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The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit's Interpretation of Materiality in Employer-Teamster v. America West

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The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit's Interpretation of Materiality in *Employer-Teamster v. America West*

I. INTRODUCTION

In the wake of Enron and other recent corporate scandals, the Bush administration and Congress acted swiftly to protect investors and punish corporate fraud with more severity than ever before.[1] Interestingly, President Bush and Congress do not appear to be alone in the crackdown on corporate fraud. The recent string of corporate collapses has also prompted state and federal courts to reevaluate their positions on securities fraud litigation.[2] On February 13, 2003, the Ninth Circuit Court of Appeals in *Employer-Teamster Joint Council v. America West Airlines* arguably joined the crackdown on corporate fraud by refusing to apply the Third Circuit's bright-line rule[3] that a misrepresentation or omission under section 10b-5 of the Securities Exchange Act is immaterial as a matter of law if the market does not immediately react upon disclosure of the misrepresented or omitted fact. In denying defendants' motion to dismiss under the heightened pleading requirements of the Private Securities Litigation Reform Act

1. Most prominently, Congress and the Bush administration enacted the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, which enhanced financial disclosure requirements, auditing standards, and criminal penalties for several forms of white-collar crime. For a discussion of other recent legal developments, see, for example, Joseph Conahan et al., *Securities Fraud*, 40 AM. CRIM. L. REV. 1041, 1103–07 (2003); Tower C. Snow, Jr., et al., *Securities Litigation: Planning and Strategies—The Time Is Now!, Defending Securities Class Actions*, 83 A.L.I.-A.B.A. 177, 191 (2003).

2. *See, e.g.*, John C. Coffee Jr., *Post-Enron Jurisprudence*, N.Y. L.J., July 17, 2003, at 5, *available at* http://www.law.columbia.edu/media_inquiries/news/july_2003/coffee_nyljjuly (noting the recent string of cases in Delaware and throughout the nation in which courts have ignored "once settled rules limiting litigation" by allowing certain derivative actions to proceed and reinstating once-dismissed cases).

3. *In re* Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1425 (3d Cir. 1997) (holding that stockholder plaintiffs failed to state a claim under Federal Rule of Civil Procedure 12(b)(6) because defendant corporation's disclosure of allegedly misrepresented information did not affect the price of the corporation's stock on the date of disclosure). The Third Circuit Court of Appeals reasoned that "[i]n the context of an 'efficient' market, the concept of materiality translates into information that alters the price of [a] firm's stock." *Id*.

(PSLRA),[4] the Ninth Circuit invoked the following rationale: "In this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious not to raise the bar of the PSLRA any higher than that which is required under its mandates."[5]

The majority's post-Enron rationale did not go unchallenged. In dissent, Judge Tallman noted, "There is no doubt in this post-Enron era suspicions have been raised regarding corporate malfeasance and insider trading. But the law is the law. Under the Reform Act, the burden to plead facts with particularity establishing the required element of materiality remains squarely on plaintiffs."[6] Judge Tallman concluded that "[t]he market's collective yawn to the allegedly material news [was] fatal to plaintiffs' ability to successfully establish the reliance element of their cause of action" and is "contrary to what the Supreme Court and our sister circuits have said in similar cases."[7]

The Ninth Circuit's decision to reject the Third Circuit's bright-line rule was particularly surprising given the fact that the Ninth Circuit has arguably been one of the most corporate-friendly forums in the federal circuit since enactment of the PSLRA.[8] Consequently, by its own admission,[9] the Ninth Circuit's refusal to adopt the Third Circuit's bright-line rule can reasonably be attributed to the seismic shift in the political and economic landscape following the Enron collapse. Despite the Ninth Circuit's admission[10] that it was influenced by factors extraneous to the pleading requirements established by the PSLRA and Rule 10b-5, this Note argues that the

4. 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, 77z-2, 78u-4, 78u-5 (2000)).

5. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 946 (9th Cir. 2003), *cert. denied*, 124 S. Ct. 433 (2003). For a discussion of the facts and procedural history of *America West*, see *infra* Part III.

6. *America West*, 320 F.3d at 951 (Tallman, J., dissenting).

7. *Id.* at 947 (Tallman, J., dissenting).

8. RICHARD PAINTER ET AL., PRIVATE SECURITIES LITIGATION REFORM ACT: A POST-ENRON ANALYSIS 6, *at* http://www.fed-soc.org/pdf/PSLRAFINALII.pdf. (last visited Mar. 8, 2004). Authors Painter, Farrell, and Adkins point out that some commentators have argued that the Ninth Circuit's 1999 decision in *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999) (holding that "deliberate recklessness" must be established to meet the PSLRA pleading standards for scienter), actually deterred more securities litigation claims than the PSLRA itself. *Id.* at 6.

9. *See supra* text accompanying note 5.

10. *See supra* text accompanying note 5.

Ninth Circuit Court of Appeals reached the correct legal conclusion—neither the PSLRA nor Rule 10b-5 endorse the Third Circuit's bright-line test that a misrepresentation or omission is immaterial if the market fails to react immediately upon disclosure of the misrepresented or omitted fact. While Congress certainly intended the PSLRA to deter frivolous securities fraud claims, it did not intend to fetter plaintiffs with an impossibly strict standard of materiality, nor did it intend to create an absolute safe harbor for corporate officials to make fraudulent representations. This Note concludes that the PSLRA should remain good law, but Congress, the Supreme Court, or both should intervene to resolve the confusion that has arisen as courts have struggled—as did the Ninth Circuit in *America West*—to interpret and apply the PSLRA pleading standards.[11] Most importantly, Congress or the Supreme Court should identify the impact, if any, the PSLRA had on the standards of materiality and reliance that were adopted by the Supreme Court in *Basic Inc. v. Levinson*. Likewise, Congress or the Supreme Court should define the contours of the fraud-on-the-market theory in litigating claims under the PSLRA. Indeed, much of the disagreement and confusion surrounding cases like *America West* has arisen because Congress failed to even address the materiality and reliance elements in the text of the PSLRA.

This Note begins in Part II with a brief discussion and background of the 1934 Act and the PSLRA, paying particular attention to the development of the fraud-on-the-market theory under the 1934 Act and the PSLRA. Part III provides the factual and procedural background of *America West*. Part IV advances two primary arguments: (1) the Ninth Circuit properly rejected the Third Circuit's bright-line rule that a misrepresentation or omission is immaterial as a matter of law if the market fails to immediately react upon disclosure of the alleged misrepresentation or omission, and (2) the PSLRA should survive the post-Enron era, but the status of the fraud-on-the-market theory and, most importantly, the

11. This Note concludes that the PSLRA as a whole has had a beneficial impact on securities litigation; nonetheless, this Note deliberately restricts its focus to the PSLRA's heightened pleading requirements, most notably, the absence of any requirements for pleading materiality and reliance under the PSLRA. This Note does not address the mélange of other issues that have arisen since enactment of the PSLRA, including the controversies surrounding the PSLRA's provisions for accounting fraud, standards for falsity and scienter, safe harbors for "forward-looking" statements, limitations on damages, and appointments of lead plaintiffs and lead counsel.

appropriate standard of materiality under the PSLRA should be clarified through legislative decree or judicial interpretation. Part V offers a brief conclusion.

II. BACKGROUND

To understand the issues presented in *America West*, it is essential to understand some legal and historical background concerning the Securities Exchange Act of 1934 and the PSLRA, especially the development of the fraud-on-the-market theory and the development of the standards of materiality and reliance for pleading securities fraud under each of the two acts.

