

MATERIALITY AND A THEORY OF LEGAL CIRCULARITY

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This Article argues that the materiality doctrine, which lies at the heart of securities fraud, has the potential to operate as a self-fulfilling prophecy. This Article labels this phenomenon “legal circularity.” In order to place the potential legal circularity of materiality in context among the various other legal doctrines that share this potential, this Article proposes a two-part Theory of Legal Circularity. First, this Article proposes the following Legal Circularity Test to identify potentially circular doctrines: A legal doctrine is potentially circular if: (1) the legal doctrine incorporates the behavior or attitude of a population or person, either hypothetical or real; and (2) the subject population or person either would (if hypothetical) or does (if real) consider prior precedent interpreting the legal doctrine when choosing said behavior or when adopting said attitude. Materiality, among other legal doctrines, arguably satisfies this test because: (1) the materiality standard focuses on whether there is a substantial likelihood that a hypothetical “reasonable investor” would consider information important when making an investment decision, and (2) a reasonable investor would arguably consider prior materiality precedent when assessing whether information is important to his or her investment decision. Second, this Article proposes a Framework to Assess Legal Circularity, with the goal of providing guidance about whether to embrace a doctrine’s potential legal circularity. Under this framework, which draws from the rich scholarship on the related but distinct concepts of stare decisis, substantive law heuristics, and precedential herding, courts and scholars should weigh (1) the risk of a “wrong” rule; (2) the effects of greater predictability; and (3) the import of reconceiving the courts’ role. Finally, this Article applies this framework to materiality, concluding that courts and scholars should explicitly embrace the legal circularity of

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materiality, coupled with increased investor education about materiality and absent any clarifying guidance from the Securities and Exchange Commission about the scope of the doctrine.

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INTRODUCTION

Materiality lies at the heart of securities fraud, dividing misrepresentations that are potentially actionable from those that pose no risk of liability. The materiality standard, which encompasses myriad policy trade-offs, is deceptively simple: a misstatement or omission is material if there is a substantial likelihood that a reasonable investor would have considered it important in making an investment decision.¹ This standard has been the subject of a deep and rich body of scholarship, yet heretofore unrecognized by scholars is its potential to be “legally circular.”²

In short, when deciding whether to grant a representation any weight when making an investment decision, a reasonable investor would arguably consider whether, under existing case law, the representation would be actionable as securities fraud if false. A reasonable investor would rely only on potentially actionable representations. Therefore, existing case law about materiality is part of a reasonable investor’s analysis. As a consequence, a court’s holding that a certain type of representation is immaterial as a matter of law operates as a self-fulfilling prophecy. Even if the court’s holding were incorrect at the time of issuance, subsequent

1. See *infra* Parts I.A & I.B (discussing “[t]he Role of Materiality in Securities Fraud” and the definition of materiality).

2. This Article’s author has previously noted materiality’s potential legal circularity in passing. See Wendy Gerwick Couture, *White Collar Crime’s Gray Area*, 72 ALB. L. REV. 1, 31 (2009) [hereinafter Couture, *Gray Area*] (“In other words, it is assumed that ‘reasonable’ investors disregard some statements by corporate officers. Of course, this assumption is self-perpetuating. Presumably, one of the reasons that reasonable investors discount puffing statements is their understanding that these types of statements cannot support a securities fraud claim.”).

reasonable investors would not rely on that type of representation henceforth. This Article labels this phenomenon “legal circularity.”³

After demonstrating that materiality is potentially legally circular, this Article places this phenomenon in context by developing a two-part Theory of Legal Circularity. Although several scholars have analyzed the potential legal circularity of other doctrines, including various constitutional doctrines, they have not approached legal circularity in a comprehensive fashion, and this Article’s Theory of Legal Circularity seeks to fill this gap.

As the first step of the Theory of Legal Circularity, this Article proposes the following Legal Circularity Test to identify potentially circular doctrines: A legal doctrine is potentially circular if: (1) the legal doctrine incorporates the behavior or attitude of a population or person, either hypothetical or real; and (2) the subject population or person either would (if hypothetical) or does (if real) consider prior precedent interpreting the legal doctrine when choosing said behavior or when adopting said attitude. Materiality and the other potentially circular legal doctrines that scholars have identified satisfy this test, and this test is useful to identify additional doctrines that are potentially legally circular.⁴

Merely because a doctrine is potentially legally circular does not mean, of course, that courts and scholars should embrace that circularity. Therefore, as the second step of the Theory of Circularity, this Article provides guidance about how to analyze whether the potential legal circularity of a doctrine should be adopted by proposing a Framework to Assess Legal Circularity. This framework draws from the rich scholarship analyzing the related but distinct concepts of *stare decisis*, substantive law heuristics, and precedential herding. Under this proposed framework, courts and scholars should weigh (1) the risk of a “wrong” rule; (2) the effects of greater predictability; and (3) the import of reconceiving the courts’ role. This framework is comprehensive and complex, yielding a different result depending on the legal doctrine at issue.⁵

Finally, in order to demonstrate how the Framework to Assess Legal Circularity should be applied and to reach a recommendation about whether courts and scholars should embrace the potential legal circularity of materiality, this Article applies the framework to the doctrine of materiality. This Article concludes that the risk of a “wrong” materiality rule is slight because materiality primarily operates as a coordination mechanism and because other actors would be empowered to correct

3. See *infra* Part I.C (arguing that materiality is circular).

4. See *infra* Part II.A (proposing a “Legal Circularity Test to identify legal doctrines that are potentially circular”).

5. See *infra* Part II.B (proposing a framework to assist courts and scholars “determine whether to embrace a legal doctrine’s potential legal circularity”).

course if an intrinsically “wrong” standard were adopted; that, when legal circularity is coupled with increased investor education about materiality and applied explicitly, the potential positive effects of greater predictability would outweigh the potential negative effects; and that, absent forthcoming materiality guidance from the Securities and Exchange Commission (“SEC”), courts should embrace this reconceived role with respect to the materiality doctrine.⁶

This Article proceeds in four parts. In Part I, this Article demonstrates the potential legal circularity of materiality by situating the materiality doctrine within securities fraud, explaining the current conception of materiality, providing examples of how the materiality doctrine operates as a self-fulfilling prophecy, identifying the two analytical steps underlying the potential legal circularity of materiality, and assessing the descriptiveness of the legal circularity of materiality. In Part II, this Article sets forth the Theory of Legal Circularity by proposing a Legal Circularity Test to identify potentially circular legal doctrines; explaining that legal circularity does not suffer from circular reasoning; distinguishing legal circularity from the doctrines of stare decisis, substantive law heuristics, and precedential herding, while recognizing that legal circularity mimics these doctrines to some degree; and proposing a Framework to Assess Legal Circularity that draws from the rich scholarship on stare decisis, substantive law heuristics, and herding. In Part III, this Article applies the proposed Framework to Assess Legal Circularity to the doctrine of materiality, concluding that courts should explicitly embrace the legal circularity of materiality, coupled with enhanced investor education about materiality and in the absence of SEC guidance on materiality. Finally, this Article briefly concludes, urging courts and scholars to incorporate the legal circularity of materiality into their analyses and urging scholars from other disciplines to apply the Theory of Legal Circularity beyond the scope of securities regulation.

I. THE POTENTIAL LEGAL CIRCULARITY OF MATERIALITY

Materiality is the linchpin of securities fraud, separating misrepresentations that are potentially actionable from those that bear no risk of liability. The materiality standard encompasses myriad policy trade-offs into a unitary objective standard: a misstatement or omission is material if there is a substantial likelihood that a reasonable investor would

6. See *infra* Part III (applying the “proposed Framework to Assess Legal Circularity to the doctrine of materiality, for purposes both of exemplifying how [the] framework should be applied and of assessing whether the potential legal circularity of materiality should be embraced”).

have considered it important in making an investment decision.⁷ This deceptively simple-sounding standard is the subject of a deep body of scholarship,⁸ yet heretofore unidentified by scholars is that the materiality doctrine has the potential to operate as a self-fulfilling prophecy. In other words, under the parlance of this Article, the materiality doctrine is potentially legally circular. This section examines the role of materiality within securities fraud jurisprudence; explains the definition of materiality as developed through case law; demonstrates why materiality is potentially legally circular; identifies the two analytical steps underlying the potential legal circularity of materiality; and assesses the descriptiveness of the legal circularity of materiality.

A. *The Role of Materiality in Securities Fraud*

The fundamental goal of securities regulation, of which securities fraud is an essential component, is the creation of honest markets via comprehensive and accurate disclosure.⁹ In short, securities regulation is premised on the philosophy that “[t]here cannot be honest markets without honest publicity.”¹⁰ This policy was a reaction to the stock market crash of 1929, which Congress attributed to the lack of information available to allow investors to make sound investment decisions.¹¹ By mandating

7. *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see *infra* Part I.B for a discussion of this definition.

8. See *infra* Part I.A-I.B.

9. *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988) (citing prior Supreme Court precedent) (“This Court repeatedly has described the fundamental purpose of the [Securities Exchange Act of 1934] as implementing a philosophy of full disclosure.”) (internal citations omitted); *id.* at 234 (“Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress.”); John H. Walsh, *Can Regulation Protect “Suckers” and “Fools” From Themselves? Reflections on the Rhetoric of Investors and Investor Protection Under the Federal Securities Laws*, 8 J. BUS. & SEC. L. 188, 218 (2008) (explaining how the floor debates over the 1933 and 1934 Acts tied the protection of reasonable investors with “public disclosure of accurate information about issuer companies”).

10. *Basic*, 485 U.S. at 230 (citing the legislative history) (“The 1934 Act was designed to protect investors against manipulation of stock prices. Underlying the adoption of extensive disclosure requirements was a legislative philosophy: ‘There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.’”) (internal citations omitted).

11. Walsh, *supra* note 9, at 217-19 (“In short, those arguing this position [that regulation should protect the investor who will exercise “reasonable care” and utilize the information regulation would make available] said, regulation would help those who were able to help themselves. In the unregulated market the solid little fellows’ efforts at investigation had been frustrated. Only sales blurbs had been available. Through regulation, disclosure would give these investors an opportunity to investigate their investments and exercise their judgment with reasonable care.”).

comprehensive and accurate disclosure, Congress hoped that investors would return to the markets.¹² As explained by Richard C. Sauer, “[r]isk is inherent in all investment activity, but the higher the quality of information provided about available investment opportunities, the more often investors will put capital to its most productive and profitable uses.”¹³

The companion goals of comprehensiveness and accuracy both center on the concept of “materiality.”¹⁴ With respect to comprehensiveness, materiality serves as the dividing line between information that is necessary to ensure that investors can make informed decisions and information that is so “trivial”¹⁵ or of such “dubious significance”¹⁶ that disclosure is unnecessary.¹⁷ As such, issuers’ mandatory disclosure obligations, both when issuing securities and when engaging in periodic reporting,¹⁸ are premised on whether the information is material.¹⁹ Additionally, prohibitions on the selective disclosure of information depend on whether the disclosed information is material.²⁰

12. Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 317 (2007).

