HURDLES OF DIFFERENT HEIGHTS FOR SECURITIES FRAUD LITIGANTS OF DIFFERENT TYPES

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

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

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

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

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I. INTRODUCTION

In the wake of the 2008 financial crisis, investors who suffered losses did what investors often do—they filed lawsuits. Many were shareholder class action suits alleging that companies failed to disclose the scale of their potential exposure to losses caused by falling real estate prices[1] and rising rates of borrower delinquency.[2] However, many were

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

2 Rates of delinquency on home loans–the number of loans on which borrowers are at least one payment past due–increased through the recession that followed the financial crisis of 2008, then slowly started to decline two years later, as reflected in data released by the Mortgage Bankers Association. *See* Press Release, Mortgage Bankers Association, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey (Sept. 5, 2008) (on file with author), *available at* http://www.mba.org/NewsandMedia/PressCenter/64769.htm; Press Release, Mortgage Bankers Association, Delinquencies Continue to Climb in Latest MBA National Delinquency Survey (Nov. 19, 2009) (on file with author), *available at* http://www.mba.org/NewsandMedia/PressCenter/71112.htm; Press Release, Mortgage Bankers Association, Delinquencies and Loans in Foreclosure Decrease, but Foreclosure Starts Rise in Latest MBA National Delinquency Survey (Nov. 18, 2010) (on file with author), *available at* http://www.mba.org/NewsandMedia/PressCenter/74733.htm.

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

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

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

[4] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012).

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

[6] This includes shares or preferred shares—a public company may sell securities through a private placement, too.

[7] The Securities and Exchange Commission ("SEC") has released new rules governing private offerings, permitting general solicitation of investors. *See* Eliminating the Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, 78 Fed. Reg. 44,771 (July 10, 2013). While such

draw on transaction-specific information that is more detailed and relevant than disclosures in an annual report, for example. That more specific information demonstrates, at a minimum, a defendant seller's interest in persuading the plaintiff to invest.[8] This Article contends that this information disparity puts the second plaintiff in a better position to provide a sufficiently persuasive story to satisfy the pleading requirements applicable to claims under section 10(b). The hurdle for an investor who bought on an exchange or in an IPO is too high, while the hurdle for the investor who bought through a private placement is too low. Overall, the disparity is one more way that the law creates an incentive to use private placements.

The difference in treatment of claims arising from different types of transactions is a symptom of a larger problem, that of financial markets outpacing their legal and regulatory framework. Congress was concerned with protecting public company shareholders when it adopted the antifraud provisions of the Exchange Act.[9] Lawmakers did not offer a rationale for discriminating against investors who buy shares of companies through transactions accessible to the investing public compared to investors in private

solicitation is now permitted, participation in the private placement is still restricted to accredited and/or sophisticated investors.

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

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

placements.[10] Subsequent legislative action that hinders shareholder lawsuits is the result of advocacy for restrictions that protect public companies from potentially costly litigation.

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

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

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

12 *See infra* Part II.B.

13 *See* Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption*, 1, 3 (Feb. 2012),

Litigation between buyers and sellers in private placements has received less scholarly attention than shareholder class actions; post-private placement litigation clearly benefits the successful plaintiff but less obviously helps anyone else.[14] This Article proposes an overhaul of pleading standards applicable to fraud claims to ease the path to recovery for plaintiffs with less pre-transaction access to information and to make more precise the pleading requirements that investors with relatively greater access to information must meet. This Article is a building block in a larger project exploring the implications of the evolution of the financial markets, a topic approached from different angles by scholars including Steven L. Schwarcz,[15] Steven Davidoff,[16] Usha Rodrigues,[17] and Elizabeth Pollman,[18]

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

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

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

16 *See, e.g.*, Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 340 (2008) (describing changes in capital markets as a result of growth of private exchanges, growing role of institutional investors and rapid innovation, and identifying failures of federal securities regulation to keep pace).

17 Professor Rodrigues has cited the growth in exempt transactions in calling for greater access by retail investors to private placements. *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3417–23 (2013).

18 Professor Pollman has raised a host of difficult questions about the implications of secondary markets for trading of shares of privately held companies, another financial market innovation that poses a challenge to the existing law and regulation of securities. *See* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 206 (2012).

among others. It also attempts to evaluate how well current legal and regulatory mechanisms protect investors and enhance stability for the identification of potential securities fraud. The Article links these conversations within securities law and conversations outside of securities law involving access to justice and raises questions about who is best placed to prevent, or at least detect, fraud. In a future article, I intend to examine the role that the regime for classification of accredited investors may have played in the financial crisis and propose reforms.

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

Part III describes the pleading standards that fraud claims under the Exchange Act must meet in order to survive a motion to dismiss. Because these cases do not often go to trial,[19] resolutions of motions to dismiss matter, and defeating such a motion preserves the possibility of damages, while a loss precludes recovery. This Part identifies the elements of a fraud pleading that often prove critical to surviving a motion to dismiss. The description of the elements of a securities fraud claim and of the evolution of the applicable pleading regime is a significant contribution of this Article.

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

19 *See* S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688.

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

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

II. THE ROLE OF PRIVATE SECURITIES LITIGATION

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

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

[21] Then-Justice William Rehnquist described private securities litigation under section 10(b) as a "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores,