Securities Issuer Liability for Third Party Misstatements: Refining the Entanglement Standard

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NOTES

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I. INTRODUCTION

Smith, president of E.com, Inc., believes his firm’s securities are undervalued. Believing that expanded coverage in the financial press will cause E.com’s securities to trade at higher prices, Smith begins a public relations program designed to help investment analysts more accurately forecast his firm’s future performance. Jones, financial analyst, takes information from the public relations program, drafts an optimistic forecast for E.com, and then asks its executives for their review and comment. Smith and his executives make extensive factual and descriptive edits to the report but refuse to comment on financial earnings projections, citing a longstanding company policy against such. Instead, Smith gives Jones repeated assurances that E.com is “well on its way to a great quarter,” and that he was “incredibly bullish” on his firm’s future earnings potential. Catching the innuendo, Jones drafts a favorable report on E.com’s prospects, causing the financial markets to bid up the company’s stock price in reliance on the new information.

In reality, Smith and his executives realize that E.com’s internal earnings projections are far below those predicted in Jones’s market report, but they take no measures to correct their company’s inflated stock price. In the meantime, Baker, individual investor, purchases a large stake in E.com, relying on the company’s market price as an indication of its fair value. Soon thereafter E.com discloses its low earnings in its mandatory quarterly financial report, its stock price plummets, and Baker loses his life savings. Baker brings a private securities fraud action under federal securities law alleging that E.com intentionally misled analysts—and therefore the market—to inflate its stock price. Is E.com liable to Baker (and other harmed investors) for the analyst’s misstatements? Under what circumstances should it be?

The prevailing standard for determining issuer liability under the federal securities laws for third party misstatements asks whether the issuer “sufficiently entangled” itself with the analyst’s report to such a degree that the analyst’s misstatements can fairly be attributed to the issuer. If the entanglement threshold is met, a company has a duty to correct material misstatements affecting the market.

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2. See id. at 163.
when it subsequently realizes their inaccuracy,³ else the company becomes liable for civil and regulatory sanctions under the federal securities fraud laws.⁴ Not surprisingly, courts applying the standard have had to grapple with what "entanglement" means in application.⁵ Although the doctrine is developing with greater clarity,⁶ the standard for liability remains too muddled for corporate managers to avoid running afoul of the law with predictive certainty.⁷

This Note cuts a bright-line path through the entanglement thicket. Part II discusses the forecasting methods of investment analysts and the information they use to construct their corporate valuations. Part III describes the federal regulatory framework governing corporate disclosure and Rule 10b-5 liability for wrongdoing. Part IV describes the contours of the prevailing entanglement standard and its related theories. Part V refines the problem in light of the analytical framework governing corporate liability for third party misstatements. Part VI discusses the policy interests of the key stakeholders involved, including securities issuers, investors, and society at large. Finally, Part VII recommends that courts adopt a practical bright-line standard for pre-publication entanglement liability premised on explicit corporate agreement with an analyst report's final contents, marshaling current doctrine, policy interests, and the

⁴. See 15 U.S.C. § 78j (1994); 17 C.F.R. § 240.10b-5 (1999). The SEC has a broad arsenal of enforcement tools, including injunctive relief, the power to prohibit violators from serving as officers or directors of corporations with registered public securities, and the power to seek monetary penalties, as well as criminal prosecution. See 15 U.S.C. § 78a(a)-(h), 78ff(a)-(c) (1994). Private claimants also have a cause of action under 10b-5 and may seek heavy damages for securities fraud violations. See Herman v. McLean & Huddleston, 459 U.S. 375, 380 (1983) (noting that a private right of action under Rule 10b-5 has been consistently recognized for more than thirty-five years).
⁷. See, e.g., Editorial, Vengeance or Growth? WALL ST. J., Nov. 25, 1991, at A14 (describing how Oracle Systems Corp. has stopped discussing forward-looking corporate prospects with analysts after being sued nineteen times for securities fraud in 1990). Theoretically, if the standards governing corporate liability for third-party misstatements were clear, then firms such as Oracle would be better able to avoid securities fraud suits stemming from manager-analyst interaction.
realities of modern financial analysis for support. Part VIII resolves the hypothetical posed above.

II. INVESTMENT ANALYSTS AND THE MECHANICS OF SECURITY VALUATION

Developing a practical standard for securities issuer liability under the federal securities laws is a complicated task because the financial markets rely on investment professionals and other third-party intermediaries to collect and disseminate information on corporate value. Consequently, when investors rely on misleading information to their detriment, determining whether a company has committed fraud or analysts have simply overestimated the company's future earnings and growth prospects often raises difficult factual and legal issues. The current legal standards governing corporate liability for third party misstatements are largely shaped by the role analysts play in capital market machinations.

A. The Role of Investment Analysts

Securities analysts collect and distribute the information required to make intelligent investment decisions to investors lacking the time, acumen, and resources to make these decisions independently. Rational investors want to know whether a publicly traded firm’s expected return justifies its stock price in light of the perceived risk. In exchange for brokerage fees, analysts supply this infor-

8. See Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 560-61 (1984). The authors define information as “data that has the capacity to alter one’s beliefs about the world, or . . . one’s beliefs about the appropriate price of an asset.” Id. at 561.


11. Professor Langevoort pointed out that active investors need information to make informed decisions and some pay for this information directly or indirectly, through brokerage commissions. See Langevoort, supra note 8, at 1025. By contrast, other investors take market efficiency for granted and engage in passive investment strategies, such as market index and mutual funds. Id.
mation by estimating the equity value of the corporations they follow through a two-stage valuation process. First, analysts gather all known and publicly available factual, or "hard," information about corporations and the environments in which they operate. Next and most importantly, analysts attempt to forecast future corporate earnings by calculating the company's anticipated future cash flows. The inherent uncertainty of future events forces analysts to cast these earnings projections as statistical probability distributions, known as "soft information." Analysts produce soft estimates of future earnings in one of two ways, the first and easiest of which is simply adopting internal projections supplied directly by the corporations. Alternatively, if a company withholds internal earnings data, analysts must create their own forecasts by piecing together fragments of accessible information, including publicly available data and voluntary corporate disclosures bearing on future earnings. Ultimately, analysts couple soft information together with historical data to form a master forecast of future earnings. Analysts then determine a corporation's market valuation by adding the discounted present value of the com-

14. See Gilson & Kraakman, supra note 8, at 561. The authors define hard information as current and historical information bearing on stock prices, as distinguished from predictions about future, uncertain events. See id. Examples of hard information include current press releases, government policies and interest rates, general business, social, and economic trends, as well as records of past stock prices and corporate performance. See Brountas, supra note 13, at 1520.
15. See S. Levine, FINANCIAL ANALYST'S HANDBOOK 1026 (1975) (noting that theory and evidence explain the close association between earnings and stock dividends, and that all evidence suggests that earnings account for the major portion of securities prices); Gilson & Kraakman, supra note 8, at 561 (observing that securities prices ultimately turn on expectations of future earnings).
16. See Gilson & Kraakman, supra note 8, at 561-62.
17. See Brountas, supra note 13 at 1522 (noting that information dispensed by corporate management to market analysts is most often shaped by earnings forecasts and projections calculated within the company for internal budgeting purposes, and that these earnings projections are known as "soft information").
18. See Langevoort, supra note 9, at 1028-31. If a company discloses internal earnings projections, investment analysts verify this information to prevent fraud and to eliminate the effects of corporate biases. See id. at 1030.
20. See id.
21. Analysts discount future earnings by the company's weighted average cost of capital, which considers the proportions of debt and equity in a company's capital structure and the amount of firm risk associated with each source of financing. See generally Tom Copeland et al., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 239-73 (2d ed. 1994) (describing the process for calculating a company's weighted average cost of capital).
pany's projected earnings to the value of its current assets. The appropriate market price of individual securities comes from dividing the company's market valuation by its number of issued equity shares.

B. Analysts and Marketplace Efficiency

Besides providing a professional service to investors demanding information, investment analysts play another important role in promoting capital market efficiency: ensuring that quoted security prices fairly reflect a company's value. According to the Efficient Capital Markets Hypothesis ("ECMH"), at any given time securities prices fully reflect all publicly available information relevant to their value. Securities analysts serve as key agents for marketplace efficiency because they uncover, collect, and analyze information bearing on stock prices and transmit their analyses to the financial markets, which then impound the information into security prices. Motivated by reputational interests as well as profit opportunities, analysts aggressively investigate all possible sources of information bearing on firm prospects, often conducting on-site facility inspections and inter-

22. See Levine, supra note 15, at 1026.
23. See Brealy & Myers, supra note 10, at 73 (demonstrating that the total value of a firm's common stock is equal to the discounted value stream on all future dividends to be paid on existing stock).
25. See Gilson & Kraakman, supra note 8, at 554-60. The ECMH comes in three generally accepted classifications: the weak form, semi-strong form, and strong form models. See id. at 555-56. In its weak form, the ECMH holds that capital markets presumptively reflect only the historical information that affects securities prices. See Brealy & Myers, supra note 10, at 325. The semi-strong model posits that capital markets securities prices reflect all past and currently available public information. See id. The strong form assumes that securities prices reflect all past and currently available public and private, or "inside," information affecting stock value. See id. Scholars by and large agree that the semi-strong form of the ECMH best approximates the observable operations of the financial markets. See Basic, Inc. v. Levinson, 485 U.S. 224, 246, 246 n.24 (1988) (citing empirical studies confirming that the securities prices on well-traded markets reflect all publicly available information). In Basic, the Supreme Court enshrined the ECMH when it held that investors were entitled to a rebuttable presumption of reliance on securities prices in securities fraud cases. Id. at 245-47.
26. See Dirks v. SEC, 463 U.S. 646, 658-59 (1983) (noting that the SEC recognizes the importance of investment analysts for the preservation of healthy markets; that it is commonplace for analysts to "ferret out and analyze information" by meeting with and questioning corporate officers and other insiders; and that the analysts' information may become the basis for judgments as to the market worth of a corporation's securities).
27. See Langevoort, supra note 9, at 1030 (asserting that analysts are objective in part because their reputations are at stake).
28. See id. at 1025.
views with corporate officers and the firm's competitors. Once released, the significance of new information becomes impounded into security prices almost instantaneously. Widespread dissemination is unnecessary, as securities prices achieve rapid equilibration when a few knowledgeable traders controlling a critical volume of market activity act on the new information. Therefore, in the ECMH paradigm, securities are considered fairly priced at any given time, and the Supreme Court has accordingly entitled investors to presumptive reliance on the integrity of market prices to make investment decisions.

C. Analysts and Securities Issuers

Public corporations generally want market analysts to cover them so that their securities will trade at optimal prices. The limited

29. See id. at 1026. Professor Langevoort describes the analyst's investigative efforts: Information is gathered from numerous sources, beginning with press releases and publicly available documents such as issuer filings with the SEC. In analyzing the profit potential of a newly announced product, for example, an analyst might talk to the issuer's competitors and customers. But at some point, in order to fill out the picture thus far drawn and to facilitate an accurate assessment of information previously generated, company officials should be questioned. These questions may be raised in group meetings with analysts commonly sponsored by issuers, or in face-to-face or telephone contacts between a single analyst and a company insider.

Id. Some courts have described the investigative efforts of investment analysts as the "mosaic theory," because skilled analysts can combine seemingly inconsequential inside information with public information into a sketch of corporate affairs that reveals material non-public information. See Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980); SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 9-10 (2d Cir. 1977).

30. See Gilson & Kraakman, supra note 8, at 569-70 (arguing that "universally" informed trading really reflects only the activity of traders who are direct recipients of information, and that the rapidity of price adjustments depends on the volume of informed trading).

31. But see Eckstein v. Bakor Film Investors, 8 F.3d 1121, 1129 (7th Cir. 1993) ("We call a market 'efficient' because the price reflects a consensus about the value of the security being traded—not necessarily because the price captures the true value of the firm's assets but because the price is the best available device to assess the significance of additional bits of information.").

32. See Basic, Inc. v. Levinson, 485 U.S. 224, 241-45 (1988). In Basic, the Supreme Court effectively took judicial notice of the dominant theory of market efficiency, the ECMH, by adopting into law the "fraud on the market" theory, which relies on the ECMH. See id. at 241-42. The court observed that:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such case is no less significant than in a case of direct reliance on misrepresentations.

Id. (quoting Paul v. Speiser, 806 F.2d 1154, 1160-1161 (3d Cir. 1986).

33. See Brountas, supra note 13, at 1540-42. The author argues that corporate speech to investment analysts allows for more sophisticated analysis of the information's market impact because analysts can understand and simplify the substantive content of the information. See id. at 1540. Because analysts are able to assess a company's disclosures and determine their
supply of analysts relative to the number of publicly traded companies inevitably causes some firms to experience difficulty finding a voice in the marketplace. To ensure sufficient coverage, many firms attempt to develop close relationships with analysts through formal public relations “guidance” programs as well as informal direct contact.

Analysts do not follow companies gratuitously. To maintain close relationships with the financial community, firms experience pressure to supply analysts with responses to pointed questions about a firm’s operations, including requests to review and comment on draft analyst reports. In many ways, the relationship between companies and analysts that ensues resembles an exchange relationship. Firms receive the coverage they want as long as they supply analysts with enough information to remain competitive within the financial information industry. Yet these incentives for firms and analysts to communicate test the bounds of federal securities law, which limits the manner and types of information firms may disclose. The clash between federal disclosure policy and market demand for information is especially attenuated in the securities fraud context, when issuers have allegedly supplied analysts with misleading information or approved their inaccurate market reports.

validity, Brountas argues that disclosure to analysts results in an implied warranty of truthfulness when the information communicated eventually enters the market, thereby enhancing the disclosing corporation’s credibility and improving the quality of information that the public obtains. See id. That lack of market coverage causes a firm’s security price to trade at lower levels is not a paradox under the ECMH, as it may initially appear. If firms are undervalued, then the market likely has not received information that would normally prompt readjustment, making the current security price fair in the sense that it reflects all publicly available and known information about the security’s value. See Eckstein, 8 F.3d at 1129-30.

34. See Brountas, supra note 13, at 1541 (claiming that smaller companies often experience difficulty finding a voice in the market).

35. See Alan K. Austin & Clay B. Simpson, Interacting with Analysts, in THE ART OF COUNSELING DIRECTORS, OFFICERS & INSIDERS: HOW, WHEN & WHAT TO DISCLOSE 89, 92 (Alan K. Austin et al. eds., 1998). The authors describe interactions between managers and analysts as a “courtship dance” in which managers attempt to give analysts enough information to keep them satisfied, while at the same time avoiding liability for any written or oral communication to analysts that could be portrayed as a material misstatement or selective and illegal disclosure of insider information. Id.; see also Herman v. Legent Corp., No. 94-1445, 1995 WL 115879 (4th Cir. Mar. 20, 1995) (describing how defendant engaged in a guidance program through periodic press releases and calls with analysts to help the market stay informed of its growth, and how analysts attempted to predict the company’s market performance based on the “guidance” information).

36. See Austin & Simpson, supra note 35, at 91 (discussing company pressures to provide sufficient company information to satisfy analysts).
III. THE FEDERAL REGULATORY FRAMEWORK

Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 in the wake of the 1929 stock market crash to ensure that investors enjoy full disclosure of material information concerning public securities in initial offerings and subsequent secondary market trading. Mandatory filing requirements, civil actions, and criminal penalties for violations serve as the primary vehicles to protect investors against fraud and manipulation in the securities market.

37. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976); see also H.R. REP. No. 73-85, at 2-3 (1933). Before the 1929 market crash a great deal of abuse plagued the securities industry, most of which involved the perpetration of fraud or other manipulative practices that hurt investors and tended to destabilize the market. See H.R. REP. No. 73-85, at 2-3 (1933). The House committee working on the 1933 legislation assessed the situation:

During the post-war decade some 50 billion of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesman ship rather than careful counsel was the rule in this most dangerous of enterprises. Id. at 2.

38. See JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 3 (2d ed. 1997) (explaining that Congress embraced affirmative disclosure as a means to curb fraud and manipulation in the securities markets). The authors note that the '33 Act adopted the regulatory philosophy of Justice Brandeis: "Sunlight is said to be the best of disinfectants: electric light the most efficient policeman." Id. at 3-4 (quoting L.D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (1914)).

39. See id. (citing H.R. REP. No. 73-85, at 2 (1933)). The Securities Act of 1933 governs initial public offerings of securities. See id.

40. See id. at 5. (citing S. REP. No. 73-792, at 1-5 (1934)). The Securities Exchange Act of 1934 governs post-issuance transactions on the nation's securities exchanges. See id.

41. See id. at 8. The '34 Act implemented a system of continuous disclosure by securities issuers. See id. First among these, the annual report on Form 10-K, requires extensive description of the company and its operations, audited financial statements for the fiscal year, and the management's discussion of the firm's position and performance. See id. The 10-Q embodies quarterly disclosures of unaudited interim financial statements and management's analysis of financial operations. See id. Form 8-K shines light on significant events that could otherwise go unobserved in the financial community, as it must be filed within 10-15 days of a material corporate development, including (1) a change in control, (2) the acquisition or disposition of a large amount of assets, (3) the commencement of bankruptcy proceedings, (4) a change in auditors, or (5) the resignation of a director in a dispute over company policy. See id.

42. See J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964) (recognizing an implied civil cause of action for violations of the anti-fraud statutes).

43. See COX ET AL., supra note 38, at 5, 11 (observing that, pursuant to the Securities Exchange Act of 1934, the SEC has regulatory control over the securities exchanges, although the Justice Department handles all criminal prosecutions arising under the Act).
Finally, Congress created the Securities Exchange Commission ("SEC") in the '34 Act to allow flexible enforcement of the federal securities laws.

A. Mandatory Disclosure Requirements

The federal securities laws contain several provisions requiring public corporations to periodically disclose financial and other business-related information relevant to the firm's financial condition. These disclosure obligations operate in tandem with the anti-fraud provisions in providing investors with full and accurate information on publicly traded firms, thereby reducing both investor speculation and blatant fraud. Regular disclosure obligations include the quarterly, annual, and current reports on Forms 10-Q, 10-K, and 8-K, and the various forms for registration statements. Apart from these routine disclosure obligations, firms also have an affirmative duty to divulge material, non-public information when circumstances develop that are reasonably likely to have material effects on a registrant's material condition or operations results. Additionally, firms must comply with the disclosure requirements of the exchanges on which their securities trade. Finally, firm managers operate under the "disclose or abstain rule," which obliges public companies to release material non-public information to the market if insider trading is anticipated or has occurred. The insider trading prohibition becomes especially problematic in the context of informal discussions between corporate insiders and analysts. Executives must walk a fine line between satiating

44. See id. at 681. (noting the SEC's rule-making authority under § 10(b) of the '34 Act).
45. See 15 U.S.C. §§ 77a-77mm (Supp. I 1995); 15 U.S.C. §§ 78a-78kk (Supp. I 1995). The regulatory framework is based on mandatory disclosure, both in initial securities registration statements and continuing reporting documents filed with the SEC. See Cox et al., supra note 38, at 4, 8. Relevant information includes facts about the company, its officers and directors, and certain types of risk and accounting disclosure. Id. at 8-9.
47. See Cox et al., supra note 38, at 19. The securities exchange acts employ a cooperative regulatory effort between the SEC and industry sponsored groups, such as the National Association of Securities Dealers ("NASD") and the nation's ten registered securities exchanges. See id. But see Halkin v. Verifone, Inc. (In re Verifone Sec. Litig.), 11 F.3d 855, 871 (9th Cir. 1993) (holding that violation of an exchange rule will not support a private claim under rule 10b-5).
48. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (holding that insiders in possession of nonpublic material information must either disclose the information or refrain from trading the stock).
49. See SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 9 (2d Cir. 1977) (likening management discussions with investment analysts to a "fencing match conducted on a tightrope").
analysts' appetite for company information without conveying material inside information, which may only be discussed if made simultaneously available to the investing public.\textsuperscript{50}