13. *Id.* (“The guiding purpose of the many and complex disclosure provisions of the federal securities laws is to promote ‘transparency’ in the financial markets.”).

14. Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1135 (2003) [hereinafter Heminway, *Materiality Guidance*] (explaining that “materiality is defined using the same, well-known legal standard for many different purposes under the federal securities laws”).

15. *Mills v. Elec. Auto-Life Co.*, 396 U.S. 375, 384 (1970) (discussing materiality in the context of § 14(a)) (“This requirement that the defect have a significant propensity to affect the voting process . . . adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).”) (emphasis omitted).

16. *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (citing prior Supreme Court precedent) (noting that “certain information concerning corporate developments could well be of ‘dubious significance’”).

17. *Basic*, 485 U.S. at 234 (stating that the role of the materiality standard is “to filter out essentially useless information that a reasonable investor would not consider significant”); Sauer, *supra* note 12, at 318 (“That all information is not created equal is recognized in the federal securities laws through the concept of ‘materiality.’”).

18. *E.g.*, 17 C.F.R. § 240.12b-20 (2002) (stating that “[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.”).

19. Yvonne Ching Ling Lee, *The Elusive Concept of “Materiality” Under U.S. Federal Securities Laws*, 40 WILLAMETTE L. REV. 661, 670-71 (2004) (“Regulation S-K, which relates to the financial condition and results of operations pursuant to informational disclosure requirements of the Securities Act of 1933 and Securities Exchange Act of 1934, contains numerous provisions that touch upon ‘materiality.’”).

20. 17 C.F.R. § 243.100-103 (2002).

With respect to accuracy, materiality serves as the dividing line between misrepresentations that are actionable and those that are too unimportant to result in liability. Liability for misrepresentations, including securities fraud liability under § 10(b) of the Securities Exchange Act,²¹ is premised on the materiality of the information.²² Indeed, Professor Michael J. Kaufman has even argued that materiality provides the basis for all other elements of securities fraud.²³

The central role of materiality within securities fraud is not uncontroversial. For example, Professor Geoffrey Rapp has argued that, because retail investors rarely decide to buy or sell specific stocks, instead investing in diversified portfolios, firm-specific information is of little import to ordinary retail investors.²⁴ Rather, “[a]ll that should matter to an average, ordinary investor is the relationship between a particular stock and the investor’s broader investment portfolio.”²⁵ Therefore, Professor Rapp argues that the materiality element should be “dropped for any claims involving fraud against ordinary investors.”²⁶ Despite critiques of materiality’s central role within securities fraud, this element remains pivotal under current doctrine. Indeed, one recent study found that 13% of securities fraud complaints were dismissed, at least in part, on the ground that an alleged misrepresentation was immaterial as a matter of law.²⁷

Even within securities fraud jurisprudence, materiality serves several different roles. When securities fraud liability is premised on an alleged

21. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2002).

22. *E.g.*, 15 U.S.C. §§ 77k(a), 77l(a)(2) (imposing liability for material misrepresentations in registration statements and prospectuses); *see Lee, supra* note 19, at 661 (“‘Materiality’ is an essential element to establish liability under U.S. Federal securities laws. These laws include the anti-fraud and proxy solicitation laws and Regulation FD.”).

23. Michael J. Kaufman, *Living in a Material World: Strict Liability Under Rule 10B-5*, 19 CAP. U. L. REV. 1, 33-75 (1990).

24. Geoffrey Rapp, *Rewiring the DNA of Securities Fraud Litigation: Amgen’s Missed Opportunity*, 44 LOY. U. CHI. L.J. 1475, 1481-82 (2013).

25. *Id.* at 1482 (emphasis omitted).

26. *Id.* at 1483.

27. Stephen J. Choi & A. C. Pritchard, *The Supreme Court’s Impact on Securities Class Actions: An Empirical Assessment of Tellabs*, 28 J.L. ECON. & ORG. 850, 862 tbl.3 (2012). This percentage reflects the sum of the following two columns in Table 3 of Choi and Pritchard’s study: “Both denied and granted dismissal based on the ground” and “Dismissal granted (at least partially) based on the ground.” *Id.* Therefore, this percentage includes some motions to dismiss that were denied in part on this basis, as long as the motions to dismiss were also granted in part on this basis. *See also* Wendy Gerwick Couture, *Around the World of Securities Fraud in 80 Motions to Dismiss*, 45 LOY. UNIV. CHI. L.J. 553, 559 (2014) (analyzing 80 opinions on motions to dismiss securities fraud class actions that were issued in 2013) (finding that in 19% of the opinions courts granted dismissal, at least in part, on the basis that a representation was immaterial as a matter of law).

misstatement, liability depends on the statement's materiality.²⁸ When securities fraud liability is premised on an alleged omission, liability depends on the materiality of the undisclosed information.²⁹ Finally, as a subset of omission liability, the obligation to disclose inside information or abstain from insider trading is triggered only when the information is material.³⁰

The policy trade-offs encompassed within the concept of materiality depend on whether materiality is being used to define the scope of liability for an alleged misstatement or for an alleged omission. In the context of alleged misstatements, if the materiality bar is set too low, the potential for liability will chill voluntary disclosure, thus contravening the goal of full disclosure.³¹ If the materiality bar is set too high, however, the potential for

28. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 156-57 (2008).

29. Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 327 (2009) [hereinafter Heminway, *Female Investors*] ("Conceptions of the reasonable investor and of materiality are rooted in disclosure. As noted earlier, assuming the existence of a duty to disclose, materiality sorts out that which must be disclosed from that which need not be disclosed; the sorting mechanism relies on a determination of the importance of the relevant facts to the reasonable investor or the reasonable investor's view on the significance of the relevant facts to the total mix of available information.").

30. Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 LA. L. REV. 999, 1006-07 (2012) [hereinafter Heminway, *Just Do It!*] ("The judge-made 'disclose or abstain' rule is the substantive focal point of U.S. insider trading regulation under Rule 10b-5 The 'disclose or abstain' rule provides that when an issuer of publicly traded securities or one of its insiders is in possession of undisclosed material information, the issuer or insider must either disclose the material information before trading in the issuer's securities or abstain from trading in the issuer's securities. Most insider trading claims are raised under Rule 10b-5 and involve the application and interpretation of this rule. Although the materiality of undisclosed information is quite clear in some cases; in others, materiality is contestable and may be determinative.").

31. Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 122-23 (2005) ("By offering protection from liability, the 'bespeaks caution' doctrine provides another incentive for issuers and others to make soft information available to investors. The same incentive effect applies to statutory safe harbors that codify the 'bespeaks caution' doctrine."); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 62 (2003) [hereinafter Choi & Pritchard, *Behavioral Economics*] ("Stringent antifraud provisions (and accompanying private and public enforcement) help ensure that the disclosures made to investors are truthful and accurate. Even if investors cannot process information rationally, the threat of private litigation and public enforcement may deter fraud and opportunistic behavior. As with disclosure, materiality forms a key component of antifraud liability Expanding the materiality concept may also lead to more frivolous lawsuits, thereby impairing the value of antifraud liability as a deterrent against fraud. Firms may also reduce their disclosures in an effort to avoid their exposure to fraud suits. Both frivolous suits and reduced disclosure will raise the

liability will not deter inaccurate disclosure, contravening the goal of accuracy.³² In the context of alleged omissions, if the materiality bar is set too low, companies will be compelled to disclose even trivial information, thus potentially overshadowing the important information and undercutting the goal of comprehensive disclosure.³³ If the materiality bar is set too high, however, companies can hide key information from investors without recourse, likewise contravening the goal of full disclosure. In the context of insider trading, if the materiality bar is set too low, it “may inhibit legitimate uses of information, such as engaging in securities analysis or leading a company into value-enhancing transactions.”³⁴ If the materiality bar is set too high, however, insiders can profit from inside information.³⁵

Despite the myriad policy trade-offs encompassed within materiality in different contexts, the Supreme Court applies a unitary materiality standard.³⁶ As a consequence, materiality occupies an uneasy role within

cost of capital, once again resulting in fewer investment opportunities for investors.”); R. Gregory Roussel, Note, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049, 1085 (1998) (“The Corporate Puffery Defense permits entrepreneurs to discuss their opinions openly with the possessors of capital. The drafters of the Reform Act specifically designed the safe harbor to encourage corporate officers to provide the market with forward-looking information.”); see also Wendy Gerwick Couture, *Mixed Statements: The Safe Harbor’s Rocky Shore*, 39 SEC. REG. L.J. 257, 258 (2011) [hereinafter Couture, *Mixed Statements*] (discussing how the statutory safe harbor for forward-looking statements was meant to achieve a similar goal of preventing companies from “refraining from voluntarily disclosing predictive information for fear of future liability if the prediction does not come to fruition”).

32. David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1398 (2006) [hereinafter Hoffman, *The Best Puffery*] (recognizing that the puffery doctrine is an attempt, albeit unsuccessful in his opinion, to “walk[] the line between overdeterrence of speech and underdeterrence of fraud”); Kaufman, *supra* note 23, at 3-4 (noting that the definition of materiality strikes a balance “between the remedial objectives of the securities laws and the dangers of over-deterrence of salutary business practices”).

33. *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (“[T]he Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach”); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976) (“[T]he disclosure policy embodied in the proxy regulations is not without limit. Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good [I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management’s fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information[,] a result that is hardly conducive to informed decisionmaking.”).

34. Wendy Gerwick Couture, *Criminal Securities Fraud and the Lower Materiality Standard*, 41 SEC. REG. L.J. 77, 78-80, 85 (2013) (hereinafter Couture, *Criminal Securities Fraud*).

35. Heminway, *Materiality Guidance*, *supra* note 14, at 1191.

36. *Basic*, 485 U.S. at 240 n.18 (“Devising two different standards of materiality, one for situations where insiders have traded in abrogation of their duty to disclose or abstain (or

securities fraud jurisprudence.³⁷ As a number of scholars have recognized, adjusting the standard to better serve the policies underlying one type of securities fraud risks upending the policies underlying another type of securities fraud.³⁸ For example, Professors Stephen J. Choi and A.C. Pritchard have recognized that lowering the materiality standard as applied to misrepresentations could solve the problem of investors being misled by over-optimism, while simultaneously creating the problem of inundating investors with too much disclosure.³⁹ Conversely, Professor Stefan J. Padfield has argued that “excessive characterization of disclosures as immaterial creates conflicts with [the] disclosure regime.”⁴⁰

for that matter when any disclosure duty has been breached), and another covering affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead), would effectively collapse the materiality requirement into the analysis of defendant’s disclosure duties.”)

37. Lee, *supra* note 19, at 674 (“In the disclosure context, the disclosure forms and statements have been used for the application for the application . . . of the materiality test. In the insider-trading context, materiality acts as a barrier against insiders profiting from inside information. Here, the disclosure context begs the question, ‘Is something material in relation to the information that the SEC requires, or [in] the statement that is being made, that must be included in order to keep the answer or the statement from being misleading?’ Now compare this to the insider-information context, which revolves around the query, ‘When has enough information been disclosed so that insiders are free to trade?’”).

38. Sauer, *supra* note 12, at 356-57 (“The conditioning of issuer disclosure obligations upon a materiality requirement is a critical component of the regulation of the capital markets. . . . The erosion of this standard to achieve such governmental objectives as a more favorable playing field in litigation should be carefully scrutinized by the courts and held in check to protect the overarching principles of our system of financial regulation.”).

39. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 61 (recognizing tension between the standard that should apply for purposes of disclosure and the standard that should apply for purposes of fraud liability: “If investors are easily led astray by overoptimism, then perhaps a broader definition of materiality is required. For example, the definition might be expanded to include ‘puffery’ that could trigger overoptimism. On the other hand, bounded rationality implies that investors will have limited attention spans—requiring more disclosure may cause them to ignore more important information. Indeed, armed with an overconfident sense of his ability to digest mountains of disclosure, an investor may miss important aspects of disclosure. Bounded rationality may therefore lead one to recommend a narrower concept of materiality for securities disclosure to reduce the amount of information given to investors.”).

40. Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 CASE W. RES. L. REV. 143, 178 (2010) [hereinafter Padfield, *Immaterial Lies*]; *see id.* at 179-80 (“To the extent that courts routinely find disclosure immaterial on the basis of safety-valve doctrines that twist the definition of materiality to the breaking point, they weaken the effectiveness of these rules by creating unnecessary confusion about the definition of materiality. By relying more on grounds other than materiality to dismiss securities claims, the courts can continue to release the pressure created by frivolous suits while at the same time arguably allowing the definition of materiality for purposes of up-front disclosure decisions to suffer less distortion.”).

In light of the myriad policy trade-offs encompassed within materiality, it is debatable whether materiality should be defined identically in the contexts of misstatements and omissions.⁴¹ Indeed, some scholars have even gone so far as to argue that, within each type of securities fraud, the standard of materiality should be adjusted depending on the identity of the speaker, the type of information, or the identity of the investor.⁴² This Article, while encouraging further scholarship on whether materiality should be a unitary standard, assumes a uniform definition of materiality, consistent with Supreme Court precedent.

B. *The Definition of Materiality*

The Supreme Court defines materiality with a deceptively simple test:⁴³ a misstatement or omission is material if there is a substantial likelihood that a reasonable investor would have considered it important in making an investment decision.⁴⁴ In another articulation, a misstatement or omission is material if it “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁴⁵

41. Lee, *supra* note 19, at 674 (“It is therefore highly plausible that materiality determinations are context-sensitive. Furthermore, it is possible that the SEC and the courts may apply ‘materiality’ standards differently in different contexts, while paying lip service to a common standard and utilizing the flexible TSC standard. However, the suggestion to redefine materiality for each context has been rejected by the SEC.”).

42. James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 519 (2009) (arguing that within the context of financial misstatements only, companies should only be vicariously liable for quantitatively large misstatements, while individuals’ liability should continue to be assessed using a qualitative materiality standard); Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “The Reasonable Investor” With “The Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473, 481 (2006) (“This Article proposes a solution for courts facing the apparent conflict between fairness to underclass investors and loyalty to Northway/Basic: an alternative materiality standard for inefficient markets. The alternative standard replaces ‘the reasonable investor’ with ‘the least sophisticated investor,’ a fictitious person modeled after the ‘the least sophisticated consumer’ from federal consumer law.”).

43. Donald C. Langevoort, *Are Judges Motivated to Create “Good” Securities Fraud Doctrine?*, 51 EMORY L.J. 309, 317 (2002) [hereinafter Langevoort, *Are Judges Motivated?*] (“This simple-sounding articulation tempts judges to treat the question as easier than it really is and proceed with excessive confidence toward an answer.”).

44. *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (“We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context.”); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”).

45. *TSC Indus.*, 426 U.S. at 449 (“Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable

This materiality test, which centers on the importance of the misrepresentation to a hypothetical reasonable investor rather than to the plaintiff investor, is an objective standard.⁴⁶ As a consequence, courts can dismiss securities fraud claims if, as a matter of law, no reasonable investor would have considered the misrepresentation to be important when making an investment decision.⁴⁷ Indeed, as discussed above, courts frequently do just that.⁴⁸

This hypothetical reasonable investor is intelligent and informed, rather than attributed with “a child-like simplicity.”⁴⁹ John H. Walsh performed an extensive study of the floor debates about the Securities Act of 1933 and the Securities Exchange Act of 1934 and found that, although there were competing characterizations of investors as “suckers and fools” and as “gullible lambs,” the “rhetoric of intelligent and trusting investors carried the day.”⁵⁰

The materiality test is contextual and fact-specific.⁵¹ Courts and scholars have identified myriad elements to be considered during the

investor as having significantly altered the ‘total mix’ of information made available.”).

