off a motion to dismiss.[256] Under such circumstances, to fault a claimant at the pleading stage for failure to discover such weaponry may be equated to requiring a batter to decipher a "spitball" or "emery" pitch before the ball is thrown,[257] or to compelling a pitcher, without inspection, to prove that a hitter has used a "corked" bat.[258]

253. *Id.*

254. *Id.* at 626 (observing that "plaintiffs have not alleged the existence of any internal documents from Inspire").

255. *Id.* (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)). The *Tellabs* Court stated that "[t]he inference that the defendant acted with scienter need not be irrefutable, i.e., of the 'smoking-gun' genre" to meet the requisite standard that the inference be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324.

256. Pursuant to section 27 of the Securities Act and section 21D of the Securities Exchange Act, as amended by the PSLRA, there must be a stay of discovery "during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 77z-1(b)(1) (2006); 15 U.S.C. § 78u-4(b)(3)(B) (2006); STEINBERG, *supra* note 4, at 256.

257. A "spitball" is a pitch delivered after applying a foreign substance to the ball, such as saliva or lubricating jelly, to alter the trajectory of the pitch. *See, e.g.*, GEORGE F. WILL, MEN AT WORK 99–100 (1990). The "spitball" has been outlawed three separate times in baseball, most recently in 1974. *See* Roger Angell, *On The Ball*, *in* ANATOMY OF BASEBALL 199, 207–08 (Lee Gutkind & Andrew Blauner eds., 2008). An "emery pitch" is a pitch delivered after the ball has been abraded, such as with an emery board or sandpaper (also known as "scuffing" or "cutting" the ball), to alter its motion in flight. Baseball Slang Dictionary from D–H: More Baseball Slang from Dinger to Horsehide, http://baseball.suite101.com/article.cfm/baseball_slang_dictionary_from_dh (last visited Aug. 26, 2010); *see also* WILL, *supra*, at 99 (describing the aerodynamic effect of cutting or scuffing the ball). Minnesota Twins player Joe Niekro was once suspended for ten games after umpires discovered an emery board that Niekro had carried onto the field in the pocket of his uniform. *See Niekro Rejects Scuff Charge*, N.Y. TIMES, Aug. 5, 1987, at A24; *see also Mischief on the Mound: An Abridged History*, N.Y. TIMES, Oct. 24, 2006, at D3, *available at* http://www.nytimes.com/2006/10/24/sports/baseball/24series_side.html (describing famous instances of spitballs, emery pitches, and other prohibited pitching practices).

258. A corked bat is a bat that has been altered by filling its core with cork to lighten its weight, in the belief that this will allow the hitter to generate greater swing speed and thus greater distance on hits. CULTURAL ENCYCLOPEDIA OF BASEBALL 77 (Jonathan

In addition to its approach to scienter for the section 10(b) claims, *Cozzarelli* also demonstrates the particularly narrow "strike zone" plaintiffs face in the Fourth Circuit in its adoption of more stringent pleading standards for other "non-scienter" securities claims such as actions under sections 11 and 12(a)(2).[259] The plaintiffs alleged that Inspire had also violated these provisions by omitting to disclose the primary endpoint of Study 109; according to plaintiffs, disclosure of that information was necessary to prevent the statements contained in the company's prospectuses from being materially misleading.[260] The court of appeals similarly rejected these claims on the basis that the complaint did not plead facts with sufficient particularity under Rule 9(b) of the Federal Rules of Civil Procedure ("FRCP").[261] The Fourth Circuit held that this heightened pleading standard applied even though the complaint " 'expressly exclude[d] and disclaim[ed] any allegation that could be construed as alleging fraud' with respect to the Securities Act claims."[262]

Reasoning that this "disclaimer" language was "conclusory," the Fourth Circuit held that the plaintiffs' allegations "sound[ed] in

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Fraser Light ed., 1997). For example, famous slugger Sammy Sosa was once ejected from a game when his bat shattered on a hit to reveal cork in its center, thus triggering an X-ray examination of seventy-six bats confiscated from his locker (all turned out negative). Ira Berkow, *At Crime Scene, Sosa Hears Mostly Cheers*, N.Y. TIMES, June 5, 2003, at A1. Rule 6.06(d) of the Rules of Major League Baseball prohibits the use of bats that have "been altered or tampered with in such a way to improve the distance factor or cause an unusual reaction on the baseball, [including] bats that are filled, flat surfaced, nailed, hollowed, grooved, or covered with a substance such as paraffin, wax, etc." PLAYING RULES COMM., *supra* note 1, at 54–55.

259. Sections 11 and 12(a)(2) of the Exchange Act (codified at 15 U.S.C. §§ 77k(a)(2) (2006)) provide a cause of action based on material misstatement(s) or half-truth(s) contained in a Securities Act registration statement or prospectus. 15 U.S.C. §§ 77k(a)(2) (2006). These provisions are somewhat similar to the anti-fraud provisions of section 10(b), but they do not require a showing of scienter. *See supra* note 119 (discussing the section 11 private cause of action).

260. *Cozzarelli*, 549 F.3d at 629. Although the issue apparently did not arise in this case, disclosure of all material facts about Study 109, including arguably its specific endpoint, may have been necessary under Item 303 of SEC Regulation S-K, 17 C.F.R. 229.303(a)(3)(ii) (2009), which requires disclosure of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." *See In re* Caterpillar, Inc., 50 S.E.C. 903, 908–12 (Mar. 31, 1992); SEC Financial Reporting Release No. 36, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

261. *Cozzarelli*, 549 F.3d at 629. FRCP Rule 9(b) requires that when alleging fraud or mistake, "a party must state with particularity the circumstances constituting fraud or mistake." FED. R. CIV. P. 9(b).

262. *Cozzarelli*, 549 F.3d at 629 (quoting Consolidated Class Action Complaint ¶¶ 73, 77, *Cozzarelli*, (4th Cir. 2008) (07-1851)).

fraud"[263] and to allow such a complaint to survive on the lesser standards of FRCP Rule 8[264] would defeat the purpose of the rule—to "protect[] defendants from the reputational harm that results from frivolous allegations of fraudulent conduct."[265] This approach sets the Fourth Circuit apart from other circuits. For example, the Fifth and Eighth Circuits hold that claims plead in this manner that are brought under sections 11 and 12 require only notice pleading under FRCP Rule 8 (i.e., when a complaint disclaims or disavows allegations of fraud in connection with such claims).[266] Accordingly, in comparison to cases from these circuits, *Cozzarelli* displays the differing burdens and varying "strike zones" that securities plaintiffs face between jurisdictions.