\section*{B. Rule 10b-5 Liability}

Federal securities fraud claims\textsuperscript{51} alleging issuer responsibility for third-party misstatements stem\textsuperscript{52} from section 10(b) of the Securities Exchange Act of 1934,\textsuperscript{53} and the SEC-promulgated Rule 10b-5,\textsuperscript{54} which together prohibit fraud in connection with the purchase or sale of securities.\textsuperscript{55} Section 10 of the '34 Act gives the SEC broad rule-making authority appropriate to protect investors or the public interest, and in 1942 the Commission adopted Rule 10b-5 as a sweeping proscription of all forms of fraud and manipulation in securities transactions.\textsuperscript{56}

The SEC defines fraud in Rule 10b-5 as “mak[ing] any untrue statement of a material fact or . . . omit[ting] 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.”\textsuperscript{57} Historically, 10b-5 fraud claimants had to “establish (1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which

\begin{footnotesize}
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\item See id.
\item The federal securities laws form the basis for both SEC enforcement proceedings and private civil actions. \textit{See generally} J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (recognizing an implied civil action under the antifraud laws).
\item See Sobol, supra note 6, at 1053. The Securities Exchange Act of 1934 has several antifraud provisions, but section 10(b) has the most expansive jurisdictional import and is invoked most frequently in securities fraud claims. \textit{See id.}
\item 15 U.S.C. §§ 78a-78kk (1994 & Supp. IV 1998). Securities Exchange Act of 1934, § 10(b) makes it unlawful for any person, directly or indirectly, through the mails, or through a national securities exchange, to use or employ, in connection with the purchase or sale of any security “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j (1994).
\item 17 C.F.R. § 240.10b-5 (1999). Rule 10b-5 states that: \[ I t \ sh all \ b e \ u n l a w f u l \ f o r \ a n y p e r s o n , d i r e c t l y o r i n d i r e c t l y , b y t h e u s e o f a n y m e a n s o r i n s t r u m e n t a l i t y o f i n t e r s t a t e c o m m e r c e , o r o f t h e m a i l s , o r o f a n y f a c i l i t y o f a n y n a t i o n a l s e c u r i t i e s e x c h a n g e , ( I ) t o e m p l o y a n y d e v i c e , s c h e m e , o r a r t i f i c e t o d e f r a u d , ( 2 ) t o m a k e a n y u n t r u e s t a t e m e n t o f a m a t e r i a l f a c t n e c e s s a r y i n o r d e r t o m a k e t h e s t a t e m e n t s m a d e , i n l i g h t o f t h e c i r c u m s t a n c e s u n d e r w h i c h t h e y w e r e m a d e , n o t m i s l e a d i n g , o r ( 3 ) t o e n g a g e i n a n y a c t , p r a c t i c e , o r c o u r s e o f b u s i n e s s w h i c h o p e r a t e s o r w o u l d o p e r a t e a s a f r a u d o r d e c e i t u p o n a n y p e r s o n , i n c o n n e c t i o n w i t h t h e s a l e o r p u r c h a s e o f a n y s e c u r i t y . \]
\item See \textit{Cox, ET AL., supra} note 38, at 681 (noting the SEC's rule-making authority under the Act).
\item \textit{See id.}
\item 17 C.F.R. § 240.10b-5.
\end{enumerate}
\end{footnotesize}
the [claimant] relied (5) that proximately caused his injury. Since any legitimate securities fraud action involves a misstatement or omission of some sort, the five elements have collapsed into materiality alone, because courts have construed recklessness as sufficient scienter and adopted the fraud on the market theory, which effectively eliminates a 10b-5 claim's reliance and causation requirements.

1. Materiality

In Basic, Inc. v. Levinson, the Supreme Court announced the standard for materiality in 10b-5 fraud cases with respect to both the substance and probable impact of speculative information released to the financial markets. Under Basic, soft information is material if "there is a substantial likelihood that the disclosure would have altered the 'total mix' of information made available." Materiality further depends "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 company activity." Ultimately, materiality of misleading statements is a mixed question of law and fact that must be decided on a case-by-case basis.

In Basic, the court applied the probability/magnitude materiality test to repeated company denials of merger negotiations. Soon

59. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-72 (9th Cir. 1990) (holding that reckless behavior meets the scienter requirement).
61. See id. at 241-42; see also supra note 32 and accompanying text. The fraud on the market theory posits that securities markets are efficient and reflect all known current and historical information bearing on stock prices. See Basic, 485 U.S. at 241-42. Misstatements affecting security value are therefore considered impounded into prevailing security prices. See id. Because investors rely on securities prices as fair and accurate representations of corporate value, they therefore detrimentally rely on fraudulent information contained in a security's price. See id. at 247. In this sense, by trading on securities prices, investors both rely upon and are damaged by material misstatements. See id.
62. See Basic, 485 U.S. at 231 (citing TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976)) (holding that information is material if it would likely influence a reasonable investor's investment decision and there is a substantial likelihood that the information would have significantly altered the 'total mix' of available information).
63. See id. at 238 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).
64. See id.; see also Greenfield v. Heublein, 742 F.2d 751, 758 (3rd Cir. 1984) (describing it as a mixed question of law and fact).
65. See Basic, 485 U.S. at 227.
after the denials, the company asked the New York Stock Exchange to suspend trading in its shares and issued a public statement that another company had approached it regarding a merger.\textsuperscript{66} A class of former company shareholders brought a securities fraud suit alleging that they had been damaged by trading in the company's stock, since management's merger denials had artificially depressed the company's stock price.\textsuperscript{67} Although the Supreme Court remanded the case for further factual determinations, in dicta it suggested that the probability of merger could be assessed through factors such as board resolutions, directions to investment bankers, and actual negotiations between the two companies.\textsuperscript{68} With respect to the magnitude of the potential merger, the Court suggested that the size of the two companies and the premiums offered over market value were good, but not necessarily dispositive, evidentiary indicia.\textsuperscript{69} The Court stressed that no particular factor by itself could make the merger discussions material.\textsuperscript{70}

2. Corporate Puffery

Courts view certain types of management promotional communications to the financial markets as categorically immaterial. Companies compete for financing in the capital markets, and corporate managers therefore experience substantial pressure to promote their firms to the investing public. Consequently, firm managers tend to characterize corporate prospects in their most favorable light, often using vague and optimistic statements to encourage investor participation. Courts describe this practice as "puffing"\textsuperscript{71} and generally find such communication lacking sufficient specificity to cross the materiality threshold.\textsuperscript{72}

While acknowledging the Supreme Court's \textit{Virginia Bancshares v. Sandberg} holding that expressions of belief or opinion concerning current facts may become material if they lack a reasonable basis,\textsuperscript{73} most lower courts have kept the materiality bar raised high in the

\textsuperscript{66.} See id. at 227-28.
\textsuperscript{67.} See id. at 228.
\textsuperscript{68.} See id. at 239.
\textsuperscript{69.} See id.
\textsuperscript{70.} See id. Instead, the question turns on each case's circumstances. See id.
\textsuperscript{71.} See Halkin v. Verifone, Inc. (\textit{In re Verifone Sec. Litig.}), 11 F.3d 865, 871 (9th Cir. 1993); Schaffer v. Timberland Co., 924 F. Supp. 1298, 1313 (D.N.H. 1996).
\textsuperscript{72.} See Raab v. General Physics Corp., 4 F.3d 283, 289 (4th Cir. 1993).
context of corporate puffing. Courts have taken a skeptical view of puffing, based largely on their common assumption that investors and analysts are too sophisticated to rely on indefinite expressions of optimism and depend instead upon specific facts. Unless corporate managers base predictions of company performance on specific and supporting facts, courts discount puffing as inactionable rhetoric.

For example, in *Raab v. General Physics Corp.*, a nuclear utility consulting and support company made statements in its annual report that regulatory changes had created a demand for the company's services with a 30-40% expected growth rate over the next several years, and that the company was positioned to carry its success from the year before into the future. A group of investors brought a securities fraud class action, alleging that the company had not disclosed the full impact of contract delays caused by the Department of Energy. The Fourth Circuit characterized the company's statements as corporate puffery lacking the specificity necessary to influence market prices and, therefore, immaterial.

C. The Irregular Disclosure Landscape

1. Insider Trading and Selective Disclosure

Publicly traded firms face insider trading penalties for selectively disclosing material nonpublic information to investment analysts when that information creates an unfair trading advantage. In such situations, the analyst too must either disclose the information or refrain from trading, otherwise, both the insider and the analyst face

74. See Rosenbaum v. Syntex Corp. (In re Syntex Corp. Sec. Litig.), 95 F.3d 922, 928 (9th Cir. 1999) (holding that simple predictions and forecasts not constituting a guarantee are not actionable); In re Stac Elec. Sec. Litig., 82 F.3d 1480, 1486 (9th Cir. 1996) (holding that company disclosures regarding contingent future possibilities are not actionable); In re Verifone, 11 F.3d at 871; Raab, 4 F.3d at 289; Krim v. Bancroft Group, Inc., 989 F.2d 1435, 1446 (5th Cir. 1993) (citing Friedman v. Mohasco Corp., 929 F.2d 77 (2d Cir. 1991) (holding that projections not worded as guarantees are generally not actionable under federal securities law)).

