No. 86-279

In the Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL., RESPONDENTS

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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MOTION FOR LEAVE TO FILE BRIEF FOR THE AMERICAN CORPORATE COUNSEL ASSOCIATION AS AMICUS CURIAE AND BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF FOR THE AMERICAN CORPORATE COUNSEL ASSOCIATION AS AMICUS CURIAE

Pursuant to Rule 36 of the Rules of this Court, the American Corporate Counsel Association ("ACCA") requests leave to file the accompanying brief as amicus curiae in support of petitioners. The attorneys for petitioners have consented to the filing of this brief. Consent has not been received from the attorney for respondents.

ACCA is a national bar association, with 26 local chapters across the country, that is devoted exclusively to the professional activities of attorneys on the legal staffs of corporations and other business entities in the private sector. ACCA has approximately 7000 members employed as corporate counsel by some 3500 organizations. Many of these members are the chief legal officers of their client corporations.

In their professional activities, members of ACCA are confronted on a regular basis with issues concerning the disclosure of contingent and inchoate events, including possible future mergers or other business developments. ACCA members are intimately involved in giving legal advice and formulating company policy on disclosure matters and in advising management on pending litigation.

Corporate counsel and their management have a substantial interest in the formulation of materiality standards that provide clarity and certainty for corporate decisionmaking and in avoiding overbroad class action rules that eliminate traditional elements of a Rule 10b-5 cause of action.

ACCA believes that the accompanying amicus curiae brief will be of assistance to the Court in its consideration of this case. The brief analyzes the issue of the disclosure of preliminary merger negotiations in the broader context of contingent and inchoate information generally and discusses the difficult practical problems that disclosure of such information poses for corporate counsel and management. In addition, the brief argues against the expansion of class action damages liability for a number of reasons that are familiar to corporate counsel. Accordingly, the brief should offer the Court a broader perspective than the parties can be expected to provide.

For the foregoing reasons, the motion of the American Corporate Counsel Association for leave to file the accompanying brief as amicus curiae in support of petitioners should be granted.

Respectfully submitted.

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BRIEF FOR THE AMERICAN CORPORATE COUNSEL ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The American Corporate Counsel Association is a national bar association devoted exclusively to the professional activities of attorneys on the legal staffs of corporations and other business organizations in the private sector. The Association and its interest in this case are fully described in the accompanying motion for leave to file this brief as amicus curiae in support of petitioners.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case concerns the correctness of the Sixth Circuit's use of the "fraud on the market" theory to sustain a Rule 10b-5 class action for damages and its conclusion that denials of preliminary merger discussions are per se material regardless of whether the prospect of a merger is highly contingent and uncertain. As we demonstrate below, the court of appeals' treatment of these issues was in error for a number of reasons.

But the fundamental unsoundness of the Sixth Circuit's approach is most evident in the incongruous and wholly unjustified results that it produces. There is no claim in this case that the defendant company or its officials made profits or avoided losses by trading in company stock during the period of the merger discussions, and therefore the special policies and rules applicable to "insider trading" do not pertain here. There also is no evidence that petitioners' statements were made for any reason other than a legitimate business purpose—to preserve the confidentiality of preliminary merger discussions for the benefit of the company's shareholders. In addition, there is no indication that the stock market was misled by petitioners' statements or that shareholders who sold their stock during this period were damaged by those statements. On the contrary, as is frequently the case, the stock market appears to have had other sources of information, and the stock price rose despite Basic's statements. The Sixth Circuit's decision thus has applied Rule 10b-5 to conduct that does not even approach fraud in any meaningful sense.

In adopting an erroneous standard of materiality, the Sixth Circuit has deprived corporate management and its advisors of a workable guide as to when preliminary merger discussions must be disclosed. Furthermore, in dispensing with proof of the traditional elements of reliance, causation, and injury, the Sixth Circuit has fundamentally altered the nature of Rule 10b-5 litigation. First, it has permitted a mammoth class action to proceed that could not properly be maintained under traditional principles. And second, it has converted Rule 10b-5 into a mechanism for redistributing tens or hundreds of millions of dollars from the company's innocent shareholders, who were not unjustly enriched by the alleged misstatements, to another group of investors who, under the decision below, would not need to prove that they were in fact injured as a result of those statements. Whatever administrative or equitable remedies might be appropriate to encourage greater corporate candor, nothing can justify

the punitive and economically senseless private damages class action that the court of appeals has countenanced in this case.

ARGUMENT

I. THE "FRAUD ON THE MARKET" THEORY ENDORSED BY THE SIXTH CIRCUIT UNJUSTIFIABLY ELIMINATES ESSENTIAL ELEMENTS OF THE RULE 10b-5 CAUSE OF ACTION, CONFLICTS WITH ECONOMIC THEORY, AND INFLICTS DISPROPORTIONATE PENALTIES.

Respondents, a class of all sellers of stock in petitioner Basic Inc. during the 14-month period ending in December 1978, seek damages under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and SEC Rule 10b-5, alleging that Basic made materially misleading statements concerning the existence of certain merger negotiations. A key question for decision is whether the Sixth Circuit improperly presumed reliance, causation, and damages in order to permit respondents' fraud claim to go forward as a class action.

The case arises out of a merger between Basic and Combustion Engineering, Inc., that had been preceded by repeated solicitations by Combustion, lengthy discussions between the companies, and persistent market rumors. Shortly after the supposedly secret merger discussions began, the stock market reacted. Basic's stock price and trading volume jumped amid rumors of merger negotiations. When a company official was asked about the rumors and stock activity, he responded in an attempt to preserve the confidentiality of the preliminary discussions by denying awareness of any "significant corporate developments" that would account for the price and volume movements in Basic stock. The market appears not to have been affected by these or subsequent denials; the reports of merger negotiations continued, and Basic's stock and trading volume continued to rise. See Pet. App. 5a-8a. There is no indication that Basic or its officials were trading in the company's stock during this period.