4. *Public Employees' Retirement Ass'n of Colorado v. Deloitte & Touche, LLP*

In *Public Employees' Retirement Ass'n of Colorado v. Deloitte & Touche, LLP*,[267] the Fourth Circuit once again considered recklessness as a basis for scienter, as construed under *Tellabs*.[268] In

263. *Id.*

264. FRCP Rule 8 requires that a complaint must state "a short and plain statement of the claim showing that the pleader is entitled to relief." FED. R. CIV. P. 8(a)(2); *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) ("[W]e assume, at least for argument's sake, that neither the [Federal Rules of Civil Procedure] nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss."); *infra* note 304 and accompanying text (discussing the application of pleading standards with regard to causation).

265. *Cozzarelli*, 549 F.3d at 629 (citing Wagner v. First Horizon Pharm. Corp., 464 F.3d 1273, 1277–78 (11th Cir. 2006); Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 784 (4th Cir. 1999), *aff'd*, 352 F.3d 908 (4th Cir. 2003)).

266. *See, e.g.*, Kapps v. Torch Offshore, Inc., 379 F.3d 207, 210 (5th Cir. 2004) (stating that "[s]ection 11 only requires notice pleading under [FRCP Rule] 8 rather than the detailed pleading mandated by [FRCP Rule] 9(b) or the [PSLRA]"); *In re* NationsMart Corp. Sec. Litig., 130 F.3d 309, 316 (8th Cir. 1997) (holding that the complaint's express disavowal of claims of fraud in connection with sections 11 and 12 avoided grounding in fraud, thus triggering the lesser pleading standards of FRCP Rule 8); *see also In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 307 (E.D.N.Y. 2002) (noting split of authority in application of Rule 9(b) to section 11 and 12(a)(2) claims).

267. 551 F.3d 305 (4th Cir. 2009).

268. *Id.* at 306. Similarly, recklessness was the basis for the plaintiffs' allegations of scienter in *Teachers' Retirement System of Louisiana v. Hunter*, 477 F.3d 162 (4th Cir. 2007), another post-*Tellabs* case. *See infra* text accompanying notes 305–28 (discussing *Hunter* in connection with causation). In that case, the Fourth Circuit held that because the plaintiffs failed to establish that any statements made by the defendants were false or misleading, the facts plead could raise no inference of either recklessness or intentional conduct. *Hunter*, 477 F.3d at 184–85. Further, the court opined that even though the plaintiffs alleged significant stock sales by insiders, the four-year class period during which the sales took place rendered any inference of scienter indicated by these sales weaker than the inference that the executives made these sales without culpable intent. *Id.* at 185.

this case, the outside auditors, not the issuer, were the target of the securities fraud claims.[269] The court ultimately found that the "most plausible" inference raised by the facts plead was that the auditors had been misled by the issuer, rather than that they were complicit in any fraud or "so reckless in their duties as to be oblivious to malfeasance that was readily apparent."[270] In the context of an accountant's responsibility in a case of audit failure, the court held that this standard required " 'more than a misapplication of accounting principles.' "[271]

The defendants, U.S.-based Deloitte & Touche, LLP and Dutch firm Deloitte & Touche Accountants ("Deloitte"), were engaged as outside auditors by Royal Ahold, N.V. ("Ahold"), a Dutch operator of grocery stores and food service enterprises in the United States and other countries.[272] In this role, Deloitte counseled Ahold on whether to report revenues from five separate joint ventures Ahold formed with grocery store operators in Latin America and Europe over an eight-year period beginning in 1992 on a consolidated or non-consolidated basis.[273] Since Ahold did not own a controlling financial interest[274] in any of the five joint ventures,[275] the propriety of consolidated reporting rested solely on the measure of control that Ahold held over the operations of each venture.[276] Deloitte advised

269. *Deloitte*, 551 F.3d at 306.

270. *Id.* at 314.

271. *Id.* (quoting SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)).

272. *Id.* at 306–07.

273. *Id.* at 308–10. On a consolidated basis, Ahold would report all of the revenues of the joint venture in its combined reporting, whereas on a non-consolidated basis, it would report revenue only in proportion to its ownership interest in the venture. *Id.* Because of the level of interests Ahold held in the joint ventures, a consolidated basis allowed the company to double the amount of revenues it could report from each operation. *Id.*

274. A controlling financial interest under United States generally accepted accounting principles ("GAAP") is defined as a majority voting interest, or as a general rule, direct or indirect ownership of over fifty percent of the outstanding voting shares of a company. CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Fin. Accounting Standards No. 94, § 13 (Fin. Accounting Standards Bd. 1987) ("FASB 94"). FASB 94 amended various provisions of the earlier controlling provision, Accounting Research Bulletin Number 51, by, among other changes, eliminating various exceptions to the general rule. *See id.* §§ 9–10; *see also* CONSOL. FIN. STATEMENTS, Acct. Res. Bull. No. 51 (Am. Inst. Certified Pub. Accountants 1959) (containing pre-amendment consolidation standards). FASB 94 left intact, however, the exception to the general rule that consolidation is appropriate "where control is likely to be temporary, or where it does not rest with the majority owners." CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, *supra*, § 10.

275. *Deloitte*, 551 F.3d at 308. Ahold held only a forty-nine percent stake in one of the ventures, and it held fifty percent in the other four. *Id.*

276. *See id.*

Ahold several months before the first joint venture was formed about control requirements under U.S. and Dutch accounting rules, and it further said that control could be demonstrated short of majority ownership by factors such as a contractual agreement among the parties.[277] Despite this advice, none of the joint venture agreements indicated that Ahold held control over their operations.[278]

Ultimately, however, Deloitte relied only upon Ahold's representations that it held the requisite level of control to justify consolidation, and Ahold reported the revenues of the joint ventures on a consolidated basis as they were formed.[279] In mid-1998,[280] Deloitte began to demand that Ahold provide substantiation for its assertion of control in order to continue reporting consolidation of joint venture revenues and to avoid restatement of prior years' financial results.[281] After almost a year, Ahold managed to produce a single countersigned "control letter" from one of its joint venture partners that stated that in the event an issue arose where the parties could not come to a consensus decision, "Ahold's proposal to solve that issue will in the end be decisive."[282] It would take Ahold nearly another eighteen months to obtain similar letters from three of the remaining joint venture partners.[283] Deloitte accepted these documents as substantiation for past and continued consolidation.[284]

Then, in 2002, Deloitte learned of a "side letter" to Ahold from one of the joint venture partners that disputed the interpretation of the joint venture agreement expressed in the control letter.[285] Within months, Ahold revealed letters to Deloitte from the remaining joint venture partners that also disputed Ahold's claim of control.[286] Two days thereafter, Ahold announced that it would restate its revenues

277. *Id.*

278. *Id.* at 309. For example, in one of the agreements, corporate decisions were to be made by a unanimous vote of the board of directors, only three of whom could be appointed by Ahold, while the other four directors were appointed by the co-venturer. *Id.* at 308.