75. See Raab, 4 F.3d at 289 (holding that statements must be definite to be actionable).
76. See id.
77. See id.
78. See id.
79. See id.
80. See Chiarella v. United States, 445 U.S. 222, 227 (1980) (holding that Rule 10b-5 is violated unless corporate insiders either disclose material nonpublic information before trading or abstain from trading altogether).
81. See Texas Gulf Sulphur Co., 401 F.2d at 848.
insider trading liability.\textsuperscript{82} The liability threat for selective disclosure presents corporate managers with the difficult task of providing analysts with enough information to ensure the desired market coverage without crossing the insider-trading threshold.\textsuperscript{83} Courts have acknowledged the fragile relationship between managers and analysts, which one court characterized as "a fencing match conducted on a tightrope."\textsuperscript{84}

Recognizing the realities of financial analysis and forecasting,\textsuperscript{85} and the importance of analyst activity to market efficiency,\textsuperscript{86} the Supreme Court created some exceptions to selective disclosure liability\textsuperscript{87} by moving away from the disclose-or-abstain regime to a rule premised instead on improper motive.\textsuperscript{88} Despite the Supreme Court's efforts to accommodate insider-analyst communications, the SEC has intensified its efforts to prevent unfair trading advantages born of selective disclosure.\textsuperscript{89} In a striking policy departure from the Supreme Court's decision in \textit{Dirks v. SEC}, the SEC recently stated its intention to "electrify[ ] the tightrope,"\textsuperscript{90} by putting reputational benefits gained from selective disclosure\textsuperscript{91} under the improper motive umbrella.\textsuperscript{92}

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83. \textit{See Elkind v. Liggett & Myers, Inc.}, 635 F.2d 156, 163-64 (2d Cir. 1980).\textsuperscript{93} The court took notice of the delicate line managers must mind in their communications with investment analysts, recognizing that "management must navigate carefully between the 'Scylla' of misleading stockholders and the public by implied approval of reviewed analyses and the 'Charybdis' of tipping material inside information... which it knows to be erroneous." \textit{Id.}
85. \textit{See Dirks v. SEC}, 463 U.S. 646, 657-59 (1983) (observing that an excessively stringent selective disclosure rule could have an inhibiting influence on the role of securities analysts, which are necessary for the preservation of a healthy market).
86. \textit{See id.}
87. \textit{See Langevoort, supra} note 9, at 1027. The early rule was that mere possession by a corporation of material, nonpublic information gave rise to a duty to disclose. \textit{See id.} (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc)).
88. \textit{See id.} The first Supreme Court decision to depart from the original rule was \textit{Chiarella v. United States}, in which the Court held that mere possession of material, nonpublic information does not give rise to a disclosure duty. \textit{Chiarella v. United States}, 445 U.S. 222, 233-34 (1980). The Court extended this exception three years later in \textit{Dirks}, when it held that liability for selective disclosure turned on whether the corporate insider communicated information to the analyst in order to receive some direct or indirect personal benefit. \textit{See Dirks}, 463 U.S. at 655.
89. \textit{See, e.g., SEC v. Stevens, No. 12813, 1991 SEC LEXIS 451, at *2 (S.D.N.Y. Mar. 19, 1991).} In the \textit{Stevens} case, which ultimately settled, the SEC had urged that a company CEO had selectively disclosed inside information to securities analysts—whose clients traded on the information—for a reputational benefit. \textit{Id.} If the SEC aggressively pursues this approach, all informal discussions between corporate insiders and analysts would be subject prosecution regardless of improper motive, since every insider communication could conceivably be classified as effected for reputational gain.
90. \textit{See Commissioner Edward H. Fleischman, Ferreting in the Interstices of the S.E.C. Attitudes to Securities Analysis,} (Jan. 24, 1991) quoted in Carl W. Schneider, Fencing on the
In *SEC v. Stevens*, the Commission demonstrated its new “reputational benefit” approach to selective disclosure when it brought suit against Phillip J. Stevens, Chairman and CEO of Ultrasystems, Inc., after Stevens made unsolicited phone calls to securities analysts warning them of a sudden business downturn likely to affect his company's earnings. Some of these analysts promptly contacted their clients, who traded on the new information. The Commission alleged that, after a previous unexpected negative quarterly earnings announcement by Ultrasystems, an analyst who had covered the company ceased his market coverage and publicly challenged Stevens on the company's financial data. The Commission charged that Steven's advance notice to market analysts of the new downturn was motivated by his expectation of a “direct, tangible benefit to his status as a corporate manager.”

Commentators point out that the SEC has not aggressively pursued its new theory of selective disclosure for reputational benefit as subject to improper motive liability, but the threat of insider trading liability remains real. Depending on the SEC's actions (i.e., discretionary enforcement decisions), many aspects of the delicate relationship between managers and analysts could be aggressively prosecuted as illegal tipping of inside information, and analysts would have to find new mechanisms for uncovering information upon which to base their earnings projections.

2. Duties to Correct and Update

When corporations release materially false information to the financial markets, they have an obligation to correct those disclo-
sures as long as the information remains "alive" and continues to influence the security's price. A similar rule applies to corporate disclosures of forward-looking information that are true when released but become inaccurate due to subsequent events. With respect to the duty to update, inaccuracy turns on whether the earlier statement would be misleading if released currently. These duties expire when new information or passage of time makes the misleading disclosures obsolete. Apart from the duties to correct and update corporate disclosures, firms that simply possess material nonpublic information that may affect the market incur no affirmative disclosure obligations unless disclosure is otherwise mandated under the federal securities laws.

3. The "Bespeaks Caution" Doctrine

Public corporations enjoy measured insulation from 10b-5 securities fraud liability for forward-looking disclosures that later become misleading so long as their initial statements are accompanied by meaningful cautionary language. This "bespeaks caution" doctrine does not, however, mean that companies can escape liability for their misstatements simply by including boilerplate cautionary language. Instead, "meaningful" turns on whether reasonable minds could not disagree that the challenged statements were not misleading.

Although the "bespeaks caution" doctrine developed at common law no later than 1986, Congress codified the doctrine in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). With the aid of

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this statutory safe harbor, the SEC encourages public corporations to make more voluntary disclosures of soft information and protects such statements if they are made in good faith and with a reasonable basis.\footnote{Colby v. Hologic, Inc., 817 F. Supp. 204, 214 (D. Mass 1993) (framing the question accordingly).}

IV. ISSUER LIABILITY FOR THIRD PARTY MISSTATEMENTS

The foregoing framework for corporate disclosures of marketsensitive information describes liability hazards when issuers speak to the market directly. The analysis becomes significantly more difficult when misleading information reaches the market through analyst reports. Put simply, the law must determine the circumstance under which a securities issuer should be held liable for the misstatements of third parties.\footnote{But see Milberg v. Western Pac. R.R. Co., 51 F.R.D. 280, 282 (S.D.N.Y. 1970) (holding that companies should not have to police everything written about them and be liable for their inaccurate contents).}

Rules for responsibility for information disseminated through analyst reports might be said to fall along a spectrum. At one pole, analysts generate and distribute reports with no company involvement. At the other, companies essentially prepare reports and channel them through analysts to the financial community. Of course, if only these two extremes existed, issuer liability for analyst reports would simply be a function of authorship. The real difficulty begins when companies interact with analysts in varying degrees along the spectrum, and the final report reflects involvement from both parties. Traditionally, locating a liability threshold on the spectrum of company involvement in an analyst report’s preparation has been the province of the entanglement doctrine.\footnote{See 17 C.F.R. § 230.175 (1999).}
A. Genesis of the Entanglement Doctrine

Generally, companies face no liability for misleading claims made about them by independent third parties.\textsuperscript{113} Significant exceptions, though, have developed that practically swallow the rule.\textsuperscript{114} The Second Circuit spawned the doctrinal forebear of this line of cases when it decided \emph{Elkind v. Liggett & Meyers Co.}, which introduced the “entanglement” theory of issuer liability for third party misstatements.\textsuperscript{115} In \emph{Elkind}, holders of Liggett & Meyers, Co. stock brought a class action lawsuit alleging, among other things, that the firm neglected its duty to update misleading analyst reports created in part with the company’s guidance.\textsuperscript{116} The \emph{Elkind} court noted that, although companies generally have no obligation to correct statements made by outsiders,\textsuperscript{117} firms could nonetheless incur \textsuperscript{10b-5} liability if third party misstatements could fairly be attributed to the company.\textsuperscript{118}

Under \emph{Elkind}, attribution turns on whether company officials have become “so involved” or “sufficiently entangled” in the preparation of the analyst’s report that it implies company agreement with the report’s contents,\textsuperscript{119} in which case liability accurses to the company just as if it had made the statements itself.\textsuperscript{120} And, once an analyst report’s contents become attributable to a company, the firm incurs liability if it fails to update information in the report that later becomes materially misleading.\textsuperscript{121} The \emph{Elkind} court observed that

\begin{itemize}
  \item \textsuperscript{113} See Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 941-42, 949 (2d Cir. 1969) (holding that, although companies may voluntarily choose to correct a statement in the press for which it is not responsible, nothing in the securities laws compel it to do so).
  \item \textsuperscript{114} See Eisenstadt v. Allen, No. 95-16255, 1997 WL 211313, at *14 (9th Cir. Apr. 28, 1997) (holding that companies may be held liable for analyst statements if they review them and endorse the spin analysts put on company information); Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1998) (holding that companies that make misleading statements to analysts with the intent that those statements be communicated to the market are liable under rule \textsuperscript{10b-5}; \emph{Elkind} v. Liggett & Myers Inc., 635 F.2d 156, 163 (2d Cir. 1980) (holding that a company may be liable for an analyst’s statement if it entangles itself to such an extent that the report can be attributed to it); Strassman v. Fresh Choice, Inc., No. C-5-20017, 1995 WL 743728, at *12 (N.D. Cal. Dec. 7, 1995) (holding that companies may endorse analyst reports after their publication and thereby adopt the statements as their own).
  \item \textsuperscript{115} See \emph{Elkind}, 635 F.2d at 163 (“The controversy before us is whether Liggett sufficiently entangled itself with analysts’ forecasts to render those predictions ‘attributable to it.’”).
  \item \textsuperscript{116} See \textit{id.} at 158. The company had been dissatisfied with its recent stock performance and attributed its suboptimal security price to lack of market appreciation for the breadth of its operations. \textit{See id.} Accordingly, the firm began an “analyst program” designed to promote better market coverage. \textit{Id.}
  \item \textsuperscript{117} \textit{Id.} at 162.
  \item \textsuperscript{118} \textit{Id.} at 163.
  \item \textsuperscript{119} \textit{Id.}
  \item \textsuperscript{121} \textit{See id.}
\end{itemize}
though Liggett & Myers had examined and commented on analyst reports and made factual and descriptive suggestions, the company had never commented on earnings forecasts or left inaccurate factual statements uncorrected. Based on these facts, the court held that Liggett & Myers had not "placed its imprimatur, expressly or impliedly, on the analysts' projections," so that the company had no duty to correct the analyst reports.223

While the facts of the Elkind case applied the entanglement analysis to pre-publication company involvement,224 subsequent court decisions have adapted the doctrine to fit other, related fact patterns.225

B. Pre-Publication Entanglement

Pre-publication entanglement theory can render companies responsible for misstatements authored by third parties.226 Under Elkind, responsibility for analyst reports depends on whether a company indicates agreement with a report's contents, which can be express or implied from company involvement in the report's preparation.227 When companies expressly adopt analyst reports before their publication, then corporate responsibility for the report's contents is relatively uncontroversial.228 In such cases, corporate involvement approximates complete authorship on the responsibility spectrum. Courts have struggled, however, to fix the degree of company involvement in an analyst report's preparation necessary to imply agreement.

1. Traditional Entanglement Theory

The Elkind court's use of the term "entanglement" suggests that corporate liability can be implied in a range of the responsibility

122. See Elkind, 635 F.2d at 163.
123. Id.
124. Id. at 162.
126. See Elkind, 635 F.2d at 163. Authorship is important for discriminating between entanglement theories: pre-publication entanglement applies when the company comments on statements authored by third parties; the conceptually similar conduit theory applies when companies supply third parties with misleading information, which the analyst then channels to the market. See In re Cirrus Logic Securities Litigation, 946 F. Supp. 1466, 1467 (distinguishing between pre-publication entanglement and the conduit theory).
127. Elkind, 635 F.2d at 163.
128. See id.
spectrum’s middle sections, which charts joint involvement between the company and the analyst.\textsuperscript{129} The \textit{Elkind} court ultimately held that company review of an analyst report, including correction of factual errors, did not imply agreement because the company corrected all erroneous factual elements and, consistent with management policy, refused to comment on earnings forecasts.\textsuperscript{130} Persuaded that the analysts knew they were not being supplied with internal earnings data, the \textit{Elkind} court held that the company’s involvement did not extend beyond the report’s factual elements\textsuperscript{131} to its overstated earnings projections.\textsuperscript{132} Accordingly, some courts have interpreted \textit{Elkind} as embracing a “scope of responsibility” approach, which classifies the types of information companies have reviewed and holds them accountable for at least those categories to which they made substantive contributions.\textsuperscript{133} By contrast, other courts have characterized \textit{Elkind} as focusing on the cumulative impression that the company’s involvement gives the analyst, in light of company practices and contextual circumstances.\textsuperscript{134} For example, if a company’s established policy does not prohibit commenting on earnings projections, then reviewing an analyst report and commenting only on factual and descriptive matters may imply that the forecasts were accurate.\textsuperscript{135} Cases premising liability on the scope of a company’s involvement and the impressions they create have used language such as “fostered” or “induced” as

\begin{footnotesize}
\begin{enumerate}
\item[129.] See Greenberg, 889 F. Supp. at 1020 (observing that \textit{Elkind} speaks in terms of “entanglement,” causing confusion among litigants). \textit{Elkind} relied upon \textit{Moerman v. Zipco, Inc.}, 302 F. Supp. 439, 446 (E.D.N.Y. 1969), and \textit{Krebs v. Fall River Industries, Inc.}, 502 F.2d 731, 739-40 (10th Cir. 1974), to support the proposition that “[w]e have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders so as to assume a duty to correct material errors in those projections.” \textit{Elkind}, 635 F.2d at 163.
\item[130.] \textit{Elkind}, 635 F.2d at 163.
\item[131.] Id.
\item[132.] Id.
\item[133.] See \textit{In re ICN/Viratek Sec. Litig.}, No. 87 CIV. 4296, 1996 WL 164732, at *4 (S.D.N.Y. Apr. 9, 1996) (holding that review of a third party report and correction of some factual errors while knowingly leaving other inaccurate statements uncorrected made the company liable for the report’s contents); \textit{Alfus v. Pyramid Tech. Corp.}, 764 F. Supp. 598, 603 (N.D. Cal. 1991) (“[W]hen a company undertakes to pass on earnings forecasts through analysts reports, it must correct figures that are incorrect.”); \textit{see also In re Boston Tech., Inc. Sec. Litig.}, 8 F. Supp. 2d 43, 55 (D. Mass. 1998) (holding that issuers may be liable for failing to correct an analyst statement when the issuer entangles itself in the making of a statement, the issuer knows a statement is false when made, and the issuer fails to disclose the statement’s falsity to investors).
\item[134.] See \textit{In re Cypress Semiconductor Sec. Litig.}, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995), aff\textsuperscript{@}d sub nom. \textit{Eisenstadt v. Allen}, No. 95-15235, 1997 WL 211313 (9th Cir. Apr. 28, 1997) (holding that the pattern of manager-analyst interaction did not amount to an implied company adoption of an analyst report because there was not practice of commenting on earnings projections).
\item[135.] \textit{see id.} at 1377 n.6.
\end{enumerate}
\end{footnotesize}
synonyms for entanglement liability. These cases attempt to fix corporate entanglement liability at a point along the responsibility spectrum where companies guide analysts to misleading conclusions without overtly controlling the report's contents or making explicitly fraudulent representations.

2. Adoption Theory

A more developed line of pre-publication entanglement cases emphasizes corporate control over the information finally transmitted to the market, thereby premising a company's responsibility on facts closer to actual authorship. Known as the prepublication "adoption" theory, this version of entanglement has its roots in the Fourth Circuit's decision in Raab v. General Physics Corp., which addressed the practical question of how analyst reports could be attributed to companies. The Raab court held that companies must have complete control over an analyst's report to be held responsible for its accuracy, in part due to the possibility that analysts will take company comments out of context or misinterpret them. Having announced this practical requirement, the Raab court further held that, to satisfy Federal Rule of Civil Procedure 9(b), plaintiffs alleging entanglement must specify how corporate information reached the investment analyst, identify the precise source of the information, and describe how the corporation could have controlled the statement's content.

136. See In re Boston Tech., Inc., 8 F. Supp. 2d at 55 (holding that entanglement has occurred when the issuer fosters, induces, or otherwise causes the statement to be made).
137. Id.
139. But see Schwartz v. Novo Industries, A/S, 658 F. Supp. 795, 798 (S.D.N.Y. 1987). Although Raab appears to be the first case espousing the view that a company must adopt the final draft of an analyst report—effectively exercising control over its final contents—in order to give rise to entanglement liability, Schwartz preceded Raab and touched upon the theme of corporate control over analyst comments when corporate liability is premised on an analyst's misstatement. Id.
140. Raab v. General Physics Corp., 4 F.3d 286, 288 (4th Cir. 1993). The Raab decision concentrates on the second portion of the holding in Elkind v. Liggett & Myers Co., which involves the manner in which firms place their imprimatur, either expressly or impliedly, on an analyst report. Elkind v. Liggett & Myers Co., 635 F.2d 156, 163 (2d Cir. 1980).
141. See Raab, 4 F.3d at 288-89.
142. FED. R. CIV. P. 9(b). Federal Rule 9(b) requires that averments of fraud be pled with specificity. Id.
143. Raab, 4 F.3d at 288; see also Schaffer v. Timberland Co., 924 F. Supp. 1298, 1310 (D.N.H. 1996). The Schaffer court invoked a detailed tripartite test requiring the plaintiff to (1) identify specific forecasts and name the defendant insider who adopted them, (2) point to specific interactions between the insider and the analyst that establish the entanglement; and (3) state
In the wake of *Raab*, the adoption theory evolved to require demonstration of a “two-way flow of information” between an analyst preparing a market report and a corporate insider expressing agreement with the report’s “spin.” In cases following *Raab*, courts have largely accepted the idea that adoption depends on the two-way flow of information, although they continue to disagree about the precise manner in which corporate adoption of an analyst report occurs. 

Most courts now require plaintiffs to (1) identify specific forecasts and the insider who adopted them, (2) point to the specific insider-analyst interactions causing the entanglement, and (3) state the dates on which the acts that gave rise to the entanglement allegedly occurred. A few have gone so far as to require plaintiffs to demonstrate that analyst reports directly quote corporate officers to prove adoption.

The development of the pre-publication adoption theory favors securities fraud defendants and might well be read as a reaction to the exploding volume of securities litigation and abuses by plaintiffs

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144. See Eisenstadt v. Allen, No. 95-16255, 1997 WL 211313, at *14 (9th Cir. Apr. 28, 1997) (holding that adoption is required for companies to approve the spin an analyst gives company-supplied information); Stack v. Lobo, 503 F. Supp. 1351, 1371-72 (N.D. Cal. 1985) (same).
145. See Eisenstadt, 1997 WL 211313, at *14 (holding that entanglement requires a two-way flow of information); Rosenbaum v. Syntax Corp. (In re Syntax Corp. Sec. Litig.), 95 F.3d 922, 934 (9th Cir. 1996) (holding that a one-way flow of information is insufficient to prove entanglement); Schaffer, 924 F. Supp. at 1310 (holding that adoption requires a two-way flow of information).
148. See Colby, 817 F. Supp. at 213 (quoting Murray v. Sony Corp. (In re Columbia Sec. Litig.), 747 F. Supp. 237, 245 (S.D.N.Y. 1990)) (holding that attribution depends on whether third parties directly quote company officials and whether these quoted statements are factually misleading).
149. Schaffer, 924 F. Supp. at 1310 (holding that, while the First Circuit has not spoken to whether direct quotation is necessary to impute analysts' statements to companies, the court would demand a “significant and specific, not merely a casual or speculative, entanglement between the defendants and the analysts” with respect to the disputed statement).
attorneys trying to extract settlements. Courts have justified their heightened pleading requirements primarily on judicial efficiency grounds. Instituting stricter pleading requirements responds to the inherently speculative nature of analyst forecasts and the incredible burden corporate managers would face if they had to answer for every inaccurate forecast generated. Stricter pleading standards also serve judicial efficiency by eliminating overly tenuous claims, and reducing the great difficulty managers experience when facing an ill-defined entanglement standard that leads to capricious judgments, as it regards them as adopting only those statements they have examined and found reasonably accurate.

3. Entanglement and Primary Liability

Although the Supreme Court has never squarely addressed the entanglement doctrine, it has drawn distinctions between degrees of 10b-5 participatory liability, which naturally inform—and possibly limit—any understanding of pre-publication entanglement. Accordingly, in recent entanglement theory cases, defendant issuers have sought cover from Central Bank v. First Interstate Bank, which eliminated secondary liability under Rule 10b-5 for aiding and abetting securities fraud. These defendants have argued that Central Bank foreclosed issuer liability for third party statements, thereby abrogating Elkind, because section 10(b) cases prior to Central Bank had described entanglement in their pleadings as “aiding and abetting.”

151. See S. REP. No. 104-98, at 9, reprinted in 1995 U.S.C.C.A.N. 679, 687-89; see also Suna v. Bailey Corp., 107 F.3d 64, 72 (1st Cir. 1997). The Suna court held that, while it has not decided whether statements in analyst reports may be attributed to defendant companies, a strict 9(b) dismissal pleading standard was necessary to prevent plaintiffs from bringing baseless suits against securities defendants “in order to increase settlement amounts or to engage in a fishing expedition for evidence on which to base their claims.” Id. at 73.

152. See In re Caere Corp., 837 F. Supp. at 1059 (noting that heightened pleading requirements serve the policy goals of FED. R. CIV. P. 11 by discouraging marginal and baseless complaints).

153. See id.

154. See id.


156. See Cooper v. Pickett, 137 F.3d 616, 623 (9th Cir. 1997); In re ICN/Viratek Sec. Litig., No. 87 CIV. 4296, 1996 WL 164732, at *5 (S.D.N.Y. Apr. 9, 1996).

157. See In re ICN/Viratek, 1996 WL 164732, at *6. The court observed:
Lower federal courts confronted with this defense have pulled Elkind clear of Central Bank by characterizing entanglement claims as theories of primary liability.\textsuperscript{154} This characterization recognizes that companies could intentionally use unwitting analysts to defraud the market: the analyst would escape liability for lack of scienter, while the company would be untouchable as a mere aider and abettor.\textsuperscript{155} Unwilling to believe the Supreme Court intended to leave defrauded investors without a remedy, lower courts have analytically refined the pre-publication entanglement doctrine as a theory of primary liability under §10(b).\textsuperscript{157} The cases addressing the effect of the Central Bank holding on pre-publication entanglement are scant, and only one federal circuit court has squarely addressed the issue.\textsuperscript{160} Therefore, to the extent that pre-publication entanglement entails something less than complete company control over an analyst report, this variety of entanglement remains subject to attack from defendants via Central Bank.\textsuperscript{162}

C. Post-Publication Ratification

Akin to the adoption theory of entanglement, the post-publication ratification of analyst reports by corporate managers model emerged from In re Rasterops Corporation Securities Litigation. The analytical difference between these two theories is subtle. In pre-publication adoption, plaintiffs search behind the scenes to attribute the analyst’s words to the corporation.\textsuperscript{155} By contrast, the post-publication ratification theory concerns corporate representations about the analyst report’s accuracy after its publication.\textsuperscript{164} In many respects, the post-publication ratification theory is easier to apply because the

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\textsuperscript{154} The differences between Elkind... and this case demonstrate that the application of Elkind will not vitiate Central Bank by allowing plaintiffs to transform the majority of aiding and abetting claims into claims of primary violation. On the contrary, Elkind held only that a certain, sharply limited category of claims could, at that time, have been pled in the alternative as aiding and abetting claims were also properly categorized as claims of primary violations of § 10(b).

\textsuperscript{155} Id.; accord Cooper, 137 F.3d at 624-25.

\textsuperscript{156} See Cooper, 137 F.3d at 624-25; Warshaw v. Xoma Corp., 74 F.3d 955, 959 (9th Cir. 1996); In re ICN/Viratek, 1996 WL 164732, at *6.

\textsuperscript{157} See In re ICN/Viratek, 1996 WL 164732, at *6.

\textsuperscript{158} See id.

\textsuperscript{159} See id.

\textsuperscript{160} See Cooper, 137 F.3d at 624-25, and Warshaw, 74 F.3d at 959, both from the Ninth Circuit.

\textsuperscript{161} See In re MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 984-87 (E.D.N.Y. 1995) (holding that Central Bank forecloses 10b-5 liability against everyone except the person that actually makes the misleading statement).

\textsuperscript{162} See In re Cypress Semiconductor Sec. Litig., 891 F. Supp. 1369, 1377 (N.D. Cal. 1995).

\textsuperscript{163} See id.
question of authorship is moot and a company’s primary liability rests on readily observable acts. While not yet expressly embraced by the circuit courts, the SEC has recently acknowledged the legitimacy of the ratification liability theory, and several lower courts have incorporated the theory into their entanglement analysis.

Despite the ratification theory’s growing acceptance as legitimate grounds for liability, courts remain divided as to what type of activity actually indicates ratification. The cases developing this theory suggest that firms may ratify analyst reports not only explicitly but also implicitly by their actions, such as by distributing already-published reports to prospective investors. Commentators have

165. See Eisenstadt v. Allen, No. 95-16255, 1997 WL 211313, at *14-15 (9th Cir. Apr. 28, 1997), aff’d 891 F. Supp. 1369 (N.D. Cal. 1995). The Eisenstadt court reviewed In re Cypress Semiconductor on appeal and did not directly comment on the lower court’s post-publication ratification theory, leaving some doubt as to the theory’s legitimacy. Id. The Eisenstadt court held, however, that plaintiffs seeking to hold a corporation liable for an analyst’s predictions must demonstrate “that a corporate insider provided misleading information to an analyst, that the analyst relied on this information and that the insider somehow endorsed or approved the report prior to or after its publication.” Id. at 14 (citing Stack v. Lobo, 903 F. Supp. 1361 (N.D. Cal. 1995)) (emphasis added).

166. See In re Presstek, Inc., Exchange Act Release No. 34-33472, 1997 WL 784548, at *9 (Dec. 22, 1997). The SEC has taken the view that under certain circumstances an issuer that disseminates false third party reports may adopt the report’s contents and be fully liable for the misstatements contained in them, even if it had no role in the report’s preparation. See id. Accordingly, if an issuer knows, or is reckless in not knowing, that the information it distributes is false or misleading, it cannot be insulated from liability because management was not actively involved in the preparation of that information. See id.


169. See In re Rasterops Corp., 1994 WL 618970, at *3 (finding that “[b]y passing out the favorable analyst reports, Rasterops was clearly implying that the company agreed with the forecasts contained in the reports’); see also In re Cypress Semiconductor Sec. Litig., 891 F. Supp. 1369, 1377 (N.D. Cal. 1995), aff’d sub nom. Eisenstadt v. Allen, No. 95-16255, 1997 WL 211313 (9th Cir. Apr. 28, 1997). The In re Cypress Semiconductor court held that “in contrast to pre-publication entanglement, liability does not depend upon imputing the analyst’s statements to the company. Rather, the corporation’s implied representation that the analyst’s forecasts are accurate is itself actionable. This is a subtle, yet important distinction between pre-publication adoption and post-publication ratification.” Id. at 1377; see also Strassman, 1995 WL 743728, at
taken this possibility to its logical conclusion, suggesting several ways that ratification may be implied. One area of controversy surrounding the post-publication ratification theory of entanglement is the significance of managerial "expressions of comfort" with analysts' reports, and whether these representations rise to the level of ratification. At least two circuits have reached different conclusions on this question, and it remains unsettled.

D. The Conduit Theory

If an analyst can be considered merely the instrument of a company's fraud, courts bypass the entanglement analysis altogether and proceed to the "conduit theory." The distinction between pre-publication entanglement and the conduit theory, then, lies in the assumption that, with respect to entanglement, companies presumably provided analysts with accurate information, and, through a two-way exchange, the company adopted the analyst's inaccurate interpretations of the company's truthful information. However, when companies deliberately or recklessly provided an analyst inaccurate information, courts have imposed 10b-5 liability regardless of whether the company adopted the resulting report.

For example, in In re Cirrus Logic Securities Litigation, shareholders of Cirrus Logic, Inc., a semiconductor manufacturer, brought a securities fraud class action against the company and certain officers and directors for, among other things, making fraudulent statements to investment analysts, and thereby, the market. Although the district court conditionally granted the company's motion for summary judgment on this allegation, the court made clear that companies

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*12 (holding that anti-fraud liability may accrue for circulation of analyst reports when pled properly).
170. See Austin & Simpson, supra note 35, at 106 (suggesting that attaching Internet hyperlinks from corporate web pages to analyst reports may also be sufficient for liability under the ratification theory).
171. See cases cited supra note 168 and accompanying text.
172. See In re Cirrus Logic Sec. Litig., 946 F. Supp. 1446, 1467 (N.D. Cal. 1996) (holding that companies that use analysts as conduits for their fraud are primarily liable under Rule 10b-5). The court noted that "one could characterize a company's intentional or reckless misrepresentations to analysts as a form of entanglement with statements in analysts' reports (or in other communications with the market) that rely on misrepresentations." Id. at 1467 n.12.
173. See id. at 1467.
174. See id. As with pre-publication entanglement, plaintiffs must prove that the fraudulent statements reached the market and thereby caused security prices to reflect the inaccuracies. See Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988).
176. Id. at 1479.
may not lie to securities analysts and escape liability because they did not adopt the analysts' interpretations of the misleading statements.\textsuperscript{177} The court observed that “[c]ases requiring more than a one-way flow of information to show entanglement presuppose that the information provided by the company is truthful and accurate. No such two-way flow of information is necessary, however, where the company deliberately or recklessly provides misinformation to the market.”\textsuperscript{178}

V. THE PROBLEM RESTATED

Resolving questions of corporate responsibility for third party misstatements has become less problematic since the advent of the conduit and post-publication ratification theories, but pre-publication entanglement liability remains too nebulous for managers to predictably avoid liability. Litigants do not know whether entanglement permits companies to implicitly adopt an analyst report by tacitly or subtly coaxing its authors to misleading conclusions,\textsuperscript{179} or demands nothing short of complete control over the report's final contents to trigger liability.\textsuperscript{180} Evidence of this confusion lies in the scores of cases in which plaintiffs pepper their complaints with talismanic phrases such as “the defendants entangled themselves to a sufficient degree,” or “the company placed its imprimatur on the analyst’s report,” without enumerating facts to support these claims.\textsuperscript{181} Judges have fared

\textsuperscript{177} Id. at 1467.
\textsuperscript{178} Id.
\textsuperscript{179} See In re Boston Tech., Inc. Sec. Litig., 8 F. Supp. 2d 43, 55 & n.11 (D. Mass. 1999) (remarking that entanglement may occur when a company fosters or induces an analyst's misleading statement, which suggests entanglement by implication).
\textsuperscript{180} See Eisenstedt v. Allen, No. 95-12255, 1997 WL 211313, at *14 (9th Cir. Apr. 28, 1997) (holding that entanglement arises only when companies endorse an analyst’s report prior to its publication); Raab v. General Physics Corp., 4 F.3d 286, 288 (4th Cir. 1993) (holding that control is necessary to demonstrate entanglement).
\textsuperscript{181} In re Boston Tech., Inc., 8 F. Supp. 2d at 57-58 (dismissing the complaint because the plaintiff alleged “entanglement” with generality); In re DSP Group, Inc. Sec. Litig., No. C 95-4025-CAL, 1997 WL 678151, at *11 (N.D. Cal. Mar. 5, 1997) (finding that plaintiff that alleged that defendant “adopted or otherwise entangled themselves with the reports of securities analysts” was too general to survive a motion to dismiss); Strassman v. Fresh Choice, Inc., No. C-95-20017, 1995 WL 743728, at *12 (N.D. Cal. Dec. 7, 1995) (ruling that complaint failed to state a claim when plaintiffs pled in conclusory fashion that the defendants adopted the report); In re Gupta Corp. Sec. Litig., 900 F. Supp. 1217, 1237 (N.D. Cal. 1994) (ruling that plaintiffs narrowly met their pleading requirement under FED. R. CIV. P. 9(b)) when they alleged that defendant had “sufficiently entangled itself with the analysts' forecasts to render those predictions 'attributable to it'” without more specificity (quoting Elkind v. Ligget & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980)); Colby v. Hologic, Inc., 817 F. Supp. 204, 214 (D. Mass. 1993) (holding that complaint failed when plaintiffs made only vague allegations of guidance).
little better, often phrasing their holdings in the same conclusory fashion, without clear explanations for how the facts met the law to yield a given outcome.\textsuperscript{182}

Doctrinal considerations only blacken the clouds hanging over the pre-publication entanglement theory. Insofar as pre-publication entanglement may encompass misleading corporate guidance, the Supreme Court's \textit{Central Bank} holding threatens to eliminate at least part of the joint-author entanglement theory as a strain of now invalid aiding and abetting liability.\textsuperscript{183} None of the circuit courts have addressed the issue decisively, and an array of lower courts have just begun to sort out whether and how \textit{Central Bank} affects the entanglement theory. These still uncharted doctrinal waters only complicate courts' efforts to apply the pre-publication entanglement theory consistently.

The uncertainty surrounding pre-publication entanglement produces many undesirable results. The vague standard floods courts with litigation,\textsuperscript{184} as corporate managers and disappointed investors must look past unsettled law to live courts to determine whether the company's activities made it liable for an analyst's statements. As long as disappointed investors think they have a chance at recovery under the murky pre-publication entanglement theory, they have an incentive to file suit. Similarly, as long as companies can press the boundaries of overreaching in their pre-publication interactions with securities analysts, they may elect to risk the threat of lawsuits in return for inflated stock prices or other short-term corporate objectives.\textsuperscript{185}

\textsuperscript{182} See \textit{Colby}, 817 F. Supp. at 214 (dismissing complaint alleging entanglement through corporate guidance without clear explanation of where the liability threshold lies); \textit{In re Verifone Sec. Litig.}, 784 F. Supp. 1471, 1486 (N.D. Cal. 1992) (holding that "[i]n order to be liable for unreasonably disclosed third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections" without further explanation of when liability attaches).

\textsuperscript{183} See \textit{Central Bank v. First Interstate Bank}, 511 U.S. 164, 191 (1994) (holding "that a private plaintiff may not maintain an aiding and abetting suit under rule § 10(b)"); \textit{In re MTC Elec. Techs. Shareholders Litig.}, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) (interpreting \textit{Central Bank} to mean that "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)").


\textsuperscript{185} At some point, of course, companies must make full and accurate disclosures under the SEC's mandatory disclosure policies. See \textit{COX ET AL.}, supra note 38, at 8. Nevertheless, commentators have pointed to the numerous strategic incentives corporate executives have to place upward pressure on their company's stock prices in the short term. See Donald C. Langevoort, \textit{Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market}
The unpredictable entanglement "standard" also engenders inefficiency within the mechanisms for securities valuation. As the pre-publication entanglement standard moves in the direction of content control, as articulated in *Raab*, companies will have wider freedom to guide analysts to incorrect conclusions with virtual impunity. Accordingly, security prices will become even more susceptible to inaccurate information, which may erode investor confidence in market efficiency and fairness. Although scholars point out that the financial community may punish firms that overreach in their interactions with investment analysts, this theory offers little comfort to harmed investors lacking a legal remedy for securities fraud. Without legal protection for reliance on analyst valuations based on company-supplied information and guidance, investors must factor this unpredictable risk into their investment calculus. In light of Congress's policy objectives in passing the securities acts, an entanglement standard providing no protection from this subtle form of manipulation frustrates the legislative purpose. For these reasons, the pre-publication entanglement theory demands further refinement.

VI. POLICY PARAMETERS

Any attempt to improve the pre-publication entanglement theory must look to satisfying three important policy considerations. Each of these stands beneath the over-arching theme of preserving investor confidence. Foremost among these is the importance of constant manager-analyst interactions and the effect legal disclosures have on security pricing. Investors demand accurate information to make sound decisions, and a liability standard that curtails manager-

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186. See Langevoort, supra note 9, at 1027. Analysts have a reputational interest at stake when they report on a company's earnings prospects, and their objectivity helps to overcome a serious moral hazard in the process of corporate disclosure. See id. at 1030.

187. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976) (observing that the Securities Exchange Act of 1934 was "intended to protect investors against manipulation of stock prices").

188. Briefly, the American capitalist economy depends upon capital to fuel economic expansion. The financial markets depend upon the surplus capital of investors to supply this demand. See ZVI BODIE ET AL., INVESTMENTS 17 (James M. Keefe et al., eds., 3d ed. 1996). If potential investors determine that the markets are too risky, they will distribute their capital surpluses to safer opportunities. Therefore, investor confidence is key to preserving the capitalist system.

189. See supra Part II.
analyst communications would sacrifice market efficiency for investor protection. Under these circumstances, investors could be more certain that securities prices reflected accurate information, but the scant amount of information reflected in the price would no longer accurately portray the totality of corporate value. As a result, securities prices would fluctuate wildly when companies made infrequent but complete disclosures, and investor confidence would fade in response to increased market volatility.

The need to preserve the dissemination of corporate information to the markets through manager-analyst interactions plays off against protecting investor reliance on the accuracy of corporate disclosures. Fundamental to the preservation of investor confidence, this policy was the purpose animating Congress's passing the '33 and '34 Acts. The quantity of information that becomes impounded in security prices becomes worthless for valuing securities when key pieces of that information contain fraud. Securities can become mispriced, and investors that trade in reliance on the fairness of security prices are subject to great financial losses when securities adjust to subsequent, contradictory disclosures. Accordingly, a pre-publication entanglement standard that makes it too easy for companies to mislead analysts and investors undermines market efficiency and investor confidence with as much force as a standard that starves the market for information.