A. The Securities Exchange Act of 1934

1. Background

The Securities Exchange Act of 1934 ("1934 Act") is a comprehensive federal body of securities law that was designed primarily to protect investors against the manipulation of stock prices by fraudulent corporate practices.[12] The adoption of a *federal* body of securities law was arguably produced out of necessity following the 1929 stock market crash and the subsequent economic instability that plagued the United States during the 1930s.[13] When President Roosevelt addressed Congress in March 1933 with plans for extensive economic legislation, he argued that federal supervision of the securities market was necessary to ensure "'full publicity and information, and that no essentially important element attending the

12. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a–78mm (2000)); *see, e.g.*, Jeffrey L. Oldham, Comment, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 1001 (2003).

13. Elisabeth Keller & Gregory A. Gehlmann, Comment, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 338 (1988). Keller and Gehlmann point out that "[t]he minimal impact of the [state] blue sky laws and the failure of the states to adopt uniform laws clearly led to a demand for federal legislation." *Id.* at 336; *see also* Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1132 (1987) ("'The wild unorganized accounting of the 1920's frequently accepted purported values as the basis for security issues, and the result was widespread frauds, deception of investors and losses.'" (quoting Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1188 (1970))).

issue shall be concealed from the buying public.'"[14] The Supreme Court in *Basic Inc. v. Levinson* aptly described the underlying rationale for the adoption of extensive disclosure requirements: "'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.'"[15]

The core of the 1934 Act's antifraud provisions are located in section 10(b).[16] Remarkably, the bulk of the 1934 Act has suffered relatively few changes since its enactment. In fact, most of the development of securities law has been left to the Securities and Exchange Commission and the courts.[17] Pursuant to its authority under section 10(b),[18] the SEC promulgated Rule 10b-5,[19] which (as the Supreme Court later concluded)[20] provides a private cause of action against perpetrators of securities fraud and insider trading. In relevant part, Rule 10b-5 reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> . . . .
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .
>
> . . . .
>
> in connection with the purchase or sale of any security.[21]

Despite its relatively simple formulation, Rule 10b-5 litigation has developed into a complex body of case law.[22] In response to a lack of guidance from statutory language or legislative history, federal courts have been forced to rely on common-law tort

14. Keller & Gehlmann, *supra* note 13, at 338 (quoting Franklin D. Roosevelt, address to Congress (March 1933), *reprinted in* M. PARRINO, TRUTH IN SECURITIES 23 (1968)).

15. 485 U.S. 224, 230 (1988) (quoting H.R. REP. NO. 73-1383, at 11 (1934)).

16. Oldham, *supra* note 12, at 1001.

17. 15 U.S.C. § 78j(b)(2000); Keller & Gehlmann, *supra* note 13, at 352.

18. 15 U.S.C. § 78j.

19. 17 C.F.R. § 240.10b-5 (2003).

20. Oldham, *supra* note 12, at 1002.

21. 17 C.F.R. § 240.10b-5.

22. Oldham, *supra* note 12, at 1003.

principles to apply Rule 10b-5.[23] Using the common law of fraud as its starting point, the federal judiciary derived "materiality, scienter, reliance, and loss causation" as the basic elements of a 10b-5 claim.[24] In combination, these elements require plaintiffs to prove reliance on a "material misstatement or omission that caused them injury, and that the defendants knowingly intended to induce their reliance."[25] Of the elements necessary to bring a section 10b-5 claim, an understanding of materiality and reliance—and their relationship to the fraud-on-the-market theory—is essential to an understanding of the controversy in *America West*.

2. The standard of materiality under the 1934 Act

The Supreme Court has addressed several positive and common-law requirements for a violation of section 10(b), including the standard of materiality applicable to securities laws.[26] Perhaps the most important Supreme Court decisions affecting the standard of materiality in securities fraud cases are *TSC Industries, Inc. v. Northway, Inc.*[27] and *Basic Inc. v. Levinson*.[28]

In *TSC Industries*, the plaintiff, a majority TSC shareholder, alleged that the corporation's proxy statement (soliciting the stockholders' approval of a transaction whereby TSC would become a wholly owned subsidiary of another corporation) was materially misleading under section 14(a) and Rule 14a-9 because it failed to disclose the extent of National's control over TSC at the time the transaction was approved by the TSC Board.[29] In holding that the omission was not material as a matter of law (in a summary judgment context),[30] the Supreme Court nevertheless stipulated that "an omitted fact is 'material' if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[31] The Court further explained that to fulfill the materiality requirement "there must be a substantial likelihood that the

23. *Id*.
24. *Id*. (footnotes omitted).
25. *Id*.
26. Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988).
27. 426 U.S. 438 (1976).
28. *Basic*, 484 U.S at 224.
29. *TSC Indus.*, 426 U.S. at 441–43.
30. *Id*. at 452.
31. *Id*. at 449.

disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[32] Although the *TSC Industries* court intended its definition of materiality solely for Rule 14a-9 contexts, federal courts that followed *TSC Industries* almost universally adopted the *TSC Industries* standard of materiality even outside the Rule 14a-9 context.[33]

Twelve years later, in *Basic Inc. v. Levinson*, the Supreme Court officially extended the *TSC Industries* standard of materiality to both the section 10(b) and Rule 10b-5 contexts.[34] In adopting the *TSC Industries* standard of materiality, the Supreme Court held that the defendant, Basic Inc., violated Rule 10b-5 when the company falsely denied that it was involved in merger negotiations with another corporation.[35] The Court acknowledged, however, that "certain information concerning corporate developments could well be of 'dubious significance.'"[36] Thus, the Court took steps to ensure that it did not "set too low a standard of materiality" out of concern that "a minimal standard might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.'"[37] Because the Court refused to set a low standard of materiality, federal judges (and corporate officials) following the *Basic* decision have often struggled to distinguish between information critical to "informed decisionmaking" and information that is merely of "dubious significance."[38] This difficulty of distinguishing between material and nonmaterial information grew even more severe following the passage of the PSLRA, especially in the context of class action lawsuits alleging securities fraud under a fraud-on-the-market theory.[39]

32. *Id.*

33. Hugh Beck, Note, *Determining the Materiality of Earnings Forecasts Under the Private Securities Litigation Reform Act in* Helwig v. Vencor, 2002 BYU L. REV. 111, 123.

34. Basic Inc. v. Levinson, 485 U.S. 224, 224 (1988).

35. *Id.* at 226–28.

36. *Id.* at 231 (quoting *TSC Indus.*, 426 U.S. at 448).

37. *Id.* (quoting *TSC Indus.*, 426 U.S. at 448–49).

38. *Id.*; *see also* Beck, *supra* note 33, at 127–28 (noting that lower courts used several different materiality tests in post-*Basic* court decisions).

39. *See, e.g.*, Herbert S. Wander & Katten Muchin Zavis Rosenman, *Securities Law Disclosure After Sarbanes-Oxley, June 2003*, 1381 P.L.I.-CORP. 11, 56–58 (Aug. 14–15, 2003) (noting the disagreement between the Third and Fifth Circuit approaches to materiality, as well as the Ninth Circuit's divergent approach in *America West*); *see also* MARTIN D.