Respondents brought this action after the merger negotiations finally reached fruition, contending that Basic's misstatements had misled them into selling their stock at prices that were artificially depressed. If this matter were tried as a conventional Rule 10b-5 lawsuit, the members of the plaintiff class would have substantial difficulty proving the elements of their claim. Few, if any, would be able to demonstrate that they relied on Basic's statements in the face of contrary market reports and rising stock prices. And even if some traders could prove reliance, it is doubtful that any could show that the prices at which they sold Basic stock were artificially depressed by the company's statements. It appears from the evidence recited by the court of appeals that the stock price throughout the period reflected whatever merger price was then under discussion, discounted for the risk in all merger discussions that an agreement might never be reached. Pet. App. 6a-8a & nn. 2, 3.

In any event, the questions of reliance and causation present individual issues. As in any transaction, each trader has personal reasons for selling Basic stock. The mix of information and motives that might have affected the stock price and influenced individual plaintiffs changed from day to day. Indeed, the district court acknowledged that if each member of the class were required to show reliance on the company's representations, "questions affecting individual members probably would predominate over common questions such that the class certification would be improper." Pet. App. 16a. To overcome that barrier, the district court invoked the doctrine of "fraud on the market":

> To circumvent what the district court perceived to be a barrier to class actions in 10b-5 cases, it applied a presumption of reliance so that common questions predominated and the class was appropriately certified.

Ibid.

The Sixth Circuit affirmed, agreeing that resort to this legal *deus ex machina* was warranted. The court of appeals reasoned that reliance, which it described as "the element of a Rule 10b-5 action that establishes the causal nexus between the defendant's wrongful conduct and the plaintiff's injuries" (Pet. App. 16a-17a), should be presumed under the "fraud on the market" theory because "proof of actual reliance would be impractical or impossible" (*ibid.*) and because Basic's stock was traded on the New York Stock Exchange. Assuming, without any record support, that Basic's statements had distorted the price of the company's stock throughout the entire 14-month class period, the court concluded that "[w]hen a plaintiff purchases on the impersonal market after * * * misrepresentations are made, the [fraud on the market] theory presumes that he relied on the supposed integrity of the market price, and thus indirectly on the misrepresentation." *Ibid.*

In presuming reliance, causation, and damages to facilitate the maintenance of an otherwise improper class action, the courts below seriously erred. As demonstrated in this brief, the "fraud on the market" theory improperly eliminates established elements of the Rule 10b-5 cause of action, conflicts with common sense and principles of economic theory, inflicts disproportionate penalties, and opens the door to windfall recoveries and coercive class action settlements. If such a radical departure from traditional legal standards is to be countenanced, it is Congress that should so declare.

A. The Sixth Circuit's Formulation Of The "Fraud On The Market" Theory Improperly Eliminates Settled Requirements Of A Rule 10b-5 Cause Of Action.

To prevail on a claim of fraudulent misrepresentation, plaintiffs have traditionally been required to prove reliance, causation, and damages. In summarily eliminating those elements to facilitate the maintenance of this class action, the Sixth Circuit lost sight of the fact that an action under Rule 10b-5 is, at bottom, a *fraud* action.

Section 10(b) is "directed at fraud 'in connection with the purchase or sale' of securities." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733 (1975). It is therefore essential to bear in mind the elements of "misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship." *Id.* at 744. This Court's decisions have repeatedly held that efforts to expand civil liability under Rule 10b-5 may not be undertaken without reference to those traditional elements of a cause of action for fraud.

The Court has held, for example, that a Rule 10b-5 claim requires proof of deception (*Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977)), that any deceptive statement must be material (*TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976)), and that a defendant must have acted with scienter, defined as intent to deceive (*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)). Likewise, the Court has held that a plaintiff suing under Rule 10b-5 must "establish the requisite element of causation in fact" as well as "damages." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 154 (1972). While the Court has permitted litigants to resort to a "presumption" of reliance in cases involving total "non-disclosure" of material facts, in view of the impossibility of proving positive reliance when there has been no disclosure, it has never suggested that reliance may be dispensed with in a case such as this, involving alleged misrepresentations of material fact. See *Hochfelder*, 425 U.S. at 206, quoting the legislative history of the civil liability provisions of the Securities Exchange Act: "[T]he burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage."

Accordingly, it was wholly improper for the courts below to presume without proof the elements of reliance, causation, and damages, merely to facilitate the maintenance of a class action proceeding. See *List* v. *Fashion*

Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965). A rule that effectively "do[es] away with the reliance requirement * * * threatens to turn all of Rule 10b-5 into a scheme of investor insurance." *Shores* v. *Sklar*, 647 F.2d 462, 486 (5th Cir. 1981) (en banc) (dissenting opinion), cert. denied, 459 U.S. 1102 (1983).

B. The "Fraud On The Market" Theory Applied By The Sixth Circuit Conflicts With Modern Economic Principles.

There is a compelling practical reason to withhold endorsement of the "fraud on the market" theory in this case. Not only is it inconsistent with prior decisions requiring proof of reliance and causation, but it also clashes with common sense and established economic principles. Indeed, it is fair to say that the Sixth Circuit's "fraud on the market" approach completely ignores the development of modern stock-market theory over the past two decades.

The Sixth Circuit described the "fraud on the market" theory as follows (Pet. App. 17a):

> When a defendant is shown to have made a material public misrepresentation that, if relied on directly, would fraudulently induce an individual to misjudge the value of the stock, the theory presumes that some investors did so rely and that the market price is distorted.

Thus, the Sixth Circuit assumed that the stock market is misled by any statement that could mislead an individual investor, and that this "distortion" of the market constitutes an appropriate measure of damages for all who purchase or sell securities at that "distorted" price. As a result, proof of individual reliance, causation, and damages is unnecessary. Apparently, in the Sixth Circuit's view, a company that makes an overly optimistic representation is presumptively liable to everyone who buys stock thereafter; a company that makes an overly

pessimistic representation is liable to everyone who sells stock thereafter. The market is presumed to be "distorted" until the issuer of the statement corrects it.

This far-reaching approach, which has never been accepted by Congress or this Court, rests on a simplistic and completely erroneous view of the operation of the stock market. While the "fraud on the market" rationale is garbed in the rhetoric of modern "efficient market" theory, it is in fact utterly inconsistent with the teachings of that theory.

Efficient market theory holds that the price of a stock, traded on an efficient market, incorporates all public (and at least some non-public) information about that stock. According to this theory, as new information comes into the market, the price of the stock quickly fluctuates to reflect that information. That is why it is so difficult to predict future stock prices and so difficult for even the best-informed investors to outperform the market in the long run. See J. Lorie & M. Hamilton, *The Stock Market: Theories and Evidence* 70-110 (1973); E. Fama, *Foundations of Finance* 133-176 (1976); R. Posner, *Economic Analysis of Law* 324-326 (1977). Whatever the merit of this theory, it plainly does not support the Sixth Circuit's ruling here.

Contrary to the court of appeals' assumption, it does not follow from efficient market theory that the market price is distorted by any misstatement that might be material to an individual average investor. The stock market cannot be equated with a single investor. Rather, the market embodies the collective wisdom of thousands of traders, with prices typically determined by the bargains struck between the most sophisticated of those traders. See *Metlyn Realty Corp.* v. *Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985) ("[t]he price of an actively traded stock reflects the value placed on it by the professional investors who follow a firm closely"). Such traders take into account *all* information about a stock, but reject much of it as inaccurate, unreliable, or con-

trary to better intelligence. See E. Fama, *supra*, at 377 ("the market is not misled" by changes in accounting technique).

The other basic feature of an efficient market is that the market is quick to correct its mistakes. If the price of a stock becomes distorted, traders frequently step in to buy the undervalued stock or sell the overvalued stock until the proper price is restored. See T. Copeland & J. Weston, *Financial Theory and Corporate Policy* 211 (1979) ("[c]apital market efficiency relies on the ability of arbitrageurs to recognize that prices are out of line and to make a profit by driving them back to an equilibrium value"); Report of the SEC Office of the Chief Economist, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* (Feb. 24, 1987), at 5 ("pre-bid market activity is inevitable. * * * [I]t makes capital markets more efficient [and] aligns actual stock prices with their theoretically correct values"). Spurred by the incentive to maximize profits or minimize losses, sophisticated traders compete intensively to ferret out information about underlying events and values. As the SEC's Chief Economist recently commented:

> [A]n army of traders, arbitragers, and stock analysts is quick to spot unusual activity of corporate executives, the calling and cancelling of meetings and other seemingly insignificant corporate developments that might give a clue to an upcoming major development. * * * Experts closely monitor such things as which brokerage firm is doing the heaviest buying and selling of a particular stock.

Id. at 6.

The SEC Report further observed that this process operates with particular astuteness in discovering information about takeovers:

> [I]t's not hard for all sorts of people to deduce that takeover action is about to occur in a stock. Computers are a big help here. Accumulation is instant

> news; so is unusual volume. Connected by a national network of direct phone lines, smart traders * * * talk to one another and to brokers constantly.

Id. at 6-7. Thus, as supposedly secret takeover plans move from possibility to concrete reality, stock prices and trading volume rise:

> Trading volume on the day of public announcement rises to 20 times its historical daily average. It is five times normal the day before the announcement and triple two days before the announcement. * * * These statistics tell a story of an active market for information about impending takeover bids.

Id. at 33.

The present case bears out these findings by the SEC's Chief Economist about the general characteristics of the takeover market, rather than the assumptions underlying the Sixth Circuit's "fraud on the market" theory. Here, the market was awash with reports that Basic was engaged in merger negotiations. These reports persisted despite Basic's statements, and Basic's stock price and trading volume continued to rise. There is no indication of a market response to Basic's statements. Rather, it appears, the market had discerned the truth about the merger talks and refused to credit Basic's denials. Pet. App. 5a-8a.

In these circumstances, the Sixth Circuit committed a fundamental error in concluding that a statement that would "fraudulently induce an individual to misjudge the value of the stock" supports a presumption that "the market price is distorted." Pet. App. 17a. Not only is the presumption unsupported by economic theory, but it directly contradicts the factual record in this case. It was therefore improper to certify a class of all sellers of Basic stock over a 14-month period, when there was no proof that the stock price was ever distorted by Basic's statements (let alone distorted throughout the class period) and no proof that common issues would predominate.

C. The "Fraud On The Market" Theory Endorsed By The Sixth Circuit Rests On An Erroneous View Of The Scope Of Liability Under Rule 10b-5.

Plaintiffs' "fraud on the market" class action suffers from another fundamental defect. Petitioners here were neither purchasers nor sellers of any securities. Yet the court of appeals assumed that all traders in the market who could allege that the market price of their investments was affected by petitioners' statements could recover their market losses from petitioners. Although a number of lower courts have accepted this conclusion, we submit that such a sweeping and open-ended liability is completely at odds with the congressional scheme. Damages in a market fraud class action should be based on the defendant's illicit profits or avoided losses, rather than on the highly conjectural damages (or unrealized gains) of traders in the company's stock.

Section 10(b) of the Securities Exchange Act does not federalize the entire law of fraud or confer a cause of action to recover general market losses based on erroneous press releases. The section is expressly limited to fraudulent activities "in connection with the purchase or sale of any security." A natural reading of those words would limit the coverage of Rule 10b-5, and the liability imposed thereunder, to fraudulent activities in connection with securities transactions engaged in by a defendant and any co-conspirators. See *Hochfelder*, 425 U.S. at 199 (Rule 10b-5 must be interpreted to avoid a "gloss to the operative language of the statute quite different from its commonly accepted meaning").