279. *Id.* at 309.

280. *Id.* at 308. Notably, this occurred after three of the five joint ventures were already in operation and more than five years since the first joint venture was formed. *Id.*

281. *Id.* at 309.

282. *Id.* Allegedly, at least one member of Ahold's Executive Board, Jan Andreae, "played a direct role" in drafting these letters. *In re* Royal Ahold N.V. Sec. & ERISA Litig., 384 F. Supp. 2d 838, 844 (D. Md. 2005).

283. *Deloitte*, 551 F.3d at 309.

284. *Id.*

285. *Id.*

286. *Id.*

due to improper consolidation.[287] The plaintiffs brought suit against Deloitte under section 10(b) for misstatements in the audit opinions that Deloitte issued concerning Ahold's financial operations, claiming that Deloitte acted fraudulently with respect to the reporting of Ahold's results on an improper consolidated basis to inflate revenues.[288] The district court ultimately dismissed these claims on the finding that the plaintiffs had failed to adequately plead scienter.[289]

The Fourth Circuit began its review of these claims with the recognition that under *Tellabs*, analysis of scienter must draw on both factual allegations in the pleadings and other evidence in the record to determine if an inference of scienter is " 'at least as compelling' " as the inference of non-culpability.[290] Drawing on *Ottman*, the court noted that recklessness can establish scienter when conduct is such an extreme departure from the ordinary standard of care that it presents a danger of misleading investors " 'to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.' "[291] Reviewing the facts alleged, the court ruled that the "most compelling" inference was that the auditors had

287. *Id.* At the time, this disclosure was largely noted only in passing by the press and investors since Ahold simultaneously disclosed other accounting frauds and errors that would eventually erase almost $25 billion in revenues and over $1 billion from Ahold's earnings. Gregory Crouch, *Royal Ahold's Inquiry Ends, Finding $1.1 Billion in Errors*, N.Y. TIMES, July 2, 2003, at C2; *see Deloitte*, 551 F.3d at 307. These restatements of revenue and earnings stemmed from the improper manner in which Ahold's subsidiary, U.S. Foodservice, Inc. ("USF"), accounted for promotional allowances from vendors to falsely increase revenues and earnings. *Deloitte*, 551 F.3d at 307. Promotional allowances are payments made to retailers by manufacturers or wholesalers, either in cash or in discounts to purchase prices, in exchange for the retailer's advertising efforts to promote certain products, such as through in-store displays and specials. *Id.*; Marianne M. Jennings et al., *The Economics, Ethics, and Legalities of Slotting Fees and Other Allowances in Retail Markets*, 21 J.L. & COM. 1, 6–8 (2001). In the retail grocery industry, these allowances can contribute significantly to retailers' profit margins, but because promotional allowances are often tied to sales volumes, these revenues are susceptible to manipulation. *See* Jennings et al., *supra*, at 7–8.

288. *Deloitte*, 551 F.3d at 313–14. Following the Supreme Court's decision in *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164, 191 (1994), plaintiffs were required to demonstrate their reliance upon disclosure deficiencies made by Deloitte in the audit reports themselves because simply aiding or abetting another's violation was held not to give rise to section 10(b) liability in private actions. *Deloitte*, 551 F.3d at 313; *see also* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 155–58 (2008) (holding that the conduct of secondary actors must independently meet all elements of liability under section 10(b), including reliance).

289. *Deloitte*, 551 F.3d at 308.

290. *Id.* at 312 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)).

291. *Id.* at 313 (quoting Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343 (4th Cir. 2003)); *see supra* note 225.

been misled by Ahold's "repeated lies and artifices," rather than that they were complicit in any fraud or "so reckless in their duties as to be oblivious to malfeasance that was readily apparent."[292] The court conceded that Deloitte's failure to demand more evidence from Ahold to support consolidation may have been improper, but that in the context of accountant conduct, recklessness requires " 'more than a misapplication of accounting principles,' "[293] but instead must virtually "amount[ ] to no audit at all."[294]

While the standard of recklessness in cases of audit failure is stringent,[295] the court's analysis of the competing inferences in this case nonetheless raises questions. First, the court did not address the long period of time—several years, in fact—in which Deloitte relied solely on Ahold's representations that it held the requisite level of control over the joint ventures, despite having provided a detailed letter to Ahold of the kinds of documentation that normally indicate control.[296] Second, when Deloitte did demand substantiation of Ahold's level of control, the company produced weakly-worded control letters, and then again only after significant periods of time.[297] These delays and the uncertain level of documentation that they ultimately produced should have caused Deloitte to suspect that Ahold was belatedly negotiating the issue of control with its joint

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292. *Deloitte*, 551 F.3d at 314.

293. *Id.* (quoting SEC. v. Price Waterhouse, 797 F. Supp 1217, 1240 (S.D.N.Y. 1992)).

294. *Id.* (quoting SEC. v. Price Waterhouse, 797 F. Supp 1217, 1240 (S.D.N.Y. 1992)). Significantly, it was Deloitte's audit work that brought to light Ahold's fraudulent accounting for promotional allowances, even though USF executives conspired with personnel from several vendors to submit false audit confirmation reports to Deloitte in the course of an investigation to substantiate USF's recorded promotional allowance revenues. *Id.* at 309–10; *see supra* note 287.

295. Courts have held that liability is only appropriate where the defendant made accounting judgments so far from the norm that no reasonable accountant would have made the same decisions if confronted with the same facts—a standard that affords broad protection in cases of audit failure. *See, e.g.*, Ley v. Visteon Corp., 2008 FED App. 0360P, 11–15, 543 F.3d 801, 814–18 (6th Cir. 2008); *In re* Saxton Sec. Litig., 156 F. App'x 917, 920 (9th Cir. 2005), *aff'd*, 227 F. App'x 750 (9th Cir. 2008); CL-Alexanders Laing & Cruickshank v. Goldfeld, 739 F. Supp. 158, 163 (S.D.N.Y. 1990). Recently, the SEC incorporated such allegations into a civil enforcement complaint against David G. Friehling and his firm, Friehling & Horowitz, CPA's, P.C., for their audit work performed on behalf of Bernard L. ("Bernie") Madoff's broker-dealer firm, Bernard L. Madoff Investment Securities LLC. Complaint at 11–14, United States v. Friehling, No. 09-MAG-429 (S.D.N.Y. filed Mar. 18, 2009), *available at* http://lawprofessors.typepad.com/files/madoff-accountant-sec-complaint.pdf.The complaint alleges that Friehling and his firm violated section 17(a) of the Securities Act and section 10(b) of the Securities Exchange Act in connection with Madoff's massive Ponzi scheme that resulted in billions of dollars of investment losses to Madoff's clients. *Id.* at 4.