3. Reliance and the fraud-on-the-market theory

Prior to *Basic*, Rule 10b-5 litigants were required to prove *actual* reliance on the corporate defendant's misrepresentation or omission.[40] After *Basic*, however, class action plaintiffs bringing a Rule 10b-5 claim were no longer required to prove actual reliance in cases involving securities traded on an open market.[41] In carving out this exception for plaintiffs in class action securities fraud claims, the Supreme Court recognized the "fraud-on-the-market" theory, which is sustained by the premise that the price of a security traded in an open and developed market inherently reflects any misrepresentations or omissions made by the corporation.[42] In other words, "[s]ince investors purchase or sell . . . securities in reliance upon the integrity of the market price, they indirectly rely upon . . . misrepresentation[s] because they buy or sell . . . at a price that reflects the misrepresentation[s]."[43] Accordingly, the *Basic* Court held that a corporation's misrepresentation "acts as a fraud on the entire market and that the plaintiffs' reliance on the market price indirectly suffices to establish the reliance requirement."[44]

Although the *Basic* court created a presumption of reliance for class action plaintiffs bringing securities fraud claims, the Supreme Court also recognized the potential for corporate defendants to rebut the presumption of investor reliance by "'[a]ny showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff . . . .'"[45] Despite the Court's insistence that the presumption of investor reliance can be rebutted,

CHITWOOD & NICHOLE T. BROWNING, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (PSLRA) UPDATE, *at* http://classlaw.com/CM/Articles/articles6.asp (last visited Mar. 8, 2004); Jonathan C. Dickey & Shoshanah V. Asnis, *Securities Litigation Update: Recent Developments Under the PSLRA and the Uniform Standards Act of 2003*, http://www.gdclaw.com/fstore/documents/pubs/SecLit_PSLRA.pdf (last visited May 26, 2004); Oldham, *supra* note 12, at 1015.

40. Oldham, *supra* note 12, at 995.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. Joel W. Sternman et al., *Discovery Stays, Lead Plaintiffs and the Fraud-on-the-Market Theory: Observations on the PSLRA and Recommendations for Change*, 1015 P.L.I. 295, 365 (1997) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988)).

practical experience suggests that defendants have faced a nearly impossible task in rebutting a presumption of reliance.[46]

Ultimately, the fraud-on-the-market theory can be summarized as follows:

a. A company's shares were traded on an efficient market.

b. Defendants were responsible for material misstatements concerning the company.

c. At least some investors, reading these misstatements and believing them accurately to reflect material information about the company, based significant trading decisions thereon, resulting in purchases causing an artificial inflation (or sales causing an artificial depression) in the market price of its shares.

d. Other buyers or sellers, including many putative class members, while unaware of the statements, subsequently bought or sold the company's shares and, by virtue of the artificial inflation/depression in the market price, paid more, or received less, than they would have had the statements been accurate. Under the fraud-on-the-market theory, those buyers/sellers may benefit from a presumption that, in trading, they relied on the integrity of the market to set a fair price for the shares. So long as some investors in the company were deceived in fact by the statements and, acting in actual reliance thereon, traded a quantity of shares sufficient to cause an artificial change in the market price, the fact that these putative class members never saw the statements would not, in the first instance, preclude the pursuit of their claims.

e. One way defendants may rebut the presumption of reliance is by showing that there never was an artificial change in the market price of the stock at issue, such as would be the case if trading by those investors actually relying upon and deceived by the misstatements was so minimal that it had no effect on the market price. Because trading causing an artificial change in the company's

46. *See, e.g.*, *id*. at 366–69. There have been only a few isolated cases in which federal courts have recognized a defendant's attempt to rebut a presumption of reliance, including, most notably, *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1116 (9th Cir. 1989) (holding that widespread press reports that Apple's "Lisa" computers entailed significant risks for investors were sufficient to counteract any optimistic statements made by Apple); *see also* Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975) (holding that the fraud-on-the-market theory can be rebutted "by proving that, despite materiality, an insufficient number of traders relied to inflate the price"); Sternman et al., *supra* note 45, at 365–72. Aside from these rare instances, corporate defendants have rarely prevailed in rebutting a presumption of reliance. *Id*. at 366.

> market price would not have occurred, those who did not actually rely upon the statements, but only relied on the integrity of the market, would not have suffered any actionable damage.[47]

While the Supreme Court's adoption of the fraud-on-the-market theory in *Basic* offered increased protection to investors, the Supreme Court's opinion opened the door to a great deal of confusion. As Jonathan R. Macey and Geoffrey P. Miller point out, the Court's "opinion was vague as to how the theory should be applied in future cases," and "[b]ecause the Court itself lacked a good understanding of the nature of the economic hypothesis it was purportedly adopting, its decision gives little guidance to future litigants."[48] To make matters worse, the uncertainty surrounding the proper application of the fraud-on-the-market theory following *Basic* intensified after enactment of the PSLRA.[49]

B. The PSLRA

1. Background

The Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act")[50] was enacted by Congress on December 22, 1995 over President Clinton's veto.[51] The PSLRA was motivated by

47. Sternman et al., *supra* note 45, at 377–80.

48. Jonathon P. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1077 (1990). Macey and Miller describe the Court's "incompetence" to adopt a particular market theory in the following way:

> The Court's confusion became transparent during its discussion of which version of the ECMH [Efficient Capital Markets Hypothesis] it was embracing. The majority noted that, although it was accepting the fraud-on-the-market theory as creating a rebuttable presumption of reliance in 10b-5 cases, 'we do not intend conclusively to adopt any *particular theory* of how quickly and completely publicly available information is reflected in market price.' Despite this disclaimer, the Court was adopting the semi-strong version of the efficient capital markets hypothesis, whether it was aware it was doing so or not.

Id. (emphasis added) (footnote omitted) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 n.28 (1988)).

49. *See, e.g.*, Oldham, *supra* note 12, at 1029–30. "[I]mplementation of the [fraud-on-the-market] doctrine by lower courts has been characterized by a complete lack of uniformity, both substantively and procedurally, which has led to an inconsistent and sweeping fraud-on-the-market presumption." *Id.* at 1029.

50. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77z-1, 77z-2, 78u-4, 78u-5 (2000)).

51. CHITWOOD & BROWNING, *supra* note 39 ("In his veto message, President Clinton observed that the PSLRA would 'have the effect of closing the courthouse door on investors

several perceived problems that were arguably well documented in congressional hearings and academic studies over the years leading up to its enactment.[52] Specifically, the PSLRA was intended to deter "strike suits," wherein shareholders would file meritless class action suits with the aim of pressuring corporate defendants into settling claims as an alternative to submitting to costly discovery processes.[53] Not surprisingly, enactment of the PSLRA was supported by corporate officials, accountants, and lawyers,[54] and was criticized by consumer groups, investors, and plaintiff lawyers.[55]

With the stated purpose of deterring frivolous securities fraud claims, the PSLRA heightens the pleading requirements for private litigants by requiring that a complaint plead with particularity both falsity and scienter.[56] To satisfy the PSLRA's falsity requirement, a complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[57] In order to satisfy the scienter requirement under the PSLRA, the complaint must "state with

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who have legitimate claims.'" *Id.* (citing 141 CONG. REC. H15214-06 (daily ed. Dec. 20, 1995))).

52. R. Bruce Josten, Executive Vice President of Government Affairs, United States Chamber of Commerce, *Letter to the U.S. Senate: PSLRA and the Uniform Standards Act* (Feb. 27, 2002), *at* http://www.uschamber.com/government/letters/020227s.htm.

> Those hearings and studies demonstrated that a small coterie of plaintiffs' lawyers brought suit whenever a company's stock price fell for any reason, alleging that securities fraud was responsible. To serve as their ostensible clients, the lawyers recruited professional plaintiffs who bought a few shares of many companies' stock for the sole purpose of bringing a class action suit the day after the share price declined. The lawyers would file literally the same boilerplate complaint in case after case–sometimes even forgetting to change the names of the companies listed as the defendant. The point of this exercise was to extract hefty attorneys' fees from companies that couldn't afford years of litigation over nuisance suits.

Id.

53. *See* Oldham, *supra* note 12, at 1021–22.

54. Carrie Johnson, *Fight Renewed Over Limits on Investor Suits*, WASH. POST, May 10, 2002, at E01, *available at* 2002 WL 20708365. Johnson notes that "[a]ccountants at what were then the Big Six firms lobbied aggressively for the measure, spending millions of dollars. The major accounting firms argued that they were unfairly targeted in shareholder lawsuits because of their deep pockets. Leaders of Arthur Andersen were so pleased with their efforts they encased the text of the new law in a paperweight and handed it out as a souvenir." *Id.*

55. *Id.*

56. 15 U.S.C. § 78u-4(b)(1) & (2) (2000).

57. *Id.* § 78u-4(b)(1).

particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[58] Finally, if the complaint fails to satisfy both the falsity and scienter requirements, the PSLRA provides that "the court shall, on the motion of any defendant, dismiss the complaint . . . ."[59]

2. The standard of materiality under the PSLRA

The standard of materiality in fraud-on-the-market actions was left undisturbed by the drafters of the PSLRA.[60] Consequently, federal courts should be bound to apply the same standard of materiality[61] established by the Supreme Court in *TSC Industries* and *Basic*. Nevertheless, federal courts have produced inconsistent outcomes using the *TSC-Basic* framework, likely because it is generally accepted that the PSLRA was intended to heighten the pleading standards under the 1934 Act.[62] In fact, the uncertainty surrounding the proper standard of materiality under the PSLRA arguably contributed to the disagreement between the majority and dissenting opinions in *America West*, as the Ninth Circuit judges were forced to reconcile the policy rationale that invigorates the PSLRA (the need to protect corporations from the costs of strike suits) with the policy rationale advanced in *Basic* (the need to protect investors in class actions from the costs of proving actual reliance).

58. *Id.* § 78u-4(b)(2).

59. *Id.* § 78u-4(b)(3)(A).

60. Beck, *supra* note 33, at 112 ("[T]he PSLRA does not express an explicit preference for the standard endorsed in *Basic* or for any of the bright-line materiality tests . . . ."); *see also*, Oldham, *supra* note 12, at 998 ("Congress did not speak directly to the fraud-on-the-market presumption in the PSLRA."); Nathaniel Carden, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 899 (1998) ("Congress rejected a version of the securities litigation reform proposals that would have entirely eliminated fraud-on-the-market actions.").

61. *See supra* text accompanying notes 26–39; *see also, e.g.*, Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000); No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 946 (9th Cir. 2003), *cert. denied*, 124 S. Ct. 433 (2003) (both applying the *TSC Industries* and *Basic* standards of materiality to securities fraud claims facing motions to dismiss under the heightened pleading standards of the PSLRA).

62. *Oldham*, *supra* note 12, at 1026 ("[T]he PSLRA and its animating policies carry important implications for the type of fraud-on-the-market presumption implemented by lower federal courts.").

3. Reliance and the fraud-on-the-market theory under the PSLRA

Like the standard of materiality, the standard of reliance and the fraud-on-the-market theory endorsed by the *Basic* court were not affected by enactment of the PSLRA, despite the fact that "[e]arly versions of the PSLRA would have eliminated the use of the 'fraud on the market' theory adopted by the Supreme Court in [*Basic*]."[63] Nevertheless, the PSLRA has affected the fraud-on-the-market theory—whether intentionally or not—in three unique ways:

> First, it reinvigorates the loss-causation element as a requirement for plaintiffs, which may be at odds with *Basic*'s double presumption of the loss-causation trigger and reliance. Second, the PSLRA's damages provision and its underlying policies evidence a rejection of the efficient market theory as a descriptive theory of the marketplace. Third, the PSLRA's conservative, pragmatic policies demonstrate Congress's desire to reduce the amount of meritless securities litigation, an aim that is inconsistent with a sweeping presumption that facilitates more litigation without any relation to the merits of a claim, as found in *Basic*.[64]

As a result, courts must continue to address the "amorphous implications" of *Basic* "without any statutory guidelines"[65] at the same time that they must apply a Reform Act with the stated purpose of deterring securities fraud claims at the earliest possible litigation stage. Again, this confusion likely led to the misunderstanding and disagreement between the majority and dissenting opinions in *America West*.

III. *EMPLOYER-TEAMSTER V. AMERICA WEST*

A. Factual Background

From 1995 to 1997, the defendant ("America West") received various warnings that its maintenance practices violated FAA standards.[66] Despite its maintenance problems, America West assured investors that its "maintenance issues were being addressed" and that

63. Sternman et al., *supra* note 45, at 361 (citation omitted).

64. Oldham, *supra* note 12, at 998.

65. Sternam et al., *supra* note 45, at 361–62; *see also supra* notes 55–56 and accompanying text.

66. *America West*, 320 F.3d at 926.

"fixes [were] in place."[67] During this same period of time, America West insiders allegedly colluded to raise the price of America West stock by May 20, 1998—the date on which they could sell their stock to the public under the stockholder's agreement.[68] To effectuate its plan to raise the price of its stock, America West allegedly made false statements about the company's outlook and misinformed analysts that its operational problems had been fixed by claiming that its improved profits were the result of "exceptionally efficient management," rather than unsafe maintenance practices and underreported maintenance costs.[69] By April 1998, the value of America West's stock had climbed to $31-5/16, at which time several "high ranking . . . 'insiders'" began selling millions in America West stock.[70]

In July 1998, following the announcement of a settlement with the FAA for violations of FAA maintenance regulations, America West's stock began to decline in value.[71] By September 1998, analysts predicted huge shortfalls for America West during the third and fourth quarters of 1998.[72] Around the same time, DLJ Securities reported that the "cause of America West's earnings deficiencies appeared to be '100% operational' and that these problems were the result of ongoing labor issues and 'a far more smothering presence of the [FAA] on the "property" than we had understood.'"[73] DLJ's report also noted its disturbance with the fact that America West's operational problems were "reminiscent of operationally-related earnings shortfalls in 1996," and that it had "'no inkling from the company of the problems . . . .'"[74] The stock eventually fell to a low of $9-5/8 in early October 1998.[75]

67. *Id*. at 927 (quoting Richard R. Goodmanson, then President and CEO of America West).

68. *Id*. at 927–28.

69. *Id*.

70. *Id*. at 928.

71. *Id*. at 928–30.

72. *Id*. at 930.

73. *Id*.

74. *Id*. (omission in original).

75. *Id*.

B. Procedural History

Investors filed a securities fraud class action on behalf of all individuals who had purchased America West Class B common stock during the class period.[76] Investors alleged that America West had violated Rule 10b-5 as well as sections 10(b) and 20(a) of the 1934 Act.[77]

In October 2000, the district court dismissed Investors' case with leave to amend for failure to state a claim under the heightened pleading requirement contained in the PSLRA.[78] The district court cited two particular failures: "(1) plaintiffs had failed to sufficiently support their allegations of false and misleading statements with great detail and all relevant circumstances; and (2) plaintiffs had failed to state with particularity facts that gave rise to a strong inference of deliberate recklessness or actual intent."[79]

In June 2001, five months after Investors had filed their second amended complaint, the district court dismissed Investors' complaint "with prejudice for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) and failure to meet the heightened pleading requirements of the PLSRA."[80] Investors promptly appealed the district court's decision in the Ninth Circuit Court of Appeals.[81]

C. The Ninth Circuit Court of Appeals' Holding

The court of appeals reversed the district court's dismissal. The majority rejected the district court's conclusion that Investors had failed to plead facts sufficient to "raise a strong inference that Defendants made false or misleading statements with actual knowledge or deliberate recklessness" in violation of section 10(b) and Rule 10b-5.[82] Most importantly, the court of appeals rejected the district court's adoption of the Third Circuit's bright-line rule that alleged misrepresentations are "immaterial as a matter of law" whenever the "market does not react immediately upon disclosure of

76. *Id*. at 924.
77. *Id*. at 930.
78. *Id*.
79. *Id*.
80. *Id*. at 930–31.
81. *Id*. at 931.
82. *Id*. at 946.

the misrepresented information."[83] In declining to adopt the Third Circuit's bright-line rule, the court of appeals reasoned that "adoption of such a rule would contravene" the framework established by the Supreme Court in *Basic* and *TSC Industries*.[84]

After declining to adopt the Third Circuit's bright-line rule, the majority proceeded to the facts alleged by Investors and concluded that plaintiffs had "sufficiently pleaded the materiality of America West's misrepresentations regarding its maintenance issues, the FAA investigation, and the FAA settlement agreement."[85] The court of appeals determined that "[a] reasonable investor would find significant the information regarding a company's deferred maintenance costs, unsafe maintenance practices, and possible sanction."[86] Likewise, the court of appeals concluded that "a reasonable investor would consider the potential effects of each of these facts on the overall economic health of the company as "'significantly alter[ing] the 'total mix' of information made available.'"[87] Most importantly, the court of appeals noted that "although America West's . . . disclosures had no immediate effect on the market price, its stock price dropped 31% on September 3, 1998 when the full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed to the market."[88]

In dissent, Judge Tallman concluded that the absence of an immediate market reaction to the allegedly material news was "fatal to plaintiffs' ability to successfully establish the reliance element of their cause of action under a 'fraud-on-the-market' theory."[89] Judge Tallman argued that the majority's refusal to adopt the Third Circuit's bright-line rule was "contrary to what the Supreme Court

83. *Id.* at 934.

84. *Id.*

85. *Id.* at 935.

86. *Id.*

87. *Id.* (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (alteration in original).

88. *Id.* The court of appeals also noted that "[t]his reaction, even if slightly delayed, further supports a finding of materiality. This is particularly true because Plaintiffs offer a reason for the delay, i.e., America West continued to reassure analysts that the settlement agreement and compliance therewith would not have noticeable economic effects on the company." *Id.*

89. *Id.* at 947 (Tallman, J., dissenting).

and our sister circuits have said in similar cases."[90] Judge Tallman thus issued the following disagreement with the majority's decision:

> While we are required to draw all inferences in favor of plaintiffs for purposes of a motion to dismiss, under the Reform Act the burden remains on the plaintiffs to plead with specificity the facts showing a materially misleading statement. The plaintiffs here have not alleged with specificity facts that would support the inferences the plaintiffs ask us to draw.
>
> What the plaintiffs fail to show is any causal connection between the FAA investigation and fine and the poor third-quarter performance. . . .[91]
>
> . . . .
>
> . . . Since these questions are left unanswered by the complaint, we cannot under the Reform Act simply give the plaintiffs the benefit of the doubt and view the market's reaction in September as indicative of the materiality of the misleading statements regarding the FAA investigation and settlement.[92]

Despite Judge Tallman's heavy reliance on the precedent established by the Third Circuit, the following section of this Note argues that, as a matter of both legal precedent and policy, the majority reached the correct decision. The district court wrongfully dismissed Investors' claim by basing its decision on the mere fact that the market did not react immediately upon disclosure of America West's misrepresentations.

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90. *Id*. "The Third Circuit has held that in an efficient market, the concept of materiality 'translates into information that alters the price of the firm's stock.'" *Id*. (quoting *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997)). Also, "[t]he Third Circuit observed that since 'efficient markets are those in which information important to reasonable investors . . . is immediately incorporated into stock prices,' information not important to reasonable investors 'will have a negligible effect on the stock price.'" *Id*. (quoting *In re Burlington*, 114 F.3d at 1425, and citing Oran v. Stafford, 226 F.3d 275, 282 (3d Cir. 2000) ("[W]hen a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock.")).

91. *Id*. at 950 (Tallman, J., dissenting).

92. *Id*. (Tallman, J., dissenting) (citation omitted).

IV. ANALYSIS: THE NINTH CIRCUIT PROPERLY REJECTED THE THIRD CIRCUIT'S BRIGHT-LINE RULE BUT FAILED TO ARTICULATE THE APPROPRIATE RATIONALE FOR ITS DECISION

This Part analyzes the two issues that are central or relevant to the principal case: (1) whether the Ninth Circuit properly rejected the Third Circuit's bright-line rule that, in order for a misrepresentation or omission to be material, the securities market must immediately react upon disclosure of the misrepresented or omitted fact; and (2) whether the PSLRA should be modified or repealed in light of the recent outbreak of securities fraud. Part IV.A discusses the legal and policy reasons why the Ninth Circuit properly rejected the Third Circuit's bright-line rule—despite inappropriately adopting its post-Enron rationale. Part IV.B argues that *America West* reflects a trend among federal courts to interpret the PSLRA according to fluctuations in economic and political conditions, rather than the language of the PSLRA itself. It concludes that the PSLRA is a necessary step to achieve litigation reform, but the pleading requirements outlined in the PSLRA should be revised by Congress or, at the very least, interpreted by the Supreme Court in order to resolve the circuit splits that have arisen and will continue to arise if federal courts are left unguided in their interpretation and application of the PSLRA.

A. A Misrepresentation or Omission Should Not Be Deemed Immaterial as a Matter of Law Merely Because the Market Fails To Immediately React upon Disclosure

The court of appeals properly rejected the Third Circuit's bright-line rule that an omission or misrepresentation is immaterial as a matter of law if the market fails to immediately react upon disclosure.[93] The majority reasoned that adoption of such a per se

93. *See Oran*, 226 F.3d at 282. In its discussion of materiality, the Third Circuit Court of Appeals invoked a bright-line rule it had fashioned three years earlier in *In re Burlington Coat Factory Securities Litigation*:

> [I]n an open and developed securities market like the New York Stock Exchange, the price of a company's stock is determined by all available material information regarding the company and its business. In such an efficient market, "information important to reasonable investors . . . is immediately incorporated into the stock price." As a result, when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock. Because in an efficient market "the concept of materiality translates into information that

rule would contravene the Supreme Court's holding in *Basic*,[94] which "expressly adopted the 'reasonable investor' standard set forth in *TSC Industries* for determining materiality in the Section 10(b) and Rule 10b-5 context."[95] Under *TSC Industries*, "[a]n omitted fact is material if there is a substantial likelihood that . . . the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[96] Applying this same standard of reasonableness to the facts in *America West*, the court of appeals readily determined that a reasonable investor would consider the existence of such information as deferred maintenance costs and ongoing FAA maintenance violations "important" to his or her "deliberations" as a shareholder.[97]

1. The PSLRA did not alter the materiality and reliance standards established in Basic

Admittedly, the Supreme Court in *Basic* adopted the fraud-on-the-market theory under the premise that "in a modern and efficient securities market, the market price of a stock incorporates all available public information."[98] However, there is no explicit requirement that a stock's value must *immediately* reflect a change in available public information. In fact, as the Ninth Circuit itself aptly noted, the *Basic* Court expressly refused to adopt such a bright-line formulation:

> In *Basic*, the Court recognized the difficulty of proving investor reliance on a misrepresentation or omission by a corporation. Thus, the Court created a rebuttable presumption of investor reliance based on the theory that investors presumably rely on the market price, which typically reflects the misrepresentation or omission.

> alters the price of the firm's stock," if a company's disclosure of information has no effect on stock prices, "it follows that the information disclosed . . . was immaterial as a matter of law."

Oran, 226 F.3d at 282 (quoting *In re Burlington*, 114 F.3d at 1425) (citation omitted). The Third Circuit thus concluded that plaintiffs' allegations were immaterial as a matter of law because the value of the stock at issue failed to exhibit any appreciable negative effects in the four days following disclosure. *Id.* at 282–83.

94. *America West*, 320 F.3d at 934.

95. *Id.* (citing Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988)).

96. 426 U.S. at 449.

97. *Id.*

98. *America West*, 320 F.3d at 947 (Tallman, J., dissenting) (citing *Basic*, 485 U.S. at 246–47).