46. *Basic*, 485 U.S. at 240 (“As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.”); *TSC Indus.*, 426 U.S. at 445 (analyzing materiality in the context of § 14(a)) (“The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.”).

47. Wendy Gerwick Couture, *Opinions Actionable As Securities Fraud*, 73 LA. L. REV. 381, 416 (2013) [hereinafter Couture, *Opinions Actionable*] (“Although the materiality element is a question of fact, courts routinely dismiss statements of opinion because they are immaterial as a matter of law, often characterizing these statements as ‘mere puffery.’”).

48. See Choi & Pritchard, *supra* note 27, at 862 (explaining that 13% of securities fraud complaints were dismissed, on the ground that an alleged misrepresentation was immaterial as a matter of law).

49. *Basic*, 485 U.S. at 234 (citing lower court precedent) (explaining that the materiality standard does not “attribute to investors a child-like simplicity”).

50. Walsh, *supra* note 9, at 190; *id.* at 227 (“At the end of the debates, the characterization of investors advanced by those who supported the investor protection regime embodied in the Securities Act and the Exchange Act stands out as distinct. They alone described investors as intelligent and trusting in the nation’s financial institutions, and yes, susceptible to mob psychology, but that was a susceptibility from which they could be protected. In the 1930s this was the rhetoric that carried the day.”).

51. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321 (2011) (explaining that, when assessing the materiality of adverse event reports, “statistical significance (or the lack thereof) . . . is not dispositive of every case”); *Basic*, 485 U.S. at 236 (describing the materiality analysis as “inherently fact-specific”); *TSC Indus.*, 426 U.S. at 450 (“The determination requires delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.”); SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 (Aug. 12, 1999) (“The Board’s present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.”); Park, *supra* note 42, at

materiality analysis, but they boil down to two factors: (1) the substance of the misstated or omitted information; and (2) the reliability of that substance.

The first factor examines whether a reasonable investor would actually care about the substance of the misrepresentation. For example, a reasonable investor would probably care if a company that he or she was considering investing in lost a major contract or failed to obtain Food and Drug Administration approval of a new product.⁵² On the other hand, a reasonable investor would probably not care about the misspelling of a board member's last name or the overstatement of profits by one dollar. In a closer case, the Fourth Circuit held that a CEO's statement that he had earned a bachelor's degree from Syracuse University, when he had actually completed only three years of study, was immaterial as a matter of law.⁵³

The second factor examines whether the misrepresentation was presented in such a way that a reasonable investor would have considered it reliable enough to factor into an investment decision. This factor encompasses a variety of considerations. For one, the identity of the speaker is relevant to the statement's reliability and thus its materiality. A statement by a company through its officers and directors is more reliable than a statement by a mere company spokesperson,⁵⁴ by an analyst,⁵⁵ or by

528 ("SAB No. 99 significantly increases the cost of defending private suits based on financial misstatements by making it clear that materiality will depend on an intensive factual inquiry."); Sauer, *supra* note 12, at 321 ("Various factors conjoin to confuse this process. Determining which facts if added, singly or in combination, to the "total mix" of available information would have been important to investors in a specific stock on a particular day is a highly circumstantial inquiry.").

52. See Thomas Lee Hazen, LAW OF SEC. REG. § 12.9 (4th ed. 2002) (listing examples of information that is probably material).

53. *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 661 (4th Cir. 2004) ("We hold that, viewed properly, it is *not* substantially likely that reasonable investors would devalue the stock knowing that Mitchell skipped out on his last year at Syracuse. That is, if one imagines a parallel universe of affairs where the one and only thing different was the MCG's filings made no mention of Mitchell's education (or, instead, said simply that he 'attended' Syracuse or 'studied economics' there), we find it incredible to believe that MCG's stock would be worth even a penny more to a reasonable investor.").

54. Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-Emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1739-40 (1998) ("The courts should also consider the identity of the speaker. Investors would most likely attach greater significance to statements made by a company's officer or director than to statements made by other representatives of the company, such as spokespersons, or to statements made indirectly by the company through analysts.").

55. *Id.* at 1731 ("Because there is a danger that an analyst may have misheard or misunderstood the company's statement, or that the analyst may have failed to communicate the statement properly, a statement reported by an analyst may be less reliable than a statement made directly by the company.").

a broker.⁵⁶ A statement by an established analyst, however, is more reliable than an anonymous commenter on the Internet.⁵⁷ Additionally, whether the statement is characterizing present facts or predicting the future affects its materiality because “[i]nvestors understand that forward-looking statements are inherently unreliable.”⁵⁸ Further, the mode of communication is relevant to a statement’s reliability and thus its materiality. For example, a statement in an SEC filing is more reliable than an off-the-cuff oral statement,⁵⁹ and an analyst report is more reliable than an internet posting.⁶⁰ Finally, the setting of the statement affects its reliability. For instance, if a statement were to be made in a promotional setting, “investors would be more likely to understand that the company’s statement may be somewhat exaggerated and may therefore place less importance on it.”⁶¹

In sum, the materiality standard is an objective inquiry into whether there is a significant likelihood that a reasonable investor would have considered the alleged misstatement or omission important when making an investment decision, taking into account both the substance of the alleged misrepresentation and indicia of its reliability.