296. *See Deloitte*, 551 F.3d at 308–09.

297. *Id.*

venture partners after the fact.[298] Third, the court arguably extended too much protection to auditors in particular by characterizing Deloitte's reliance on Ahold's representations and scant substantiations as nothing more than a "misapplication of accounting principles."[299] Undoubtedly, an unduly broad application of this standard, as perhaps illustrated by the Fourth Circuit's decision, can be applied to shield virtually *any* decision requiring an auditor's judgment or discretion in the performance of the audit, beyond purely technical accounting treatments. *Deloitte* and the preceding cases thus aptly illustrate the stiff hurdle that the Fourth Circuit's approach to the element of scienter poses to securities plaintiffs, particularly with regard to establishing recklessness as a basis for a defendant's required state of mind.

C. Causation

An additional element of a private securities fraud claim is loss causation, or that a direct and proximate relationship exists between the loss suffered and the defendant's misrepresentation or omission.[300] For example, in *Miller v. Asensio & Co.*,[301] the Fourth Circuit affirmed a jury verdict that found liability under section 10(b) but awarded zero damages.[302] The court of appeals held that section 10(b) contemplates this result.[303]

The PSLRA does not explicitly address the element of causation concerning the application of a stricter standard of pleading. Whether FRCP Rule 9(b) should apply to this element in section 10(b) litigation remains unresolved.[304] In the case discussed below,

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298. *Id.*

299. *See id.* at 314 (quoting SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)). Notably, in *Price Waterhouse*, in the context in which this language arose, highly technical factors such as the proper method to account for a complex series of leases, the correct level of bad debt reserves, and unreconciled intercompany accounts were at issue. *Price Waterhouse*, 797 F. Supp. at 1223.

300. *See* Securities Exchange Act § 21D(b)(4), 15 U.S.C. § 78u-4(b)(4) (2006); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

301. 364 F.3d 223 (4th Cir. 2004).

302. *Id.* at 225.

303. *Id.* at 231–32. The Fourth Circuit also declined to remand for a new trial on the issue of damages. *Id.* at 234–35, 235 n.10 (citing 15 U.S.C. § 78u-4(b)(4); Teague v. Bakker, 35 F.3d 978, 996 (4th Cir. 1994)); *id.* at 235 (quoting MCI Telecomms. Corp. v. Wanzer, 897 F.2d 703, 708 (4th Cir. 1990)).

304. *See, e.g.*, Berson v. Applied Signal Tech., Inc., 527 F.3d 982, 989 (9th Cir. 2008) (noting that the Supreme Court in *Dura Pharm.*, 544 U.S. at 346, only assumed, without deciding, that the less stringent provisions of Rule 8 should apply). In *Berson*, the Ninth Circuit found it unnecessary to make an explicit ruling on which standard to apply since the court of appeals held that the complaint satisfied the heightened pleading standard of

Teachers' Retirement System of Louisiana v. Hunter,[305] the Fourth Circuit considered this question and ruled that plaintiffs must affirmatively plead facts that establish causation " 'with sufficient specificity to enable the court to evaluate whether the necessary causal link exists.' "[306] Although the opinion is silent on what standard should apply in this evaluation, it appears that the court of appeals employed a "strong inference" analysis similar to its treatment of materiality.[307]

In *Hunter*, the Fourth Circuit considered securities fraud claims that arose as the result of a dispute between two brothers, the co-founders of Cree, Inc. ("Cree").[308] After founding the company in 1987 along with his brother, Eric Hunter served as chief executive officer of Cree until 1994 when F. Neal Hunter took over the position, serving as chief executive officer until 2001 and as chairman of the board until 2004.[309] In 2003, Eric filed suit against Neal and other officers of Cree, alleging violations of federal and state securities laws, defamation, and intentional infliction of emotional distress.[310] Although the suit was quickly settled, the allegations in the complaint sparked a number of class action securities suits by purchasers of Cree stock from 1999 until the filing of Eric's complaint in 2003, which the court consolidated and considered together.[311]

FRCP Rule 9(b). *Id.* at 990. Other courts have adopted a similar approach. *See, e.g.*, Cellular Tech. Services. Co. v. TruePosition, Inc., 609 F. Supp. 2d 223, 236 n.7 (D. Conn. 2009) (failing to reach the issue because the complaint did not satisfy the more lenient pleading standards of FRCP Rule 8); *In re* Dell, Inc. Sec. Litig., 591 F. Supp. 2d 877, 906 (W.D. Tex. 2008) (noting the split of authority among district courts; opining that language in *Dura* indicates that FRCP Rule 8 is the correct standard but that the complaint failed that lesser pleading standard); *In re* eSpeed, Inc. Sec. Litig., 457 F. Supp. 2d 266, 295 (S.D.N.Y. 2006) (assuming *arguendo* that FRCP Rule 8 applied, but other deficiencies in the complaint precluded reaching the issue). *See generally* Matthew L. Fry, *Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post-*Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 51–54 (2008) (asserting that neither the PSLRA nor the FRCP require a heightened standard of pleading for loss causation in federal securities fraud cases).

305. 477 F.3d 162 (4th Cir. 2007).

306. *Hunter*, 477 F.3d at 186 (quoting Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005)).

307. *See id.* at 184–88.

308. *Id.* at 168. Cree, Inc. manufactures semi-conductor devices and materials for use in various light emitting diode ("LED") lighting applications such as automotive, gaming, architectural, and general electronic components. Cree, Inc., Annual Report (Form 10-K), at 1–5 (Aug. 19, 2008).

309. *Hunter*, 477 F.3d at 168.