> However, in crafting this presumption in favor of investors, the Court specifically stated "we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in the market price."[99]

Despite accurately recognizing the *Basic* court's refusal to adopt a bright-line rule with respect to *when* the market must react upon disclosure of an omitted or misrepresented fact, the majority failed to summarize or discuss whatever impact the PSLRA might have had on the "reasonable investor" standard set forth in *Basic* and *TSC Industries*. Of course, as noted in Part II,[100] the actual text of the Reform Act says nothing with respect to the standards of materiality and reliance under a fraud-on-the-market theory.[101] Rather, the text of the PSLRA merely heightens the requirements to prove falsity and scienter in securities fraud actions.[102] Nevertheless, in his dissenting opinion, Judge Tallman discusses the materiality and reliance standards as if they had somehow been altered by the PSLRA. Thus, Judge Tallman argues that, "[*u*]*nder the Reform Act*, the burden to plead facts with particularity establishing the *required element of materiality* remains squarely on plaintiffs. Plaintiffs also maintain the *burden to plead detrimental reliance*. These pleading standards have not been met here."[103] In the following paragraph, Judge Tallman once again confuses the materiality and reliance standards established under *Basic* with the PSLRA scienter and falsity requirements:

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99. *Id.* at 934 n.12 (quoting *Basic*, 485 U.S. at 248 n.28) (citation omitted).

100. *See supra* text accompanying notes 60–65.

101. *See supra* Part II.

102. The entire relevant text of the PSLRA regarding pleading requirements for securities fraud actions reads as follows:

> [T]he complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1) (2000). With respect to scienter, the entire relevant text reads as follows:

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

Id. § 78u-4(b)(2).

103. *America West*, 320 F.3d at 951 (Tallman, J., dissenting) (emphasis added).

> While we are required to draw all inferences in favor of plaintiffs for purposes of a motion to dismiss, *under the Reform Act* the burden remains on the plaintiffs to plead with specificity the facts showing a materially misleading statement. The plaintiffs here have not alleged with specificity facts that would support the inferences the plaintiffs ask us to draw.
>
> What the plaintiffs fail to show is any causal connection between the FAA investigation and fine and the poor third-quarter performance. . . .
>
> . . . . Since these questions are left unanswered by the complaint, we cannot *under the Reform Act* simply give the plaintiffs the benefit of the doubt and view the market's reaction in September as indicative of the materiality of the misleading statements regarding the FAA investigation and settlement. [104]

Judge Tallman's language is unmistakable: his repeated references to the PSLRA in discussing the materiality and reliance elements indicates that his opinion was informed by the wrongful assumption that the PSLRA controls the materiality and reliance issues. As has already been noted,[105] the only support for Judge Tallman's conclusion that the statements were immaterial as a matter of law must come from either the text of Rule 10b-5 or the *TSC-Basic* framework. While Judge Tallman generally alleges that the majority departed from *Basic*,[106] the only specific precedent that Judge Tallman invokes to support his conclusion comes from neighboring circuit courts. In fact, after working through a cursory description of the reasonable investor standard and the fraud-on-the-market theory established in *Basic*, Judge Tallman simply engages in a lengthy discussion of the established law in other circuits.[107]

Despite the fact that Judge Tallman confounded his analysis of the materiality and reliance elements by referencing the PSLRA, his opinion provides a much more clear and concise summary of the essential elements to Investors' cause of action than the majority opinion. Judge Tallman summarizes these elements as follows:

104. *Id*. at 950 (Tallman, J., dissenting) (emphasis added).

105. *See supra* notes 60–65 and accompanying text.

106. *America West*, 320 F.3d at 947 (Tallman, J., dissenting) ("The majority's analysis is contrary to what the Supreme Court and our sister circuits have said in similar cases.").

107. *Id*. at 947–49 (Tallman, J., dissenting).

> "(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentation would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed . . . ."[108]

In light of the fact that the PSLRA did not alter the standard of materiality set forth in *Basic* and *TSC Industries*,[109] the court of appeals was correct to conclude that all five elements had been met for the purposes of stating a valid claim—especially considering the fact that the court must draw all inferences in favor of plaintiffs for purposes of a motion to dismiss.[110] First, there was little debate that America West made public misrepresentations, that its shares were traded on an efficient market, or that the Investors traded the shares during the time the misrepresentations were made. The only significant dispute was whether the misrepresentations were material and whether an investor could reasonably rely on the misrepresentations. Because the PSLRA did not alter the *Basic-TSC* definition of materiality[111] and did not establish a per se requirement of immediate market reaction upon disclosure,[112] the court of appeals correctly concluded that America West's misrepresentations and omissions were material under the *Basic-TSC* framework. For purposes of a motion to dismiss, the court of appeals was obligated to draw an inference in favor of Investors that America West's stock plummeted in value *because of* the misrepresentations—even if the decline in stock occurred days or months afterward.

2. As a matter of policy, the Basic *court was wise to avoid adopting a bright-line rule that the market must react within a specified period of time*

Whenever there is a material change in available public information, a period of time inevitably lapses during which the public must assimilate the new information and determine the value

108. *Id*. at 947 (Tallman, J., dissenting) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988) (emphasis added) (citation omitted)).

109. *See supra* notes 60–65 and accompanying text.

110. *America West*, 320 F.3d at 950 (Tallman, J., dissenting).

111. *See supra* notes 60–65 and accompanying text.

112. *Id*.

of the affected security. A security's value does not always *immediately* reflect presently available public information; rather, a security's value usually reflects the way the public has interpreted available public information *over a period of time*. Whether the public makes its determination in one hour, one day, or one month, the *Basic* court likely recognized that there will always be a period of time where the value of a stock remains in limbo upon public disclosure of an omitted or misrepresented fact.

If the absence of an immediate market reaction were fatal to plaintiffs' ability to state a claim, innocent investors bringing valid securities fraud claims would fail to survive corporate defendants' motions to dismiss because, as this Note has just observed,[113] the market rarely reacts *immediately* to disclosures of misrepresented or omitted facts. While an efficient market often reacts within hours or days of disclosure, there are other extraneous factors that might delay a market reaction, including misleading, contemporaneous statements issued by the corporate defendant or mistaken reactions on the part of analysts and investors. The Third Circuit's test also precludes the distinct possibility that the public might simply be slow to recognize the importance of disclosed information in cases where—as the Ninth Circuit Court of Appeals found in *America West*—officers or directors issue fraudulent, contemporaneous statements intended to eliminate public worries that the newly revealed information might affect the stock's value. The bright-line rule put forth by the Third Circuit, while theoretically sound under the fraud-on-the-market theory—i.e., a stock's value in an efficient market inherently reflects all "available material information"[114]—is not practically sound in real-world securities markets.

The Third Circuit's bright-line rule also forces federal judges to decide on a case-by-case basis what constitutes "immediate" market reaction—a question that is not always easy to answer—especially at the pretrial stage. In reality, the materiality question is a causal question[115] that is best left for determination at the trial stage—not

113. *See supra* text accompanying note 105.

114. Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988).