This reading is consistent with the original purpose of Rule 10b-5. As this Court has noted, "Rule 10b-5 was adopted in order to close 'a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities *if they engage in fraud in their purchase*.'" *Blue Chip Stamps*, 421 U.S. at 736 n.8 (emphasis added). Moreover, proponents of implying

a private cause of action under Section 10(b) relied heavily on Section 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b), which provides that a contract made in violation of any provision of the Act is voidable at the option of the deceived party. See *Blue Chip Stamps*, 421 U.S. at 735. That justification is completely absent when a defendant has not entered into any securities transactions affected or tainted by a violation of the statute, so that there are no unjust profits to be disgorged or contracts to be voided.

There are additional reasons for favoring a construction of Rule 10b-5 that would limit liability to persons involved in securities transactions. The other principal anti-fraud remedies prescribed in the securities laws contain this very limitation. Thus, Section 11(a) of the Securities Act of 1933, 15 U.S.C. § 77k, applies only to the issuer, its officers and underwriters, and other persons involved in the underwriting process. Similarly, Section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*, imposes civil liability on any person who "offers or sells a security" by means of a prospectus or oral communication that includes a misstatement or omission of a material fact. These limitations on the *express* rights of action created by Congress have obvious relevance in defining the contours of an *implied* cause of action under Section 10(b), particularly since that section by its terms is restricted to fraud "in connection with the purchase or sale of any security." It would be anomalous indeed to "impute to Congress an intention to expand the [defendant] class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." *Blue Chip Stamps*, 421 U.S. at 736. See *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 884 (2d Cir. 1968) (en banc) (Moore, J., dissenting), cert. denied, 394 U.S. 976 (1969) (the securities laws are concerned with purposeful schemes to defraud, not allegedly misleading corporate publicity).

Furthermore, the flow of information to investors would be significantly impaired if the issuance of an arguably misleading press release could result in damages that far exceed any profits the defendant might have made. As Judge Friendly noted in *Texas Gulf Sulphur*, 401 F.2d at 867 (concurring opinion), most corporations would opt for silence rather than take "the risk that a slip of the pen or failure properly to amass or weigh the facts —all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." See also Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 640 (1985):

> We cannot justify [fraud on the market damages] by saying * * * that the excessive remedy promotes desirable unconditional deterrence. * * * [A] firm that discloses information in the aftermarket as it goes along inevitably takes the risk of excessive optimism and excessive pessimism. A rule that penalizes excesses in either direction would lead to quiet, not (necessarily) to an increase in the world's portion of truth. Investors would not want a rule that promoted silence whenever possible.

Where a corporation has been trading in its own securities and has been enriched by its "fraud," the disgorgement remedy is consistent with these concerns and with the express statutory language, because damages would be based upon a defendant's ill-gotten gains "in connection with the purchase or sale of" securities. Imposition of damages liability under Rule 10b-5 makes little sense, by contrast, where a defendant is neither a purchaser nor a seller of securities. (The Rule 10b-5 remedy is supplemented, of course, by the full panoply of civil and criminal remedies available to the SEC and the Department of Justice to enjoin and punish those who make materially false statements to the public securities markets, see, *e.g.*, 15 U.S.C. §§ 78u and 78aa.)

D. The Sixth Circuit's "Fraud On The Market" Theory Leads To Speculative And Disproportionate Damages Awards And To Coerced Settlements.

There is another substantial reason for refusing to adopt a "fraud on the market" approach in securities cases: fundamental fairness. Much like the theory rejected by this Court in *Blue Chip Stamps*, the "fraud on the market" theory leads to damages awards that are "largely conjectural and speculative" (*Blue Chip Stamps*, 421 U.S. at 735) and that are so totally disproportionate to any sensible judgment about appropriate damages liability that Congress could never have intended to authorize them.

Consider, for example, the case of a speech by a corporate official that does not mention tentative plans to sell a key division at a large profit. Six months later, after 10 million shares have changed hands, the division is sold. Thereafter, the company's stock price rises $20 per share. Under the "fraud on the market" approach, the company—and, in the final analysis, its innocent shareholders—could be liable to sellers of its stock for $200 million. (Likewise, if a speech or press release were to omit potential bad news, a class of buyers would be able to file a comparable claim.)

Consider next the case of a corporate official who buys 1000 shares of stock for $10 per share while in possession of material non-public information that is wrongfully withheld. During the course of the next month the company's trading volume is 20 million shares. At the end of the month, the information is released, the stock rises to $20 per share, and the official sells the previously acquired shares. Under the "fraud on the market" approach, the official could be held liable for $200 million.

These examples, which are typical of pending class actions across the country, demonstrate that the Sixth Circuit's "fraud on the market" approach yields penalties

grossly out of proportion both to the misconduct at issue and to the measure of damages Congress has prescribed in similar situations elsewhere in the federal securities laws. Indeed, Congress recently added Section 21(d) to the Securities Exchange Act, 15 U.S.C. § 78u(d), to permit the SEC to recover civil penalties for insider trading. Even in connection with that emotion-laden issue, Congress carefully limited recovery to "three times the *profit gained or loss avoided* as a result of such unlawful purchase or sale" (emphasis added). It would be anomalous, to say the least, to punish more harshly those defendants who may have made misstatements but neither bought nor sold for their own accounts. "The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Blue Chip Stamps*, 421 U.S. at 748.

The inevitable result of such a liability scheme is coercive settlements. If a defendant cannot defeat a motion for class action certification or obtain summary judgment, the incentive to settle, rather than bear even a small risk that a jury might find liability, is enormous. As the Court noted in *Coopers & Lybrand* v. *Livesay*, 437 U.S. 463, 476 (1978), "[c]ertification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense." That is especially true in this category of litigation, given the immense damages presumed by the "fraud on the market" theory.

Encouragement of coerced settlements harms all shareholders. The settlement amounts are simply transferred from one set of innocent investors (the corporation's shareholders) to another set of investors, with a large

portion paid for attorneys' fees and other expenses. In addition, there are enormous direct and indirect social costs associated with this process, caused by uncertainty and distortion of management efforts. Over time, and given the diversification of most investors through pension and mutual funds and the like, the only net winners in the process are the lawyers. Under the "fraud on the market" theory, the evils that this Court warned against in *Blue Chip Stamps* are thus realized with a vengeance: "unduly expansive imposition of civil liability" leads "to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." 421 U.S. at 739.