310. *Id.*

311. *Id.*

The consolidated class action complaint, among other claims,[312] alleged securities fraud violations of section 10(b) against Cree and control person violations under section 20(a)[313] against several of Cree's officers and directors, stemming from Cree's transactions with six other companies over a four-year span that the plaintiffs contended represented "channel stuffing" schemes[314] and "round-trip" transactions[315] to artificially boost Cree's revenues.[316] While Cree

312. The consolidated class action complaint also alleged violations of sections 18(a) and 20A of the Exchange Act, 15 U.S.C. §§ 78r(a), 78t-1(a) (2006), and section 304 of the Sarbanes-Oxley Act, 15 U.S.C. § 7243 (2006), against various individual officers of Cree. *Hunter*, 477 F.3d at 169–70, 188–89. Section 18(a) provides for liability for materially false or misleading statements contained in SEC Exchange Act filings that a purchaser or seller detrimentally relied upon and that caused damages, unless the defendant can show that she "acted in good faith and without knowledge that the statement was false or misleading." 15 U.S.C. § 78r(a). Section 20A, 15 U.S.C. § 78t-1(a), establishes a private right of action for insider trading on behalf of "contemporaneous traders" who traded "the same class of securities on the opposite side of the transaction during the time that the allegedly illegal inside trade(s) occurred." STEINBERG, *supra* note 4, at 377; *see supra* notes 54–81 and accompanying text (discussing the "classical" and "misappropriation" theories of liability for insider trading). Section 304 of the Sarbanes-Oxley Act mandates that the CEO and chief financial officer (CFO) of a reporting company reimburse the company for bonuses received and profits derived from personal sales of company stock during any fiscal year where a restatement of financial results is required because of misconduct or material non-compliance with SEC requirements. 15 U.S.C. § 7243.

313. 15 U.S.C. § 78t(a). This statute imposes liability against any person "who directly or indirectly controls any person liable" for a violation of the Exchange Act (or any rules or regulations promulgated thereunder), "unless the controlling person acted in good faith and did not directly or indirectly induce" or cause the violation. *Id.*

314. "Channel-stuffing" is a fraudulent practice to inflate revenues by inducing customers to order products in excess of their current demand (often through price discounts or by granting an unqualified right of return) that allows the seller to record current revenues from the sales. This practice may be designed to meet analyst expectations or to conceal negative trends. *See Hunter*, 477 F.3d at 169; *see also* Broudo v. Dura Pharm., Inc., 339 F.3d 933, 940 (9th Cir. 2003) (noting that channel stuffing claims may be probative of scienter if intent is to artificially inflate income), *rev'd*, 544 U.S. 336 (2005).

315. "Round-trip" transactions are an arranged series of related purchases and sales between companies that lack any true economic substance, but they allow one or both participants to fraudulently record additional revenues, typically to improve financial statements or meet analyst expectations. *See Hunter*, 477 F.3d at 169. Such transactions formed the basis of the allegations in *Stoneridge Investment Partners, L.L.C., v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). In *Stoneridge*, Charter Communications, Inc. ("Charter"), allegedly agreed to overpay Scientific-Atlanta, Inc. and Motorola, Inc. for cable television equipment that it purchased from the two companies on the condition that Scientific-Atlanta and Motorola would then purchase advertising from Charter in an amount equal to the overpayment to complete the round-trip. *Id.* at 152–54. While Scientific-Atlanta and Motorola followed generally accepted accounting principles and recorded the sales and purchases as a "wash" transaction (that is, booked the transaction as a pure offset with no effect on total revenue or expense), Charter both recorded the advertising fees as revenue and capitalized its purchases of the cable television equipment to overstate both revenue and net income. *Id.* at 155. In a 5–3 decision (with Justice

had disclosed certain aspects of the challenged transactions in its public filings, the plaintiffs alleged that the true character of these dealings only became clear in light of the allegations made by Eric Hunter, as an insider, in his complaint against Cree and its fiduciaries. Because these allegations differed from what Cree had previously revealed, those earlier disclosures allegedly were materially misleading.[317] Indeed, according to the court, news of the litigation instituted by Eric Hunter "caused" Cree's stock price to fall the next day by nearly twenty percent.[318]

The Fourth Circuit affirmed dismissal of the suit on the basis of several pleading defects,[319] including failure to adequately plead loss causation.[320] Drawing upon the Supreme Court's statements in *Dura Pharmaceuticals, Inc. v. Broudo*,[321] the Fourth Circuit held that a plaintiff must not only plead and prove loss causation, but also that the element of loss causation requires that a complaint plead facts establishing causation with sufficient particularity.[322] The court of appeals held that the plaintiffs had failed to plead causation under

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Breyer not participating in the consideration or decision of the case), the Supreme Court held that Scientific-Atlanta and Motorola had no liability under a section 10(b) private right of action for their role in the alleged fraud. *Id.* at 167. The Court reasoned that the defendants' alleged misconduct was not relied upon by investors, thereby precluding the imposition of primary liability. *Id.* at 164–67. *See generally* Matthew L. Mustokoff, *Fraud Not On the Market: Rebutting the Presumption of Classwide Reliance Twenty Years After* Basic, Inc. v. Levinson, 4 HASTINGS BUS. L.J. 225, 242–43 (2008) (interpreting the Court's ruling as demarcating the boundary between the sphere of publicly-available sources such as prospectuses, financial statements, and proxy statements upon which markets place reliance, and the sphere of secondary actors such as vendors and customers, accountants, attorneys, and investment banks whose activities underlie those sources).

316. *Hunter*, 477 F.3d at 169.

317. *Id.*

318. *Id.* at 168 ("from $22.21 to $18.10").

319. *Id.* at 183–84. For example, the court of appeals ruled that the plaintiffs had failed to allege facts to support a reasonable belief that the statements at issue were in fact misleading, and it further stated that the complaint failed to establish the strong inference of scienter required under the PSLRA. *Id.*; *see* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 747 (1995) (codified at 15 U.S.C. § 78u-4(b)(2) (2006)).

320. *Hunter*, 477 F.3d at 185. Loss causation is defined as a causal link between the disclosure deficiency alleged and the loss suffered. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005). While the PSLRA did not impose a stricter pleading standard for causation as it did for scienter, the statute does provide that a plaintiff must prove causation, which thus requires an affirmative pleading of this element. *See* 15 U.S.C.S. § 78u-4(b)(4) (LexisNexis 2010); *Dura Pharm.*, 544 U.S. at 346 (noting that plaintiff has the burden to show that the alleged acts or omissions of the plaintiff "caused the loss for which the plaintiff seeks to recover damages"); *see also supra* text accompanying notes 179–299 (discussing Fourth Circuit decisions addressing scienter).

321. 544 U.S. 336 (2005).