C. Materiality’s Potential Legal Circularity

This section identifies an aspect of the materiality analysis that has not been examined by other scholars. Materiality is arguably circular because earlier courts’ rulings on materiality affect the future behavior of reasonable investors, which in turn affects future courts’ rulings on materiality. Therefore, earlier courts’ materiality rulings have the potential

56. *Id.* at 1730-31 (“Certainly, a reasonable investor would place greater significance on a statement made by a company than on a statement made by a broker. The investor is well aware that the company, through its officers and directors, owes fiduciary duties to its investors. On the other hand, a reasonable investor might be more likely to discount a statement made by a broker, who is trying to make a sale.”).

57. Sauer, *supra* note 12, at 322 (“The source and presentation of information may also influence its perceived reliability to investors. A report from an established analyst typically carries more weight with investors than a pseudonymous posting on an Internet thread. Thus, even intentionally false statements about a company by an individual with no ability to influence investment decisions may be deemed immaterial.”).

58. O’Hare, *supra* note 54, at 1733.

59. O’Hare, *supra* note 52, at 1738 (“An important factor to consider is where the statement was made. If the statement was made in a document filed with the SEC, a reasonable investor might find a vague statement to be significant, despite its vagueness. On the other hand, if the statement was made orally, in a casual setting, a reasonable investor would probably not attach much significance to a vague statement of corporate optimism.”).

60. Sauer, *supra* note 12, at 322.

61. O’Hare, *supra* note 54, at 1738.

to operate as self-fulfilling prophecies. As this section posits, the potential legal circularity of materiality affects both the substance and reliability factors of the materiality analysis. This section further demonstrates how legal circularity arguably operates within the materiality doctrines of puffery, bespeaks caution, and trivial matters. Additionally, this section identifies the two analytical steps that underlie the legal circularity of materiality and cites authority in support of the existence of each step. Finally, this section examines the descriptiveness of the legal circularity of materiality, concluding that the evidence is mixed about whether courts are currently treating materiality as legally circular.

1. An Overview of the Potential Legal Circularity of Materiality

The doctrine of materiality is arguably circular. Whether a reasonable investor would consider a statement or omission to be important when making an investment decision is arguably informed by whether prior courts have found statements or omissions of the same ilk to be material. If prior courts have found that certain statements or omissions are immaterial as a matter of law, a reasonable investor would arguably not consider similar statements or omissions to be important when making an investment decision because there is no legal incentive for the speaker to be accurate. If prior courts have found that certain statements or omissions are potentially material, on the other hand, a reasonable investor would arguably give similar statements or omissions greater weight because the speaker bears the risk of liability for misrepresentations. Therefore, when a court rules that an alleged misrepresentation is immaterial as a matter of law or that it is potentially material, this ruling is a self-fulfilling prophecy.

A simple example demonstrates the potential circularity of materiality. In isolation, it is debatable whether an investor would consider an executive's statement that "X is a good asset" to be important when making an investment decision. Once a court has decreed that this type of statement is immaterial as a matter of law, however, subsequent reasonable investors would understand that this statement is not actionable and can be made without recourse. As such, subsequent reasonable investors would not consider the statement that "X is a good asset" to be important when making their investment decisions. The court's earlier pronouncement of the statement's immateriality, regardless of whether the pronouncement was well-founded at the time that it was made, is thus a self-fulfilling prophecy.

Professors Choi and Pritchard have similarly recognized that materiality has the potential to operate circularly:

Market participants also will adjust their behavior to take into account new judge-made securities law. Consider a judicial opinion that defines materiality to reflect the disclosure needs of behaviorally challenged investors. Investors, once aware of this change, may be less skeptical in interpreting information (given the added protection of antifraud liability), which may then leave them more exposed to fraud. Subsequent judges may then find even prior, ill-advised changes to the definition of materiality now justified given the reduced vigilance of investors.⁶²

Professors Choi and Pritchard have indeed identified one example of potential legal circularity, but this Article argues that this potential permeates numerous facets of the materiality analysis.

The potential legal circularity of materiality affects both factors of the materiality analysis. In some contexts, legal circularity affects whether a reasonable investor would consider the substance of the alleged statement or omission to be important. More often, legal circularity affects whether a reasonable investor would consider an alleged statement or omission sufficiently reliable to be important. In order to demonstrate the potential impact of legal circularity on these two factors of the materiality analysis, this Article will explain how legal circularity arguably operates within the materiality doctrines of puffery, bespeaks caution, and trivial matters.

a. The Potential Legal Circularity of the Puffery Doctrine

Under the puffery doctrine, generalized statements of optimism are deemed immaterial as a matter of law.⁶³ In the classic articulation, “[v]ague, optimistic statements are not actionable because reasonable investors do not rely on them in making investment decisions.”⁶⁴ This doctrine affects both the substance of the alleged misrepresentation and its reliability, and each aspect is arguably legally circular.

62. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 50.

63. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119 (10th Cir. 1997) (“Statements classified as ‘corporate optimism’ or ‘mere puffing’ are typically forward-looking statements, or are generalized statements of optimism that are not capable of objective verification.”); Heminway, *Female Investors*, *supra* note 29, at 302 (“Under the ‘mere puffery’ defense, a person against whom a securities fraud action has been brought argues that alleged misrepresented facts are not materially inaccurate or incomplete because those alleged facts constitute nothing more than nonspecific, positive representations.”).

64. *Grossman*, 120 F.3d at 1119.