These concerns weigh heavily against approval of the "fraud on the market" theory endorsed by the Sixth Circuit. If such a draconian remedy is to be fashioned, it should be done by Congress, "after the kind of investigation, examination, and study that legislative bodies can provide and courts cannot." *Diamond* v. *Chakrabarty*, 447 U.S. 303, 317 (1980). See also *Texas Industries, Inc.* v. *Radcliff Materials, Inc.*, 451 U.S. 630, 646 (1981).

II. THE MATERIALITY STANDARD UNDER RULE 10b-5 DOES NOT REQUIRE DISCLOSURE OF CONTINGENCIES SUCH AS PRELIMINARY MERGER DISCUSSIONS, AND MANAGEMENT'S DECISIONS TO DISCLOSE OR NOT TO DISCLOSE CONTINGENT EVENTS ARE NOT ACTIONABLE WITHOUT PROOF OF FRAUDULENT INTENT.

The second issue before the Court—the legal obligations surrounding disclosure of preliminary merger discussions—is a specific instance of a pervasive problem frequently encountered by corporate management: whether, when, and how to divulge information about contingent and inchoate future events. Developments that may or may not come to pass are a daily fact of corporate life, and so is the need for confidentiality to protect the value of the endeavor. Creating and marketing a new product, forecasting future economic and market trends, and plan-

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ning company operations and predicting performance—these and a host of other uncertainties continually confront those who administer the corporate disclosure system. The Court's decision will have important repercussions for innumerable situations far removed from the disclosure of preliminary merger discussions.

A rule of materiality that is not clear or that compels premature disclosures would deprive companies of one of their most valuable commodities—confidential information. Moreover, a broad standard would breed uncertainty and inhibit effective management. For every statement that a company publishes, corporate officials, in consultation with a host of lawyers, accountants, and other advisors, would have to consider whether there is some undisclosed fact concerning a contingent or inchoate event that might have a bearing on what is being said. The complexities and delays involved in that process would be costly and stultifying. And given the potentially catastrophic liability that could result from a disclosure decision that a jury later finds to be inadequate and therefore in violation of the securities laws, companies inexorably would be driven to disclose more information than is legally required—information that it would be in the best interest of the companies and their shareholders to maintain in confidence.

During preliminary merger talks, for example, must a company reveal the existence of discussions when it issues an annual report to stockholders, when it files a periodic report with the SEC, or when it makes a press release or gives an interview to the media? If management previously, and accurately, denied rumors of a possible merger, must it affirmatively make a corrective disclosure if preliminary merger talks subsequently develop? And if it has disclosed merger discussions, is management thereafter obligated to give a blow-by-blow account as the negotiations take their inevitable twists and turns, for either the better or the worse?

More generally, do the federal securities laws require a company to tell the world—including its competitors at home and abroad that it is researching an important new technology? Under what circumstance is management obligated to disclose that a government investigation is possible or underway? When must management reveal contingent liabilities arising out of unasserted legal claims? And when and how much need be disclosed about asserted claims or pending litigation?

In our economic system, corporate management must be accorded a wide berth to exercise its informed business judgment in deciding whether, when, and how to disclose this kind of information in order to promote the best interests of shareholders. See *Blue Chip Stamps*, 421 U.S. at 759 n.4 (Powell, J., concurring) ("[p]recise factual accuracy with respect to a corporate enterprise is frequently impossible" for matters that do not involve "hard facts," such as "[t]he outcome of pending litigation, the effect of relatively new legislation, the possible enactment of adverse legislation, the cost of projected construction or of entering new markets, the expenditures needed to meet changing environmental regulations, [and] the likelihood and effect of new competition or of new technology").

A. The Materiality Standard Governing Disclosure Of Information Concerning Contingencies Should Provide Clear Guidance To Management And Not Inhibit Legitimate Corporate Activities.

Materiality "has become one of the most unpredictable and elusive concepts of the federal securities laws." *SEC* v. *Bausch & Lomb Inc.*, 565 F.2d 8, 10 (2d Cir. 1977). "The SEC itself has despaired of providing written guidelines to advise wary corporate management of the distinctions between material and non-material information," relying instead on an "after-the-fact, case-by-case approach" (*ibid.*). See also Kripke, *Rule 10b-5 Liability and "Material" "Facts"*, 46 N.Y.U. L. Rev. 1061, 1069 (1971).

1. *The General Standard Of Materiality.*

The general standard of materiality under the federal securities laws is set forth in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). The test under *TSC* for determining the "significance of an omitted or misrepresented fact" (*id.* at 445) is whether "there is a substantial likelihood" that it "would have assumed actual significance in the deliberations of the reasonable shareholder" because it "significantly altered the 'total mix' of information made available" (*id.* at 449).

Where the information at issue involves an uncertain future event, the "traditional rule" is that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company['s] activity." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d at 849. The probability/magnitude test is properly viewed as part of the *TSC* standard. See, *e.g.*, *Dirks* v. *SEC*, 681 F.2d 824, 842-843 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983); *Harkavy* v. *Apparel Industries, Inc.*, 571 F.2d 737, 741 (2d Cir. 1978).

The probability/magnitude test is a useful elaboration of the more general *TSC* standard. By itself, however, it is not an adequate rule for determining the disclosability of contingent and inchoate information. The ad hoc balancing of probability and magnitude is too vague and imprecise to provide meaningful guidance to corporate management—particularly when their judgments are reviewed after-the-fact by lay juries in securities fraud litigation. Moreover, the test denies management necessary discretion to regulate disclosures that could be detrimental to proper and desirable corporate activities.