322. *Hunter*, 477 F.3d at 186.

this standard because, first, Eric Hunter's federal complaint made no allegation with respect to the round-trip transactions, and second, the transactions asserted to constitute channel-stuffing had already been disclosed to the markets by means of Cree's SEC filings.[323] The court of appeals agreed with the district court's determination that "Eric Hunter's complaint disclose[d] nothing new, but merely attribute[d] an improper purpose to the previously disclosed facts."[324] Since the market had no knowledge of the first category of transactions and had already incorporated information about the second category, the Fourth Circuit reasoned that neither could have caused the stock drop that followed Eric Hunter's lawsuit against Cree.[325] In the view of the Fourth Circuit, the drop in Cree's stock price "more logically occurred" because the market recognized that a lawsuit by a founder and former insider of the company could create significant instability and disrupt the operations of the company, such that the loss resulted from nothing more than generalized market risks.[326]

While the pleading of requisite causation alone would not have saved the plaintiffs' complaint in this case,[327] the court's approach to this element merits scrutiny. Certainly, the fact that the Fourth Circuit placed little, if any, regard in Eric Hunter's role as Cree's former CEO raises some doubt about its reasoning. As the dissent rightly noted, it would be difficult to "envision a more direct and proximate causal link than an insider's disclosure of fraud that causes a sudden and severe drop in stock price" to establish a reasonable inference of causation under the normal pleading rules of FRCP Rule 8.[328] But going further, it appears that the court of appeals here

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323. *See id.* at 186–87.

324. *Id.* at 187.

325. *Id.*

326. *Id.* at 188.

327. *See supra* note 319. The lengthy dissent in this case, however, presented compelling arguments that the complaint in fact did adequately establish both the existence of material misstatements and a strong inference of scienter. *Hunter*, 477 F.3d at 191–94 (Shedd, J., dissenting). Notably, the dissent appears to apply an analysis similar to the standard that would be adopted a short time later in *Tellabs* by weighing inferences of culpable and non-culpable intent to determine that, because of the identities and positions of those entering into the channel stuffing and round-trip transactions, an inference of scienter was more plausible than an inference of innocent conduct. *See id.* at 193–94; Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 208, 324 (2007).

328. *Hunter*, 477 F.3d at 194 (Shedd, J., dissenting). The dissent analyzed the complaint's allegations of causation under FRCP Rule 8, which requires only a "short and plain statement of the claim." FED. R. CIV. P. 8(a)(2). Under that standard, the dissent opined that, based on the drop in Cree's stock price of twenty percent upon the public disclosure of the information contained in Eric Hunter's suit against the company, "a

applied not only the stricter pleading requirements of Rule 9(b) but also a standard akin to the *Tellabs* requirement for scienter, as seen in its conclusion that Cree's stock drop "more logically occurred" from the market's fear of the general disruption Hunter's lawsuit could cause, rather than the misconduct alleged by a former CEO. To the extent then that *Hunter* can be read to extend the requirement that plaintiffs establish an inference that is "more logical" or even "at least as compelling" as competing inferences to elements of a securities fraud claim beyond scienter (such as causation), it significantly narrows the "strike zone."

V. BACK TO THE BULLPEN[329]

As these cases and the attached empirical information in Table I illustrate, plaintiffs in federal securities fraud cases have met with sparse success in the Fourth Circuit over the last several years. This occurrence is perhaps in large part due to the particularly narrow "strike zone" created by the confluence of legislative and judicial restrictions during that time, as well as to the stringent interpretations employed by that court of appeals to both the substantive elements and procedural provisions related to these claims. For example, many cases from the survey period did not survive motions to dismiss or summary judgment based on the interpretations developed by the Fourth Circuit over time for the elements of materiality and scienter,[330] or they failed to maintain class certification on appeal.[331]

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reasonable inference of loss causation plainly exist[ed] under [the] facts [plead]." *Hunter*, 477 F.3d at 194 (Shedd, J., dissenting).

329. The "bullpen" (sometimes written as "bull pen") describes both the area where pitchers warm up before taking the field and a team's staff of relief pitchers that can be called on during a game. CULTURAL ENCYCLOPEDIA OF BASEBALL, *supra* note 258, at 126–27; *see, e.g.*, Tyler Kepner, *Free-Spending Yankees Use Discount Parts In the Bullpen*, N.Y. TIMES, Mar. 31, 2009, at B12. The origin of the term is not entirely clear, although some historians assert that it arose from the early days of the National League, when relief pitchers would warm up near roped-in areas along foul-ball territories where fans who had arrived late were penned in like livestock. CULTURAL ENCYCLOPEDIA OF BASEBALL, *supra* note 258, at 127. Others believe the term arose from the turn-of-the-century era, when pitchers would warm up near "Bull Durham" tobacco advertisements painted on the outfield fence. *Id.*; *cf.* WILL, *supra* note 257, at 130–31 (describing the origin of the term "bullpen" as "[o]ne of baseball's impenetrable mysteries").

330. *See, e.g.*, Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 344–45 (4th Cir. 2003) (rejecting the Second Circuit's "motive and opportunity" pleading standard in favor of "case-specific" analysis of scienter); Marsh Group v. Prime Retail, Inc., 46 F. App'x 140, 146 (4th Cir. 2002) ("Given the background of *Raab* and its progeny, we are constrained to find that the alleged misstatements in this case are immaterial and hence not actionable."); *see also* Svezzese v. Duratek Inc., 67 F. App'x 169, 172 (4th Cir. 2003)

When viewed together with the narrow approach that the Fourth Circuit has adopted for other elements of federal securities claims such as loss causation—both in pleading requirements and in the relative strength of the allegations required[332]—it appears that the "strike zone" for plaintiffs could constrict even further. While this may not come as welcome news for securities plaintiffs in the Fourth Circuit, one can hope that even a "prolonged slump" cannot truly last forever.[333]

(describing the "relatively lenient" Second Circuit standard as representing one end of the spectrum of standards recognized by the federal circuit courts).

331. *See, e.g.*, Gregory v. Finova Capital Corp., 442 F.3d 188, 189–92 (4th Cir. 2006); Gariety v. Grant Thorton, L.L.P., 368 F.3d 356, 365–69 (4th Cir. 2004).

332. *See supra* notes 300–27 and accompanying text.

333. Although it may sometimes seem so. For example, as the Chicago Cubs began the 2010 season, they faced the prospect of seeing their 102nd year without a World Series title. *See* Paul Sullivan, *'Failure' of 2009 Leaves Bad Taste: Cubs Begin Camp with High Hopes, Lower Expectations*, CHI. TRIB., Feb. 18, 2010, at C1.

