TYPE I ERROR, TYPE II ERROR, AND THE PRIVATE SECURITIES LITIGATION REFORM ACT

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My comments follow the academic tradition of favorably and briefly mentioning the principal paper, and then going on to discuss what seems to be something else entirely.

The subject of Professor Weiss' paper is proposed Section 21D(b)(2) of the Private Securities Litigation Reform Act.[1] This section wrestles with an inescapable difficulty that goes along with the concept of fraud: a necessary element of any fraud claim, whether brought under the federal securities laws or at common law, is the defendant's state of mind.

Lord Justice Bowen once observed that a man's state of mind is just as much a fact as his state of digestion.[2] I have always wanted to offer the rejoinder: both are extremely difficult for the outside observer to detect. One of the problems with proving state of mind as an element of any cause of action is that, unless the defendant is required to submit to a polygraph, there will always be a good deal of uncertainty about what the defendant thought, or did not think, at the relevant point in time. This uncertainty inevitably gives rise to the problem law and economics scholars refer to as "legal error."

If I may inflict some theory on you, scholars generally divide error into two categories. The first category of legal error is called Type I error, or the "false positive." In securities litigation, an example of a Type I false positive would be a judicial finding that a defendant had fraudulently misrepresented something, when in fact no fraud occurred. The second type of error is called Type II error, or the "false negative." A Type II false negative occurs when a court trying to decide whether the defendant has committed fraud mistakenly finds there has been no fraud, even though fraud actually occurred.

Professor Weiss' paper neatly documents how Congress in drafting Section 21D(b)(2) was concerned with both Type I error (allowing meritless suits to proceed) and Type II error (keeping legitimate fraud claims out of court). But Congress was particularly concerned about a form of Type I error: the so-called "strike suit." Section 21D(b)(2) tries to discourage strike suits by raising the pleading standards plaintiffs must meet. In particular, plaintiffs are

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1. Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675 (1996).

2. Edgington v. Fitzmaurise, 29 Ch. D. 459, 483 (1885).

required "to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[3]

Professor Weiss' paper brilliantly analyzes just how unsatisfactory a standard this is. If I can summarize his argument, the standard requires two things: first, some facts that could give rise to an inference of fraudulent scienter; and second, the judge's belief that these facts are enough to support a "strong inference." I was quite persuaded by the time I was done reading Professor Weiss' paper that any plaintiffs' attorney with two neurons to rub together could, if she spent a little time, be able to come up with some particularized facts that conceivably support an inference of fraud. From that point it is determined at least as much by what the judge had for breakfast, as by any legal standard, whether the facts the plaintiff's attorney has presented will be deemed to support a strong inference of fraudulent scienter.

Professor Weiss goes to great lengths to try to add some determinacy to this indeterminate standard. I admire and applaud his efforts, and believe he offers some very valuable suggestions. I'm particularly intrigued by the notion that courts, in weighing whether the plaintiff has pleaded particularized facts supporting a strong inference of fraudulent scienter, should explicitly take into account what information is available to the plaintiff before discovery has begun.[4]

Nevertheless, what strikes me as especially interesting is Professor Weiss' ultimate conclusion that no perfect standard can be devised that accurately separates strike suits from meritorious suits. As a result, he concludes, the "inevitable effect of Congress' decision will be to increase somewhat the number of cases in which open market fraud will go unremedied [and] to decrease somewhat the number of cases in which defendants will be forced to incur the cost of defending (or settling) non-meritorious claims."[5] In other words, increasing the pleading standard under Section 21D(b)(2) will decrease Type I error, but instances of Type II error—meritorious suits thrown out of court because plaintiffs, without discovery, cannot offer sufficient evidence of fraud—will increase.

I want to spend the remainder of my discussion inquiring into whether there is anything intelligent we can say about balancing Type I against Type II error in securities litigation. I want to focus on this question because I believe, having observed the antics on Capitol Hill surrounding the passage of the Private Securities Litigation Reform Act, that a realistic sense of the relative costs of Type I and Type II error in securities litigation has been missing from the debate. I hope I can contribute something of a sense of proportion to the discussion.

Let us first talk about Type I error: the strike suit. If you listen to the rhetoric coming from Capitol Hill, you will swiftly reach the conclusion that the problem of strike suits is endemic and horribly costly. Indeed, it is draining the life out of American enterprise.

3. The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, § 101(b).
4. Weiss, *supra* note 1, at 704.
5. *Id.* at 707.

When the proponents of securities litigation reform start to talk dollars and cents, however, you very quickly get a better idea of the magnitude of the social losses supposedly flowing from strike suits. Most often, corporate losses from defending against meritless strike suits are described as running in the millions or tens of millions of dollars. When the proponents of securities litigation reform get really ambitious, they will sometimes mention figures in the hundreds of millions. Let us give securities litigation reform the benefit of the doubt, and assume that innocent corporations lose hundreds of millions of dollars annually, in terms of lost executive time and lawyers' fees, to meritless strike suits.

Now I want to talk about the cost of an increase in Type II error. To explore the cost of Type II error in securities litigation, I need to make a little bit of a theoretical diversion, and discuss more generally the costs of fraud.

When securities scholars get together, they often find they agree on very little. But there is one thing they do agree on: fraud is very, very bad for securities markets.[6] In lay terms, fraud is bad for securities markets because it erodes investor confidence. This occurs because fraud makes it difficult for investors to detect differences in the quality of the securities they buy. Companies issuing bad securities—poorly run firms that throw away money and do a poor job for their investors—can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms.

What happens in such a market? Very quickly the market gets flooded with bad firms, because fraud allows them to sell worthless securities at high prices. Until, of course, investors learn that they can't distinguish between good and bad companies. When that happens, investors begin to discount the quality of *all* the securities in the market. In other words, they lose confidence in the market, and will no longer pay high prices even to good firms selling quality securities. At this point, the good firms exit the market, because they can't get a decent price for their securities. The market comes to be dominated only by dubious firms willing to sell at very low prices because their securities are in fact worth even less. This is the "market for lemons" phenomenon first described by the economist George Ackerlof many years ago.[7]

Because fraud turns the securities market into a "market for lemons," there is a consensus in the securities field that fraud is bad. What has been amazing to me, however, is how little discussion there has been of the implications of this consensus for securities litigation reform. The reason we tend to forget the dangers of fraud for securities markets may be that the federal securities laws have, in fact, been highly successful in deterring fraud. The observation that some civil lawsuits charging securities fraud seem questionable to outside observers is not at all inconsistent with the notion that the federal antifraud laws are doing exactly what they are supposed to be doing—deterring more egregious cases.

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6. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673–80 (1984) (describing value of antifraud rules).

7. George Ackerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

Among legal scholars, this idea is often referred to as the Priest-Klein selection hypothesis.[8] The Priest–Klein hypothesis predicts that when legal rules are reasonably clear and enforceable, people behave in accordance with the rules. Thus, the only cases likely to show up in court are cases where the proper behavior under the rules is sufficiently uncertain that the parties can disagree. This in turn suggests that when you have a rule against fraud that is clear and enforceable, exactly what you would expect and hope to see would be that the only cases brought are cases where reasonable people can disagree on the merits.

In lay terms, Congress' assumption that we can afford to reduce antifraud protections because flagrant fraud does not appear to be a serious problem in the U.S. securities market reminds me of the following scenario. Suppose the residents of a town experience a horrible crime wave. Cars are being broken into, homes are being broken into, citizens are being held up at gunpoint. The residents of the town go out and hire a bunch of policemen. Lo and behold: the crime stops, and the policemen start to spend their time issuing tickets for jaywalking. Then the residents turn around and say to each other, "What do we need all these policemen for? We don't have a crime problem."

I can't help but suspect that something similar is going on in Congress at this moment. Let's explore what might happen if we did fire the policemen, and the result was an increase in the incidence of securities fraud.

Although the figure is constantly rising, the market value of publicly-held equities issued by United States corporations presently exceeds $8 *trillion*.[9] That's just stocks, of course. According to federal Flow of Funds accounts, the market value of corporate bonds currently outstanding is another $2 or $3 trillion.[10] Throw in commercial paper, and some of the non-bond debt forms corporations issue, and I think it safe and fair to say that the market value of United States corporate securities outstanding today significantly exceeds $10 *trillion*. That's $10,000,000,000,000.00.

Let's assume that firing some policemen—in this case, some plaintiffs' lawyers—discourages strike suits but also makes it more difficult for investors to pursue legitimate fraud claims. And let's assume, conservatively, that the net result is that investors concerned by the increased likelihood of securities fraud come to discount the value of the securities market by one percent—a measly fifty points off the Dow Jones Industrial Average. That would be the equivalent of a $100 *billion* decline in the market value of outstanding corporate securities.

When I look at Congress worrying about firms losing hundreds of millions of dollars from strike suits, I cannot help but think about the foolishness of trading in hundreds of *millions* of dollars of Type I error costs for, potentially, hundreds of *billions* of dollars of Type II costs. That is exactly

8. George Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).

9. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS: FLOWS AND OUTSTANDINGS FOURTH QUARTER 1995, tbl. L.4, line 13, at 70 (Mar. 8, 1996) (value of corporate equities at close of last quarter of 1995 amounted to $8.4 trillion).

10. *Id.* at tbl. L.2, line 7 (value of nonfinancial corporate bonds at close of last quarter of 1995 amounted to $1.3 trillion) and tbl. L.3, line 7 (value of financial corporate bonds at close of last quarter of 1995 amounted to $1.1 trillion).

the possibility raised by Section 21D(b)(2)'s attempt to reduce strike suits by raising pleading requirements.

That observation does not imply that I do not believe strike suits are serious phenomena. Strike suits may, in fact, be imposing significant costs on United States firms, and even though I worry about hundreds of billions of dollars in lost market value more than hundreds of millions of dollars lost to strike suits, I do think that hundreds of millions are worth addressing. But it seems to me there may be better ways to do this than raising the pleading requirements for securities fraud claims.

Perhaps one of the best strategies may be not to fire the policemen, but to change them. As much as I liked Professor Weiss' paper, I am even fonder of an earlier article he wrote with Professor John Beckerman.[11] In that article, Professors Weiss and Beckerman suggest not that we make it harder for plaintiffs to bring fraud claims, but rather that we try to change the choice of lead plaintiff from the investor whose lawyer is first in line at the courthouse to the investor who has the largest financial interest. Such an approach might do much to address Type I error without unduly increasing the risk of Type II error.

I have done my best to set the stage for tomorrow's discussion of the role of institutional investors in securities litigation. I will now turn things back over to our moderator, Professor Ares.

11. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).