The Court recognized in *TSC* that the disclosure of information that is not sufficiently significant "may accomplish more harm than good" (426 U.S. at 448). As the Court noted, the potential liability for a securities violation "can be great indeed" and, "if the standard of ma-

teriality is unnecessarily low, * * * the corporation and its management [may] be subjected to liability for insignificant omissions or misstatements" (*ibid.*). In addition, "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking" (*id.* at 448-449). The Court thus was mindful of "the need to avoid the adverse consequence of setting too low a threshold for civil liability" (*id.* at 449 n.10).

In addition to materiality, a duty to disclose must exist before management is required to make disclosure. *TSC* involved a proxy solicitation by management, that is, a focused effort to induce a shareholder response, and the standards utilized by the Court reflected the heightened need for information that applies when management solicits a shareholder response or an investment decision. But in the absence of such circumstances, and in the absence of insider trading or other similar conduct, the governing disclosure standards must derive from the specific disclosure requirements set forth in the federal securities laws and in applicable accounting standards. See *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980). Such standards furnish concrete guidance on the duty to disclose as applied to matters such as annual reports, earnings releases, and mergers that have been consummated in principle or in a final agreement. Courts should not lightly extend such disclosure obligations, on an unpredictable ad hoc basis under generalized anti-fraud provisions such as Section 10(b), to encompass preliminary merger discussions, unasserted legal claims, or other contingent events.

2. *The Proper Materiality Standard For Disclosure Of Information Concerning Contingent And Inchoate Developments.*

a. A sound materiality standard for disclosure of information about contingent or inchoate matters should provide clarity, maximize the overall welfare of shareholders, and avoid misleading investors.

First, the materiality test governing disclosure should be clear and workable. As the Court cautioned in *Dirks* v. *SEC*, 463 U.S. 646, 658 n.17 (1983), a standard that is "inherently imprecise * * * prevents parties from ordering their actions in accord with legal requirements." It "is essential * * * to have a guiding principle for those whose daily activities must be limited and instructed by the [securities laws]." *Id.* at 664. Accordingly, to the extent possible, there is a "need to create a bright-line rule [of materiality] that will allow firms to plan corporate transactions" and assure that "they will not be condemned no matter which way they proceed on disclosure." *Flamm* v. *Eberstadt*, No. 86-1754 (7th Cir. Mar. 9, 1987), slip op. 10.[1]

Without a clear rule, management will be exposed to suit regardless of the disclosure action it takes. For example, at whatever point an adverse contingency is revealed, recent purchasers of the company's stock predictably will contend that the disclosure should have been made earlier (before they bought their shares); and whenever a favorable contingency is disclosed, recent sellers can be expected to argue that it should have been announced sooner. See *Flamm*, slip op. 15. Moreover, whether management decides to disclose or not to disclose a contingency, investors who are disappointed by the eventual course of events will bring suit, arguing that management should have made a different decision. See, *e.g.*, *Walker* v. *Action Industries, Inc.*, 802 F.2d 703, 710 (4th Cir. 1986), cert. denied, 107 S.Ct. 952 (1987); *Reiss* v. *Pan American World Airways, Inc.*, 711 F.2d

[1] See also, *e.g.*, Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5 (1975), which discusses the disclosure of contingent liabilities. FASB-5 provides, for example, that an unasserted legal claim should be disclosed if it "is considered probable" that the claim will be asserted and there is "a reasonable possibility that the outcome will be unfavorable" (¶ 10). See also ¶¶ 36, 38 (factors to be considered in evaluating the probability that a claim will be asserted and that the outcome will be unfavorable).

11, 14 (2d Cir. 1983); *Staffin* v. *Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982). Companies and their shareholders should not be subject to such an inescapable risk of litigation and potential liability.

Second, premature disclosure of contingencies and inchoate developments can interfere with legitimate business objectives and reduce investor welfare. For instance, a corporation may seek to withhold public announcement of a major new contract in order to permit completion of delicate negotiations for the necessary financing. See *State Teachers Retirement Board* v. *Fluor Corp.*, 654 F.2d 843, 846 (2d Cir. 1981). Likewise, disclosure of a significant mineral discovery may be delayed until the company has acquired rights to the properties. See *Texas Gulf Sulphur*, 401 F.2d at 848, 850 n.12. The materiality standard governing disclosure of contingent and inchoate information must leave ample room for management's exercise of its business judgment to undertake legitimate activities that are in the best interest of the corporation and its stockholders overall.

As another example, premature disclosure of pending or prospective lawsuits and unasserted legal claims would also be undesirable. Among other concerns, such disclosure can unnecessarily intrude upon the attorney-client and work-product privileges; risk admissions that could be held against the company in litigation; result in characterizing claims as "material" even though they might later be settled on terms that would be immaterial; and, in the case of unasserted claims, invite litigation against the company that might otherwise not be brought. See generally American Bar Association, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (1975). Such injuries to stockholder welfare should not be needlessly inflicted by an overbroad and amorphous standard of materiality.

Third, as the courts of appeals have recognized, the premature disclosure of contingencies can be confusing

and misleading to investors. Accordingly, the lower courts generally have held that this information is not material, thereby leaving to management's informed judgment the decision whether to disclose uncertain contingencies. See *Greenfield* v. *Heublein, Inc.*, 742 F.2d 751, 756-757 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985); *Reiss*, 711 F.2d at 14; *Staffin*, 672 F.2d at 1205-1207; *Missouri Portland Cement Co.* v. *H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976); *Susquehanna Corp.* v. *Pan American Sulphur Corp.*, 423 F.2d 1075, 1084-1085 (5th Cir. 1970). A similar conclusion has been reached for other types of "soft" information, such as projections and evaluations. See, *e.g.*, *Walker*, 802 F.2d at 707-710; *Kademian* v. *Ladish Co.*, 792 F.2d 614, 625 (7th Cir. 1986); *Radol* v. *Thomas*, 772 F.2d 244, 252-253 (6th Cir. 1985), cert. denied, 106 S.Ct. 3272 (1986); *Starkman* v. *Marathon Oil Co.*, 772 F.2d 231, 239-242 (6th Cir. 1985), cert. denied, 106 S.Ct. 1195 (1986); cf. *Flynn* v. *Bass Brothers Enterprises, Inc.*, 744 F.2d 978, 985-988 (3d Cir. 1984). Thus, the disclosure requirements of the federal securities laws do not insist that massive amounts of undigested information be conveyed to public investors.