115. *Id.*; Oldham, *supra* note 12, at 1034–38. "[T]he real inquiry should be whether the misrepresentation affected the market price." Oldham, *supra* note 12, at 1035. Oldham's position that the determinative question in actions brought under a fraud-on-the-market theory should be causation is well supported by a wide range of commentators, including law professors Donald Langevoort, Jonathan Macey, and Geoffrey Miller, and finance professors Mark Mitchell and Jeffrey Netter. *Id.* at 1035–36; *see also* Carden, *supra* note 60, at 900

in the context of a motion to dismiss.[116] In fact, the Ninth Circuit itself, reasoning from the *TSC Industries* Court's position that materiality is "a mixed question of law and fact,"[117] concluded as recently as 1995 that "the materiality of an omission is a 'fact-specific issue which should ordinarily be left to the trier of fact.'"[118] The same Ninth Circuit decision noted,

> Only in two situations should the Court resolve this question as a matter of law: (1) If the immateriality of the statement or allegedly omitted fact is so obvious that reasonable minds could not differ . . . or (2) "[I]f the information is trivial or is 'so basic that any investor could be expected to know it.'"[119]

The Ninth Circuit's approach in *Fecht* is also consistent with the Supreme Court's observance in *TSC Industries* that "the jury's unique competence in applying the 'reasonable man' standard is thought ordinarily to preclude summary judgment in negligence cases."[120] While there is certainly a reasonable argument for securities litigation reform and judicial economy, the rights of securities fraud victims should not be trampled in the process of reform. As Arthur Miller recently argued, "Courts . . . too often appear to be placing their interests in the efficient resolution of disputes, concerns about jury capability, and other matters above litigants' rights to a day in court and jury trial . . . ."[121]

("Rather than interpreting [the] fraud-on-the-market [theory] as a rebuttable presumption of reliance, courts should instead understand the theory as a method of proving causation.").

116. Arthur R. Miller, *The Pretrial Rush to Judgment: Are the "Litigation Explosion," "Liability Crisis," and Efficiency Clichés Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U. L. REV. 982, 1073 (2003). Miller cites the following example to demonstrate the often harsh consequences of the courts' misuse of the motion to dismiss:

> [I]n *In re MCI Worldcom, Inc. Securities Litigation*, the plaintiff class complaint alleged in great detail material misrepresentations and omissions in violation of the Securities Exchange Act. The district court granted the defendants' motion to dismiss, which almost seems whimsical given more recent public revelations about the company apparently burying billions of dollars of costs with accounting machinations to create a false picture of the company's profits and sales.

Id.

117. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

118. Fecht v. Price Co., 70 F.3d 1078, 1080–81 (9th Cir. 1995) (quoting Kaplan v. Rose, 49 F.3d 1363, 1375 (9th Cir. 1994)).

119. Snow et al., *supra* note 1, at 269 (quoting Ganino v. Citizens Util. Co., 228 F.3d 154, 162 (2d Cir. 2000) (quoting Goldman v. Belden, 754 F.2d 1059, 1067 (2d Cir. 1985))) (second alteration in original).

120. 426 U.S. at 450 n.12.

121. Miller, *supra* note 116, at 982.

A bright-line rule requiring immediate market reaction would also force courts to decide what constitutes *sufficient* market reaction, which ultimately defeats the purpose of litigation reform—to preserve both judicial and economic resources. Not only would parties waste time and resources litigating the issue of immediacy, they would also waste resources arguing over whether or not there was a significant market reaction at all. Courts would once again have to decide on a case-by-case basis whether or not the market reaction was sufficient to satisfy the reliance and materiality elements, despite the fact that, like the immediacy issue, the sufficiency of the market's reaction is a question that should be preserved for the trier of fact, not a court handling a motion to dismiss.

Finally, the Third Circuit's bright-line rule obscures the only truly relevant question under the *Basic* test—i.e., whether the misrepresented or omitted facts would have altered the "total mix" of information for a reasonable investor, and whether a reasonable investor could have reasonably relied to his or her detriment on the misrepresented or omitted facts. While the market's response time and the degree of the market's reaction are important considerations in the materiality and reliance contexts, such factors should not be determinative. Ultimately, the immediacy and significance of a market's reaction should serve only as two of several factors which a court might weigh in deciding whether to dismiss a case. A court should also be empowered (and expected) to look at other evidence of materiality, such as insider trading and accounting abnormalities.

In the principal case, America West itself clearly thought the information would have been important to a reasonable investor, or it would not have allegedly attempted to conceal the nature of its maintenance problems in the first place.[122] Surely the officers did not conceal the maintenance problems and the deferred maintenance costs out of a desire to avoid burying its shareholders in an avalanche of "trivial" information. Rather, the directors and officers allegedly concealed the corporation's maintenance problems, as well as the looming maintenance costs that the corporation had deferred, in an effort to drive up the value of America West's stock. Furthermore, there was extensive evidence of insider trading,[123] which is highly suggestive that the misrepresentations and omissions were material.

122. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 927 (9th Cir. 2003), *cert. denied*, 124 S. Ct. 433 (2003).

123. *Id.* at 927–28.

Again, for purposes of a motion to dismiss, the court of appeals was reasonable to conclude that there was "a substantial likelihood" that the disclosure of the omitted facts would have been viewed by the "reasonable investor as having significantly altered the 'total mix' of information made available.'"[124] To deny plaintiffs an opportunity to approach the trial stage simply because the market failed to react immediately upon disclosure of America West's misrepresentations and omissions would not only injure plaintiffs with valid securities fraud claims but would also wrongfully protect corporate officials, accountants, and attorneys who willfully defraud the public.

B. Should the PSLRA Survive in the Post-Enron Era?

The PSLRA was certainly dealt a heavy blow by the outbreak of corporate fraud and the resulting economic instability and public outcry, yet no one has presented credible evidence that the Reform Act was actually the cause of the Enron collapse.[125] Nevertheless, the Enron collapse raised suspicions throughout the legal community that the PSLRA has overprotected fraudulent corporate executives and closed the courthouse to innocent victims of corporate fraud. As the *America West* case demonstrates, even judges have begun to question and even redefine the scope and application of the PSLRA. This section argues that the PSLRA can be a potentially useful tool in reforming securities litigation, but the Act's pleading standards—especially with regard to the materiality and reliance elements under a fraud on the market cause of action—do not provide sufficient guidance to lower federal courts. In fact, the PSLRA's pleading standards have spawned severe confusion[126] among lawyers and judges and, even worse, have left too much discretion for federal courts to fashion rules that contradict the basic principles endorsed in *TSC Industries* and *Basic*. Congress or the Supreme Court (or both) must expand and clarify the pleading standards in a way that prevents courts from interpreting and applying the PSLRA by simply referring to changes in the political and economic landscape.[127] The

124. *TSC Indus.*, 426 U.S. at 449.

125. PAINTER ET AL., *supra* note 8, at 28 ("Using Enron to justify . . . roll-backs is ill-advised where no one has yet repudiated SEC Chairman Harvey Pitt's testimony before Congress that there is no relationship between the PSLRA and the demise of Enron.").

126. Kevin P. Roddy, *Seven Years of Practice and Procedure under the Private Securities Litigation Reform Act of 1995*, SJO14 A.L.I.-A.B.A. 395, 436–38 (2003).

127. *See supra* note 5 and accompanying text.

pleading standards should be sufficiently clear that lawyers and judges can enjoy some degree of certainty with respect to each of the falsity, scienter, reliance, and materiality elements.

The PSLRA has arguably had both a beneficial and detrimental impact on securities litigation.[128] On the positive side of the spectrum, the PSLRA has arguably reduced the number of frivolous claims brought by plaintiffs' lawyers merely seeking to extract a settlement offer from corporations who cannot afford to undergo costly discovery or time-consuming litigation processes. For example, a recent National Economic Research Associates ("NERA") study supports some claims that the PSLRA has reduced nuisance suits.[129] According to the NERA study, settlement values have declined by eight percent from 1996 to 2003.[130] This trend is particularly noteworthy in light of the public outcry and wave of litigation that ensued after the string of corporate collapses in 2001. Similarly, the PSLRA has arguably cut down on the volume of securities fraud claims initiated each year. Although the yearly total of claims increased slightly after the PSLRA was enacted, the number likely would have been much higher without the PSLRA, given the huge increase in publicly traded companies since 1995.[131]

Despite some indications that the PSLRA has been successful in deterring "strike suits," many have argued that the PSLRA has had disastrous consequences for investors and some have even blamed the recent string of corporate collapses on the adoption of the PSLRA.[132] Others have simply criticized the success of the PSLRA in deterring the negative consequences of frivolous lawsuits. According

128. For a detailed study of pre-PSLRA and post-PSLRA litigation statistics, see PAINTER ET AL., *supra* note 8, at 11; *see also*, Roddy, *supra* note 126; CHITWOOD & BROWNING, *supra* note 39.