TABLE I. SURVEY OF CASES FROM JANUARY 1995 TO JANUARY 2009*

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
1	Unfavorable for plaintiff; decision on merits	Wassel v. Samuel	Summary judgment for defendant
2	Unfavorable for plaintiff; decision on merits	Herman v. Legent Corp.	Judgment as a matter of law for defendants
3	Unfavorable for plaintiff; decision on merits	Wong v. Aragona	Summary judgment for defendants
4	Unfavorable for plaintiff on procedural grounds	Izadpanah v. Gross	Summary judgment for defendants
5	Unfavorable for plaintiff on procedural grounds	Allen v. Lloyd's of London	Preliminary injunction reversed and remanded with instructions to dismiss

* *See supra* notes 13–19 and accompanying text for scope and methodology of good-faith effort to locate all cases within the parameters of the survey, but no guarantee is extended that all such cases have been located.

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed summary judgment based on res judicata and affirmed FRCP Rule 11 sanctions	No. 93-2635, 1995 WL 5772 (D. Md. Jan. 9, 1995)	Jan. 9, 1995
Court of appeals affirmed judgment as a matter of law for defendants because statements of future projections were immaterial, and statements of past performance were not false or fraudulent	No. 94,1445, 1995 U.S. App. LEXIS 5568 (4th Cir. Mar. 20, 1995)	Mar. 20, 1995
Court of appeals affirmed summary judgment for defendants on securities claim based on finding that loan agreement was not a security within the meaning of the Exchange Act	No. 93-1667, 93-1998, 1995 WL 434829 (D. Md. July 25, 1995)	July 25, 1995
Court of appeals affirmed summary judgment for defendants because statute of limitations had run on securities claim	No. 95-1163, No. 95-1246, 1996 U.S. App. LEXIS 1172 (4th Cir. Jan. 30, 1996)	Jan. 30, 1996
Court of appeals reversed preliminary injunction and order to make Exchange Act § 14(a) disclosures with instructions to dismiss case on holding that United States federal securities laws did not apply by virtue of forum and choice of law clauses agreed upon by the parties	94 F.3d 923 (4th Cir. 1996)	Sept. 3, 1996

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
6	Unfavorable for plaintiff; decision on merits	Gasner v. Bd. of Supervisors of the County of Dinwiddie Va.	Summary judgment for defendants
7	Unfavorable for plaintiff; decision on merits	Banca Cremi S.A. v. Alex. Brown & Sons, Inc.	Summary judgment for defendants
8	Unfavorable for plaintiff; decision on merits	Teague v. Bakker	Affirmed judgment on verdict
9	Unfavorable for plaintiff; decision on merits	Hilton v. First Union Corp.	Dismissal of complaint
10	Unfavorable for plaintiff; decision on merits	Phillips v. LCI Int'l, Inc.	Dismissal of complaint
11	Unfavorable for plaintiff; decision on merits	Longman v. Food Lion, Inc.	Summary judgment for defendants

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed grant of summary judgment to defendant based on lack of materiality and causation	103 F.3d 351 (4th Cir. 1996)	Dec. 31, 1996
Court of Appeals affirmed grant of summary judgment to defendants because of lack of justifiable reliance due to investor's recklessness	132 F.3d 1017 (4th Cir. 1997)	Dec. 30, 1997
Jury found interests in a vacation park did not meet the *Howey* test (328 U.S. 293 (1946)) for a security; court of appeals upheld adequacy of jury instructions	No. 96-2186, 1998 U.S. App. LEXIS 7079 (4th Cir. Apr. 8, 1998)	Apr. 8, 1998
Court of appeals affirmed dismissal on determination that no misstatement or omission existed	No. 98-1852, 1999 U.S. App. LEXIS 15426 (4th Cir. Mar. 22, 1999)	Mar. 22, 1999
Court of appeals affirmed dismissal based on lack of materiality and scienter	190 F.3d 609 (4th Cir. 1999)	Sept. 15, 1999
Court of appeals affirmed summary judgment based on immateriality of alleged disclosure deficiencies	197 F.3d 675 (4th Cir. 1999)	Oct. 7, 1999

	General Outcome	Case Name	Fed. Sec. Disposition
12	Unfavorable for plaintiff; decision on merits	Krim v. Coastal Physician Group, Inc.	Dismissal of complaint
13	Unfavorable for plaintiff on procedural grounds	Gen. Conf. Corp. of Seventh Day Adventists v. Namer	Reversed summary judgment for plaintiff on procedural grounds (lack of notice to defendant)
14	Unfavorable for plaintiff; decision on merits	Dellastatious v. Williams	Summary judgment for defendants
15	Unfavorable for plaintiff; decision on merits	Migdal v. Rowe Price-Fleming Int'l, Inc.	Dismissal of complaint
16	Unfavorable for plaintiff; decision on merits	Moseman v. Van Leer	Summary judgment for defendants
17	Unfavorable for plaintiff; decision on merits	Marsh Group v. Prime Retail, Inc.	Dismissal of complaint

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed dismissal based on immateriality of alleged disclosure deficiencies	No. 98,2361, 1999 WL 1008975 (4th Cir. Nov. 8, 1999)	Nov. 8, 1999
District court granted summary judgment for plaintiff, but court of appeals reversed and remanded for lack of notice provided to defendant	No. 9-2461, 2000 WL 543042 (4th Cir. May 4, 2000)	May 4, 2000
Court of appeals affirmed summary judgment on claims for control person liability under § 20(a) of Exchange Act with holding that defendant directors acted in good faith	242 F.3d 191 (4th Cir. 2001)	Feb. 22, 2001
Court of appeals affirmed dismissal of suit against investment advisers under § 36(b) of the Investment Company Act ("ICA"), because plaintiffs failed to establish that fees were excessive or that fund directors were "interested" under the ICA	248 F.3d 321 (4th Cir. 2001)	May 1, 2001
Court of appeals held that plaintiffs were bound by signed release of claims based on reasonable inquiry standard	263 F.3d 129 (4th Cir. 2001)	Aug. 27, 2001
Court of appeals affirmed dismissal based on immateriality of alleged disclosure deficiencies	No. 01-2500, 2002 U.S. App. LEXIS 17987 (4th Cir. Aug. 30, 2002)	Aug. 30, 2002

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
18	Unfavorable for plaintiff; decision on merits	Svezzese v. Duratek, Inc.	Dismissal of complaint
19	Unfavorable for plaintiff; decision on merits	Cohen v. USEC, Inc.	Dismissal of complaint
20	Mixed outcome	Hayes v. Crown Central Petroleum Corp.	Affirmed dismissal of complaint in part; vacated and remanded in part
21	Unfavorable for plaintiff; decision on merits	Robinson v. Glynn	Summary judgment for defendants
22	Unfavorable for plaintiff; decision on merits	Mueller v. Thomas	Dismissal of complaint
23	Unfavorable for plaintiff; decision on merits	Ottmann v. Hanger Orthopedic Group, Inc.	Dismissal of complaint