Indeed, the SEC traditionally *prohibited* companies from disclosing "soft" information such as projections and appraisals in documents filed with the Commission. See, *e.g.*, *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-1294 (2d Cir. 1973); *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447, 451 (10th Cir. 1968). This policy "stemmed from [the Commission's] deep distrust of the[] reliability [of this information]" (*Gerstle*, 478 F.2d at 1294) and its concern that such disclosures "were likely to mislead investors" (*Walker*, 802 F.2d at 707).

In the past decade the SEC has shifted its position to permit—but not to require—the disclosure of financial projections and other so-called "forward-looking" information if supported by a reasonable basis and made in good faith. See 17 C.F.R. 229.10; see also *Walker*, 802

F.2d at 707, and *Starkman*, 772 F.2d at 239-241 (tracing the evolution of the SEC's change in policy). By allowing, but not requiring, disclosure the SEC has left the disclosure decision to the informed judgment of management. See also 17 C.F.R. 229.10(b)(3)(iv) ("the responsibility for determining whether to discontinue or to resume making projections is best left to management"). Moreover, recognizing the serious danger of potential corporate liability for disclosing forward-looking information, the SEC specifically adopted a "safe harbor" immunity section that provides that disclosures covered by the rule will not be deemed fraudulent unless the plaintiff shows that the information was prepared without a reasonable basis or was revealed other than in good faith. See 17 C.F.R. 230.175. These special provisions, recently adopted by the SEC after careful and extensive consideration, attest to the substantial practical problems that attend the disclosure of information about contingent or inchoate developments.

b. These considerations are well illustrated by the issue of the materiality standard governing disclosure of preliminary merger discussions. In that context, three circuits have adopted the so-called price/structure rule, under which merger talks are not material until an agreement in principle has been reached. See *Flamm*, slip op. 8-15; *Greenfield*, 742 F.2d 751; *Reiss*, 711 F.2d 11; *Staffin*, 672 F.2d 1196; see also Note, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 Yale L.J. 547 (1987).[2]

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[2] The government contends in its amicus brief at the petition stage (at 9 n.11, 12 n.13) that, notwithstanding the clear and recent decision in *Reiss*, the Second Circuit does not follow the price/structure rule. In support of its contention, the government relies on decisions in "insider trading" cases. However, as those decisions themselves recognize, a different (and broader) standard of materiality applies in "insider trading" cases than in cases involving allegedly false or misleading disclosures; indeed, the very fact that insiders were trading on the basis of non-public information is a compelling indication that it was material. See *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39, 48 (2d Cir. 1976); *SEC* v. *Shapiro*, 494 F.2d

The price/structure rule serves the important policies outlined above: it provides meaningful guidance to management as to when the disclosure of merger negotiations is required; it permits the exercise of informed business judgment to decide whether to make earlier disclosure; and it guards against the risk that litigation will ensue whatever disclosure decision is made. By contrast, the alternative tests fail to serve these policies. Thus, although the government has acknowledged (U.S. Am. Br. 10 n.11) that some merger discussions may be so precursory and tentative that they are immaterial as a matter of law, it has endorsed a legal standard that does not differentiate those cases from others in which the government believes that preliminary negotiations may be material. As Judge Easterbrook recently explained, however:

> If disclosure must occur at an earlier date, how much earlier? That would be fertile ground for disputation. No matter how soon the firm announced the negotiations, investors could say that it should have done so a little sooner. * * * The time at which information should be disclosed ought to be readily ascertainable.

Flamm, slip op. 15. The government's approach—to let the jury apply an ad hoc balancing test to the particular facts of each individual case—does not furnish workable answers to the difficult and recurring disclosure questions that arise in the merger area.

What is more, premature public disclosure of pending merger talks can irreparably interfere with the pursuit and successful completion of the merger. See ***Flamm***, slip op. 12-15; ***Greenfield***, 742 F.2d at 757; ***Staffin***, 672 F.2d at 1206-1207. As the foregoing decisions explain, a rule that preliminary merger negotiations are not material will best promote the overall interest of stockholders as a group.

1301, 1306-1307 & n.3 (2d Cir. 1974); see also *Texas Gulf Sulphur*, 401 F.2d at 851.

Finally, in some instances management properly could decide not to disclose preliminary merger discussions because such disclosure might be misleading to investors. See *Greenfield*, 742 F.2d at 756, 757; *Staffin*, 672 F.2d at 1205-1207. The court in *Reiss* emphasized this concern (711 F.2d at 14):

> Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned. We are not confronted here with a failure to disclose hard facts which definitely affect a company's financial prospects. Rather, we deal with complex bargaining between two (and often more) parties which may fail as well as succeed, or may succeed on terms which vary greatly from those under consideration at the suggested time of disclosure.

See also statement of SEC Commissioner Grundfest, P-H Information Services Corporate Acquisition Ideas, *Disclosure Policy: A Commissioner's Viewpoint* 5, 7 (May 1986) (premature disclosure of preliminary merger negotiations may actually be more misleading than secrecy for investment decisions). Similarly, because a corporation may have a duty to update previous statements (see, *e.g.*, *Greenfield*, 742 F.2d at 758), "successive, possibly cancelling, announcements might have been required * * * [a]s the situation evolved," which "would have tended to confuse and mislead, rather than enlighten, the investing public" (*id.* at 757). See *Walker*, 802 F.2d at 710.

B. Management Does Not Act With Scienter If Its Decision Whether To Disclose Information About Contingent And Inchoate Developments Is Made Conscientiously And Without Intent To Defraud Investors.

In addition to materiality, scienter is an essential element of a Rule 10b-5 cause of action. Many of the policies underlying the scienter requirement also underlie the need for a clear standard of materiality, and therefore

the scienter requirement provides additional support for the price/structure rule.