The third policy bearing on improving the pre-publication entanglement theory is the importance of preserving judicial and macroeconomic efficiency. Lawsuits are expensive, and when parties must resort to the courts to determine whether actionable fraud has been committed, society carries the burden of these costs—directly, by paying the legal system to handle them, and indirectly, by devoting resources to an unproductive endeavor. An efficient issuer liability standard for pre-publication manager-analyst interaction should

190. See Raab v. General Physics Corp., 4 F.3d 286, 288 (4th Cir. 1993) ("[T]he securities laws do not serve as investment insurance."); In re Caere Corp. Sec. Litig., 837 F. Supp. 1054, 1059 (N.D. Cal. 1993). A standard that makes it easy for disappointed investors to shift their risk to companies would create a disincentive for managers to communicate with analysts. See id.

191. See Ernst & Ernst, 425 U.S. at 194-95.

192. In contrast to the previous scenario, in which securities prices do not embody enough information to represent true market values, the securities fraud scenario lends itself to manipulative inflation of securities prices.


194. For example, if the pre-publication adoption theory prevails, then companies will be free to mislead investors, avoiding liability as long as they do not exercise control over the final statement or make blatantly fraudulent disclosures.
minimize social costs as much as possible, and a clear liability stan-
dard, understood before the fact, is an indispensable means to this end. And clear standards depend on doctrinal fidelity with higher
court precedents, leaving potential litigants with a clear and common
understanding of the controlling law.

VII. BEYOND ENTANGLEMENT: CRAFTING A BETTER
LIABILITY STANDARD

Many of the problems with the pre-publication entanglement
theory spring from its source, Elkind v. Liggett & Myers, Inc.,195 and
identifying these deficiencies provides a basis for refining issuer
liability for third party misstatements. Elkind has spawned confusion
in the courts because its language is hopelessly imprecise and its
holding subject to different interpretations.196 The expression
“entanglement” denotes confused and complicated involvement be-
tween two entities,197 a linguistic referent that does not, in this context,
constitute a clear and predictable standard. Most courts use the term
entanglement to describe issuer liability for pre-publication involve-
ment with third-party misstatements,198 although a majority of courts
have also embraced corporate control over the report’s final contents
as the appropriate liability threshold.199 Obviously, joint involvement
and solitary control are diametrically opposed concepts. Therefore, as
a first step towards refining the pre-publication entanglement stan-
dard, the term “entanglement” should be abandoned in favor of clearer
language describing the specific activities undertaken by firms in their
manager-analyst interactions that give rise to securities fraud li-
ability.

In response to these deficiencies, a bright line should be drawn
at express corporate agreement with the final contents of an analyst’s
draft report, and implied adoption theories should be rejected.
Accordingly, plaintiffs pleading securities fraud under Rule 10b-5

(holding that entanglement can be demonstrated if the issuer fosters or induces the analyst’s
misleading statement), with Raab v. General Physics Corp., 4 F.3d 286, 288 (4th Cir. 1993)
(holding that there is no liability unless the issuer exercises complete control over the analyst
report’s final contents).
198. See In re Boston Tech., Inc., 8 F. Supp. 2d at 55 (finding most courts use the term
“entanglement”).
199. See cases cited supra notes 138-40.
should demonstrate (1) that company officials reviewed the final contents of a third party’s statement prior to its publication, and (2) that the company expressly agreed with the report’s contents in unmistakable language, thereby adopting the statements as the company’s own. This proposed theory rests on the premise that markets will successfully adapt to liability standards that are clear and predictable. At first blush the new theory seems to favor manager-analyst communications at the expense of investor protection, because it raises the bar for actionable securities fraud. However, if the standard is applied correctly, it serves both policy interests, because investors will be better able to determine the quality of corporate disclosures before the fact and thereby protect themselves from fraud.

Part of the problem inherent in determining the validity of corporate disclosures to the market, including commentary on third party statements, is that companies possess information asymmetrically—only the company knows whether its disclosures are reliable. Analysts partly cure this problem by scrutinizing available data and confirming its accuracy, but their work is by no means a guarantee of corporate veracity. Realistically, the role of analysts in confirming corporate disclosure accuracy works only in the sense that analysts may penalize overreaching firms in the form of less market coverage. Despite this check, however, investors that rely on analyst reports have no immediate legal remedy when companies guide investors to misleading conclusions without actually supplying false information. Moreover, investors cannot protect themselves by making investments based on sound information. Avoiding this problem can take two forms: either crafting a liability standard that imposes liability for implicit company agreement or enabling investors to protect themselves. Given the intricacies of manager-analyst communications, designing a manageable standard for misleading implications is unrealistic. By contrast, a liability standard based on explicit corporate agreement cures this deficiency because investors will know when analyst reports contain information that companies have guaranteed by exposing themselves to legal recourse. In this way, investors will benefit from more complete disclosure because firms will have to sig-

200. See Langevoort, supra note 9, at 1030 (describing the moral hazard problem caused by information asymmetry that companies possess vis-à-vis outsiders).
201. See id. (suggesting that analysts serve as bonding agents for corporate disclosures).
202. See, for example, In re Cirrus Logic Securities Litigation, 946 F. Supp. 1446, 1466-67 (N.D. Cal. 1996), for an example of a company that directly lied to an investment analyst.
203. See id. at 1030.
204. In some sense, investors reward analyst firms that consistently report accurate information, but in the short term investors are still vulnerable to fraud without legal recourse.
nal whether their disclosures are backed by a remedy or not, allowing investors to calculate their risk premiums accordingly.

A standard based on explicit adoption also promotes market efficiency because it allows manager-analyst communications to continue unfettered. The only difference under the newly proposed standard is that companies must indicate whether their commentary rises to the level of adoption. All parties will recognize that company activity short of explicit agreement carries no legal remedy and is, implicitly, less reliable. With a greater focus on statements bearing corporate certification, companies will experience pressure to characterize all comments and disclosures, and while many of these will not rise to adoption, the additional degree of qualification should help analysts create more accurate forecasts. As a result, securities prices will embody a sufficient quantity of accurate information, including uncertified predictions, to fairly approximate corporate value, while investors will be better able to protect themselves by assessing the remedy-backed reliability of various reports before making their investment decisions.

Finally, a standard premised on explicit corporate agreement with a third party's pre-publication statements should relieve the courts of the excessive litigation born of uncertainty. One of the paramount goals of Anglo-American jurisprudence is predictive certainty, such that parties may determine their rights and liabilities before taking action. The proposed explicit adoption standard achieves this clarity, and as long as courts apply the standard consistently, the tide of securities fraud claims should abate, as companies will know when they will incur liability. Similarly, clear liability standards will give parties incentives to settle claims actually brought, because the merits of the actions will be easier to assess. Finally, the proposed explicit adoption standard should also ensure doctrinal consistency with Central Bank, since actionable corporate agreement with a third party's statements will be limited to a single, decisive, affirmative act, thereby removing any questions of secondary liability.

205. The manager-analyst communications are subject, of course, to the insider trading prohibitions.
VIII. HYPOTHETICAL RESOLVED

Applied to the E.com hypothetical, the new standard would make the exchange between company president Smith and analyst Jones legally insignificant. Smith’s winks, nods, and innuendo do not cross the liability threshold. For E.com to incur liability for Jones’s statements to the market, Smith would have to give his express agreement with the final draft of Jones’s report before the information was transmitted to the investing public. This demonstrates the uninteresting ex post aspects of the proposed standard. Observe, however, its significance for analyst Jones’s suspicion of Smith’s statements. He will press Smith to endorse the final version of his report, and, if Smith does not, Jones will realize that Smith’s claims about the company’s prospects are overly optimistic. He might note this fact in his report, or even draft a new, less optimistic report in order to explore what assessment of E.com Smith could back with a legal remedy. Smith might refuse to sign any draft report presented to him, but Baker and other investors will place less confidence in E.com’s prospects—manifested in the form of lower security prices—unless Smith does so. Moreover, Baker can make his decision to invest in E.com with the advance knowledge of whether the company has effectively bonded the information in the analyst’s report. Thus, Baker can better protect himself from investment risk by assessing the quality of information regarding E.com’s value. As long as courts consistently apply the bright-line test, all parties will be better able to assess their rights and liabilities before injury has occurred.

IX. CONCLUSION

The relationship between corporate managers and analysts is a continuous, dangerous, and necessary balancing act between preserving capital market efficiency and protecting investors from market manipulation. Determining corporate liability for misstatements made by third-party analysts is therefore like searching for a bright line down the middle of an already precipitous high wire. The clumsy entanglement doctrine has frustrated this effort. Although the post-publication ratification and conduit theories have improved the predictable application of the entanglement doctrine to certain manager-analyst interactions, the pre-publication entanglement theory remains fraught with uncertainty. As a result, investors and managers have turned to the courts ex post to determine whether a securities violation has occurred. Moreover, to the extent that companies may legally
mislead the market by guiding analysts to erroneous conclusions, the
efficiency of the capital markets has been compromised.

Market-driven behavior provides the solution for this problem.
The search for a pre-publication entanglement bright line remains
futile as long as the question remains “when does a corporation imply
agreement with an analyst’s report prior to publication?” Instead,
courts should announce the circumstances under which investor reli-
ance is justified, leaving the market to adjust to the law, as opposed to
the law adjusting to the market. A bright line standard based on ex-
licit company agreement with an analyst report’s final contents
brings all parties down from the tightrope. If companies purchase
credibility by committing to the accuracy of an analyst report, then
investors will know which investments carry a legal remedy for fraud
and adjust their investment decisions accordingly. Investors will bene-
fit from an improvement in the accuracy of corporate disclosures with-
out chilling manager-analyst communications necessary for market
efficiency. Similarly, if managers, analysts, and investors know the
threshold past which companies incur liability for misrepresentations,
they can ascertain their respective legal rights and obligations before
causing or suffering damage, thereby conserving judicial resources.

* D. Joseph Meister