129. Elaine Buckberg et al., *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?*, NERA, *available at* http://www.nera.com/wwt/publications/6143.pdf (last visited May 26, 2004).

130. *Id.*

131. Johnson, *supra* note 54.

132. *See, e.g.*, Robert S. Greenberger, *Questioning the Books: Panel in Enron's Wake to Review Lawsuit Curbs*, WALL ST. J., Feb. 6, 2002, at A8 ("'By forcing through special exemptions for securities, Congress has contributed to the "Wild West" mentality reflected in Enron's hidden partnerships,' said the judiciary panel's chairman, Sen. Patrick Leahy (D., Vt.)."); *see also* Johnson, *supra* note 54, at E01 ("Surveying the post-Enron wreckage, Sen. Richard C. Shelby (R-Ala.) says 'Congress needs to take some blame, noting that seven years ago lawmakers passed a measure [the PSLRA] that made it more difficult for investors to sue corporations and accounting firms involved in fraud.'").

to one commentator, "the procedural skirmishing in class actions brought under the Securities Act of 1933 . . . and the Securities Exchange Act of 1934 . . . has been more intense and time-consuming than that experienced under the prior statutory scheme, adding time and expense to the burdens inherent in such cases."[133] Arguably the most serious criticism of the PSLRA, however, is the difficulty that federal courts have had interpreting and applying the Act, as well as the severe circuit splits that have arisen in response to the Act.[134] Indeed, "[d]espite the PSLRA's stated aim of providing a uniform standard for pleading Rule 10b-5 claims, the courts have applied a number of different interpretations of the PSLRA's heightened pleading standards."[135] Worst of all, the divergent results throughout the federal circuits have spawned a great deal of uncertainty, which the PSLRA was intended to avoid in order to deter frivolous claims and better compensate plaintiffs who bring valid claims.[136]

Regardless of the arguments made for and against the PSLRA, the Ninth Circuit's reaction to the Enron collapse certainly reflects a trend among judges to water-down the PSLRA.[137] While the Ninth Circuit's holding is grounded in a solid application of the law, it certainly represents a step back from its holding only a few years earlier in *Silicon Graphics*, where the court of appeals raised the required state of mind to meet the scienter element under the PSLRA to deliberate recklessness—a level more strict than that actually required by the PSLRA.[138] However, much of the uncertainty in *America West* could have been avoided if Congress

133. Roddy, *supra* note 126, at 404; *see also* Sherrie R. Savett, *The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995*, 39 ARIZ. L. REV. 525, 531 (1997) (observing that the PSLRA "produces great delay in getting the case moving to the merits").

134. *See, e.g.*, CHITWOOD & BROWNING, *supra* note 39.

135. *Id.* ("Since passage of the PSLRA, several separate lines of authority have developed concerning the proper interpretation of the scienter provision."). For an in-depth outline of the circuit courts' divergent interpretations and applications of the PSLRA, see *id.*; Dickey & Asnis, *supra* note 39, *at* http://www.gdclaw.com/fstore/documents/pubs/SecLit_PSLRA.pdf (last visited May 26, 2004).

136. Dickey & Asnis, *supra* note 39, at 1 ("In any event, the caselaw under the PSLRA and SLUSA surely cannot be said to provide certainty or predictability, and in that respect the ultimate congressional goal of eliminating meritless litigation continues to be elusive.").

137. *See, e.g.*, Coffee, *supra* note 2; Greenberger, *supra* note 132; Johnson, *supra* note 54, at E01.

138. *See* CHITWOOD & BROWNING, *supra* note 39, at 7.

had simply clarified its position with respect to the materiality and reliance elements relevant to cases brought under a fraud-on-the-market theory. Because Congress makes no mention of either the materiality or reliance elements in the PSLRA, courts are left to guess what Congress intended, leaving "each circuit to cobble together its own frameworks."[139]

Given the severe confusion that has arisen among federal courts, Congress should revisit the text of the PSLRA and articulate the ways—if any—that the materiality and reliance elements have been modified by the PSLRA. Even if Congress intends to adopt standards as stringent as the Third Circuit's bright-line rule, it should at least say so in the text of the PSLRA in order to avoid confusion. Finally, if Congress is unable or unwilling to revisit the PSLRA, the Supreme Court should provide some insight by hearing appeals involving the most common circuit splits—especially those circuit splits involving the materiality and reliance elements. Without further guidance from Congress or the Supreme Court, the PSLRA will spawn more confusing case law, more severe circuit splits, and more intense suspicions of the PSLRA from both its supporters and its detractors.

Ultimately, a practical approach to deciding materiality, especially for purposes of a motion to dismiss, would require judges to decide only the issue of loss causation.[140] In other words, a judge should merely ask whether the revelations of allegedly misrepresented or omitted facts could have reasonably caused the value of the stock to change. Under this approach, unless "reasonable minds could not differ," or the information "is so basic that any investor would be expected to know," a court should never dismiss a case where plaintiffs establish a reasonable inference that a misrepresentation or omission had a causal impact on the value of a corporation's stock.

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139. *Id*. Note, however, that even the two elements that *are* defined in the text of the PSLRA have spawned a great deal of confusion. *See id.*

140. *See* Oldham, *supra* note 12, at 999.

> [I]n determining whether the fraud-on-the-market presumption of reliance applies, courts should require plaintiffs to prove that a company's alleged misrepresentation actually affected the price of the company's security, such that the plaintiffs' reliance on the market mechanism constituted indirect reliance. By requiring that plaintiffs provide legal proof that the defendant's alleged misrepresentation actually caused the stock price to change, and by uniformly requiring plaintiffs to do so at class certification, courts can transform the fraud-on-the-market doctrine into a theory of indirect reliance that accords with Congress's objectives in the PSLRA.

Id. (footnotes omitted).

V. CONCLUSION

Although the Ninth Circuit's decision in *America West* was undoubtedly influenced by the recent string of corporate fraud scandals, the court of appeals reached the correct legal result. That is, there should *not* be a bright-line rule that an omission or misrepresentation is immaterial as a matter of law in the absence of an immediate market reaction upon disclosure. As both the Supreme Court and the Ninth Circuit have indicated, materiality is a "mixed question of law and fact"[141] that should best be left to a jury,[142] not a court in the context of a motion to dismiss. Ultimately, the Third Circuit's bright-line rule not only strips the jury of its role as fact finder but also insulates fraudulent corporate officials, accountants, and attorneys from liability.

America West also reflects much more than the mere controversy surrounding the Third Circuit's bright-line rule. The case exemplifies the confusion that the PSLRA has produced among federal judges and also demonstrates the Reform Act's vulnerability to changes in the political and economic landscape. Much of the Ninth Circuit's confusion in *America West*, as well as the uncertainty that practitioners face in applying the PSLRA, could be eliminated if Congress provided further guidance with respect to the materiality and reliance elements. Congress would do well to simply adopt a specific fraud-on-the-market theory or, in the alternative, simply renounce the fraud-on-the-market theory altogether and adopt an individualized loss-causation requirement.[143] Without clarifying its position one way or the other, the intentions of Congress to reform securities fraud litigation will continue to succumb to the political and economic pressures that define the pre- and post-Enron eras.

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141. TCS Indus., Inc. v. Northway, Inc. 426 U.S. 438, 450 (1976); *see also supra* notes 25–28 and accompanying text.

142. Fecht v. Price Co., 70 F.3d 1078, 1080–81 (9th Cir. 1995); *see also supra* notes 25–28 and accompanying text.

143. *See supra* note 123 and accompanying text.