Scienter is generally defined as "'a mental state embracing intent to deceive, manipulate, or defraud.'" *Dirks*, 463 U.S. at 663 n.23. This "independent element of a Rule 10b-5 violation" is satisfied "only where there is 'intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.'" *Ibid.* Accordingly, scienter is lacking "unless [the defendant] acted other than in good faith." *Hochfelder*, 425 U.S. at 206. See also *Dirks*, 463 U.S. at 674 nn. 10, 11 (Blackmun, J., dissenting) (scienter requires that the defendant "must know that his conduct violates or intend that it violate his duty"; "the scienter requirement functions in part to protect good-faith errors," and thus a person who "in good faith does not believe that the information is material * * * lacks the necessary scienter").

As discussed above, there are legitimate business reasons to preserve the confidentiality of preliminary merger discussions prior to agreement on price and structure. Therefore, if a corporate official, who is not trading in corporate stock, decides to withhold information about pending merger discussions in order to preserve their confidentiality for the benefit of shareholders, he is acting in good faith and without scienter.

In addition, where the materiality of information about contingent and inchoate matters is not amenable to a clearly defined test like the price/structure rule, the scienter requirement provides vital protection against unjustified damages liability. Where management conscientiously decides whether, when, and how to disclose such information in the best interests of shareholders overall, it has not acted with scienter even though the disclosure may prove to be incomplete or inaccurate. A "person making a soft disclosure in good faith and with reasonable prudence should be protected against liability,

even if his opinion or prediction turns out to be incorrect." Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. Pa. L. Rev. 254, 304 (1972).

It therefore is not enough for a plaintiff to allege and prove that management knew that it was disclosing or omitting the information in question; management invariably will be aware of what it is doing. "To prove *scienter*, more than a conscious failure to disclose must be shown. Rather, there must be proof that the non-disclosure was intended to mislead." *Reiss*, 711 F.2d at 14. This standard is required by "the business judgment rule and the teachings of *Ernst & Ernst* v. *Hochfelder*," see *State Teachers Retirement Board* v. *Fluor Corp.*, 500 F. Supp. 278, 293 (S.D.N.Y. 1980), aff'd in pertinent part, 654 F.2d 843 (2d Cir. 1981):

> [I]t is inappropriate * * * [to] focus[] the inquiry on the defendant's knowledge of the danger of non-disclosure rather than on whether it pursued the course of non-disclosure with a wrongful purpose. For instance, it is a reality of the marketplace that when management chooses to delay the release of information because it does not know if it has all the facts, or for whatever reason, rumors may circulate, and some speculators may profit from them while some shareholders, ignorant of the rumors, will sell. Under the definitions of reckless conduct which plaintiff asks this court to apply, knowledge of this danger alone, regardless of the reason for non-disclosure, would result in liability.

In other words, "there must be more than an intent not to disclose this information; there must also be proof that the omissions were made with an intent to deceive or defraud investors" (500 F. Supp. at 299). Conduct that is "mistaken but honest in belief" is not a Rule 10b-5 violation. *Sanders* v. *John Nuveen & Co.*, 554 F.2d 790, 792 (7th Cir. 1977). See also, *e.g.*, *Barker* v. *Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496-497 (7th Cir. 1986); *McLean* v. *Alexander*, 599 F.2d 1190,

1198, 1202 (3d Cir. 1979); *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1044-1045 & n.20 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 200-201 (Winter 1986).

Accordingly, where management decides not to disclose information because of a concern that investors might be misled, the requisite scienter is lacking. See *Reiss*, 711 F.2d at 14. Similarly, if management acts for a legitimate business reason—for example, to preserve the confidentiality of pending merger negotiations (*ibid.*) or to permit sensitive financing arrangements to be made (*Fluor Corp.*, 654 F.2d at 850, 853)—it has not acted with scienter. In addition, as former SEC Commissioner Longstreth has explained, scienter cannot be shown when management's disclosure decisions were reasonably based on advice of counsel. See Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1185, 1196 (1982). And scienter generally will be absent if management did not stand to benefit personally from its disclosure decisions at the expense of the company's shareholders. See *Barker*, 797 F.2d at 497; *Fluor Corp.*, 500 F. Supp. at 292.

In this case, the district court, acting on a "voluminous" and "detailed" record (Pet. App. 2a), concluded that there was no evidence of scienter on petitioners' part. The company's statements regarding merger discussions prior to an agreement on price and structure served legitimate business concerns. The Sixth Circuit therefore erred when it reversed the district court on the ground (Pet. App. 16a) that summary judgment is presumptively inappropriate on the issue of scienter. See *Anderson* v. *Liberty Lobby, Inc.*, 106 S.Ct. 2505, 2514 (1986).

In cases involving scienter, as in all other cases, a plaintiff must, in order to defeat summary judgment, adduce evidence that would be sufficient to support a

favorable jury verdict at trial. *Anderson*, 106 S.Ct. at 2510-2512, 2514. Where a plaintiff's pretrial submission fails to satisfy that standard, the case can and should be disposed of summarily. See *Celotex Corp.* v. *Catrett*, 106 S.Ct. 2548 (1986). Summary judgment is especially appropriate where the plaintiff's claim does not rest on an objectively reasonable premise—for example, where the action alleged to be fraudulent was not in the economic self-interest of the defendant. See *Matsushita Electric Industrial Co.* v. *Zenith Radio Corp.*, 106 S.Ct. 1348, 1356, 1361 (1986).

These principles make clear that summary judgment properly can be entered for a defendant on the issue of scienter, as a number of courts have held in Rule 10b-5 cases. See, *e.g.*, *Barker*, 797 F.2d at 496; *Bryson* v. *Royal Business Group*, 763 F.2d 491 (1st Cir. 1985); *Reiss*, 711 F.2d at 13-14; *Fluor Corp.*, 500 F. Supp. at 294, 299. The Sixth Circuit suggested no reason why the same disposition was not appropriate here.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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