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed dismissal for failure to allege facts giving rise to "strong inference" of scienter	No. 02-1587, 2003 U.S. App. LEXIS 11647 (4th Cir. June 12, 2003)	June 12, 2003
Court of appeals affirmed dismissal because statute of limitations had run; remanded for FRCP Rule 11 sanctions findings	No. 02-1459, 2003 U.S. App. LEXIS 14546 (4th Cir. July 21, 2003)	July 21, 2003
Court of appeals affirmed dismissal of certain Exchange Act § 14(a) claims based on lack of materiality; vacated and remanded for district court consideration whether other statements contained in proxy statement were materially false and misleading under § 14(a)	No. 02-2190, 2003 U.S. App. LEXIS 21060 (4th Cir. Oct. 17, 2003)	Oct. 17, 2003
Limited liability company interests at issue held not to be securities within confines of Exchange Act	349 F.3d 166 (4th Cir. 2003)	Nov. 13, 2003
Court of appeals affirmed dismissal due to plaintiffs' lack of justifiable reliance and failure to allege duty to disclose, thereby rendering both the alleged misrepresentations and omissions not actionable	No. 02-2091, 2003 U.S. App. LEXIS 25792 (4th Cir. Dec. 19, 2003)	Dec. 19, 2003
Court of appeals affirmed dismissal for failure to establish requisite "strong inference" of scienter	353 F.3d 338 (4th Cir. 2003)	Dec. 22, 2003

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
24	Unfavorable for plaintiff; decision on merits	Poth v. Russey	Summary judgment for defendants
25	Favorable for plaintiff but with zero recovery	Miller v. Asensio & Co., Inc.	Affirmed jury verdict finding liability but zero damages
26	Unfavorable for plaintiff based on class certification issues	Gariety v. Grant Thornton LLP	Remand for further consideration on class certification
27	Unfavorable for plaintiff; decision on merits	Jarmuth v. Charles Schwab and Co.	Summary judgment for defendant
28	Unfavorable for plaintiff; decision on merits	Keeney v. Larkin	Dismissal of complaint
29	Unfavorable for plaintiff; decision on merits	Nolte v. Capital One Fin. Corp.	Dismissal of complaint

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed summary judgment because plaintiff failed to establish falsity of alleged written misrepresentations and could not reasonably rely upon alleged oral misrepresentations	No. 03-1308, 2004 U.S. App. LEXIS 5861 (4th Cir. Mar. 30, 2004)	Mar. 30, 2004
Court of appeals affirmed jury verdict finding § 10(b) liability but awarding zero damages; declined to remand for new trial on damages	364 F.3d 223 (4th Cir. 2004)	Apr. 14, 2004
Court of appeals reversed and remanded to district court for further consideration of class certification; plaintiffs filed amended consolidated complaint; majority of claims were settled or dismissed (see Gariety v. Thornton, 2006 U.S. Dist. LEXIS 31296 (S.D. W. Va. Apr. 3, 2006))	368 F.3d 356 (4th Cir. 2004)	May 12, 2004
Court of appeals affirmed grant of summary judgment under § 10(b)	No. 04-1394, 2004 U.S. App. LEXIS 11810 (4th Cir. June 16, 2004)	June 16, 2004
Court of appeals affirmed dismissal due to lack of materiality and failure to adequately plead scienter	No. 03-2127, 2004 U.S. App. LEXIS 14952 (4th Cir. July 20, 2004)	July 20, 2004
Court of appeals affirmed dismissal of suit based failure to plead falsity of alleged misrepresentations with sufficient particularity	390 F.3d 311 (4th Cir. 2004)	Dec. 2, 2004

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
30	Unfavorable for plaintiff; decision on merits	Greenhouse v. MCG Capital Corp.	Dismissal of complaint
31	Unfavorable for plaintiff; decision on merits	*In re* PEC Solutions, Inc. Securities Litigation	Dismissal of complaint
32	Unfavorable for plaintiff on procedural grounds	Glaser v. Enzo Biochem, Inc.	Dismissal of complaint (of federal securities claims)
33	Unfavorable for plaintiff on procedural grounds	Hayes v. Crown Cent. L.L.C.	Denial of leave to file late appeal
34	Unfavorable for plaintiff based on class certification issues	Gregory v. Finova Capital Corp.	Denial of class certification
35	Unfavorable for plaintiff; decision on merits	Teachers' Ret. Sys. of La. v. Hunter	Dismissal of complaint

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals affirmed dismissal because alleged disclosure deficiencies were held to be immaterial	392 F.3d 650 (4th Cir. 2004)	Dec. 21, 2004
Court of appeals upheld dismissal based on failure to plead scienter adequately	418 F.3d 379 (4th Cir. 2005)	Mar. 18, 2005
Court of appeals affirmed dismissal of federal securities fraud claims based on running of statute of limitations, but reversed on dismissal of state common law fraud claim	No. 03-2188, 2005 U.S.App. LEXIS 4598 (4th Cir. Mar. 21, 2005)	Mar. 21, 2005
Court of appeals denied appeal of dismissal of federal securities suit because plaintiffs failed to file a timely notice of appeal or obtain an extension	No. 04-1425, No. 04-1505, No. 04-1709, 2005 U.S. App. LEXIS 8280 (4th Cir. May 11, 2005)	May 11, 2005
Court of appeals reversed class certification of suit under §§ 11 and 15 of the Securities Act	442 F.3d 188 (4th Cir. 2006)	Mar. 14, 2006
Court of appeals held that plaintiffs plead only general market risks instead of particularized fraud and failed adequately to allege loss causation	477 F.3d 162 (4th Cir. 2007)	Feb. 20, 2007

	General Outcome	*Case Name*	*Fed. Sec. Disposition*
36	Unfavorable for plaintiff; decision on merits	Cozzarelli v. Inspire Pharm., Inc.	Dismissal of complaint
37	Unfavorable for plaintiff; decision on merits	Pub. Employees' Ret. Ass'n of Colo. v. Deloitte & Touche, LLP	Dismissal of complaint

Summary (Fed. Sec. Claims)	*Citation*	*Date Decided*
Court of appeals upheld dismissal with prejudice of suit for alleged violations of §§ 10(b), 20(a), and 20A of the Exchange Act and §§ 11, 12(a)(2), and 15 of the Securities Act based on *Tellabs* standard and failure to plead with specificity under FRCP 9(b)	549 F.3d 618 (4th Cir. 2008)	Dec. 12, 2008
Court of Appeals affirmed dismissal for failure to establish requisite "strong inference" of scienter	551 F.3d 305 (4th Cir. 2009)	Jan. 5, 2009