First, the puffery doctrine affects the substance of statements because it purports to “decode”⁶⁵ a company’s statements, explaining what the company is actually implying (and not implying) with its generalized statements of optimism.⁶⁶ For example, in *Eisenstadt v. Centel Corp.*, a company stated that the planned auction of the company was “going well” and “going smoothly.”⁶⁷ The Seventh Circuit, applying the puffery doctrine, stated that no reasonable investor would have interpreted these statements to mean something positive because “[e]verybody knows that someone trying to sell something is going to look and talk on the bright side.”⁶⁸ As Judge Posner explained:

An utterly candid statement of the company’s hopes and fears, with emphasis on the fears, might well have pushed the company’s stock below \$40, but perhaps only because, given the expectation of puffing, such a statement would be taken to indicate that the prospects for the auction were much grimmer than they were. Where puffing is the order of the day, literal truth can be profoundly misleading, as senders and recipients of letters of recommendation well know. Mere sales puffery is not actionable under Rule 10b-5.⁶⁹

The puffery doctrine’s effect on the substance of a statement is arguably circular. As Professor Donald C. Langevoort has explained, at the

65. Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87, 107 (1999) [hereinafter Langevoort, *Half-Truths*] (“Judge Richard Posner made the plausible observation that corporate rhetoric has gradually evolved to a point where it has become the norm to use language that overstates corporate prospects. Listeners thus gradually learn the code. Once this happens, then all companies are effectively forced to conform. If a company does not use the overly optimistic rhetoric but instead tells the truth, the market will nonetheless assume that the disclosure is still in code and hence things must be that much worse.”).

66. Couture, *Opinions Actionable*, *supra* note 47, at 430 (“This Article proposes that courts apply the following *reasonable implication* test to distinguish potentially material opinions from those that are immaterial as a matter of law: Does the opinion reasonably imply an allegedly false, material fact?”); Langevoort, *Half-Truths*, *supra* note 65, at 113 (arguing that the first step in order to impose liability for a half-truth is to analyze “if it is spoken or written in such a way that, in context, even a reasonably savvy investor would draw a natural—but materially mistaken—inference from it.”).

67. *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 741 (7th Cir. 1997).

68. *Id.* at 745 (“We doubt that nonspecific representations that an auction process is going well or going smoothly could, in the circumstances of this case . . . influence a reasonable investor to pay more for a stock than he otherwise would. *Everybody* knows that someone trying to sell something is going to look and talk on the bright side. You don’t sell a product by bad mouthing it.”) (emphasis in original).

69. *Id.* at 746.

time that the Seventh Circuit made this pronouncement, it was debatable whether “everybody” would have interpreted these statements to mean that the auction was proceeding disappointingly.⁷⁰ Henceforth, however, in light of the Seventh Circuit’s pronouncement, reasonable investors would arguably understand this code. Therefore, even if the Seventh Circuit was off-base in its original ruling (as it may well have been), subsequent reasonable investors would not consider these statements to be important, rendering these statements immaterial as a matter of law. Therefore, the Seventh Circuit’s ruling operates as a self-fulfilling prophecy.

Second, the puffery doctrine affects the reliability of statements because it depends on the premise that generalized statements of optimism are mere “positive spin” and thus inherently unreliable.⁷¹ For example, in *Grossman v. Novell, Inc.*, the Tenth Circuit held that a company’s statements that it had “experienced ‘substantial success’ in integrating the sales forces of the two companies, that the merger was moving ‘faster than we thought,’ and that the merger presented a ‘compelling set of opportunities’ for the company” were immaterial as a matter of law because they were “the sort of soft, puffing statements, incapable of objective verification, that courts routinely dismiss as vague statements of corporate optimism.”⁷² As explained by Professor Langevoort, “[t]he standard line here is that savvy investors know enough to recognize the habitual propensity of managers to put a positive spin on the company’s prospects, and thus ignore it.”⁷³

The puffery doctrine’s effect on the reliability of statements is also arguably circular. As various scholars have noted, including Professor Stephen M. Bainbridge, Professor G. Mitu Gulati, Professor Langevoort, and Professor Padfield, it is indeed questionable whether, in isolation, a reasonable investor would ignore puffing statements as inherently unreliable.⁷⁴ Once courts have so decreed, however, reasonable investors

70. Langevoort, *Are Judges Motivated*, *supra* note 43, at 310-11 (“Judge Posner said that a reasonable investor would understand that ‘smoothly’ coheres with ‘disappointingly,’ if not ‘disastrously.’ While this conclusion *may* be right (I am not sure by any means), it is rather stunning for Judge Posner to conclude that this inference is so clear that no reasonable juror could possibly think otherwise, the standard test for dismissal as a matter of law.”); Langevoort, *Half-Truths*, *supra* note 65, at 123 (“What I am bothered by is his conclusion that it is essentially beyond doubt that the informed investment community would treat Centel’s ‘smoothly’ statement to indicate nothing more than that officials were not certain that there would be an auction failure. That is possible, but not empirically self-evident.”).

71. *Eisenstadt*, 113 F.3d at 746 (“Centel put a rosy face on an inherently uncertain process; investors would have expected no less . . .”).

72. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1121-22 (10th Cir. 1997).

73. Langevoort, *Half-Truths*, *supra* note 65, at 121.

74. Stefan J. Padfield, *Is Puffery Material To Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 340-41 (2008) [hereinafter Padfield, *Is Puffery Material?*]

would arguably learn that these statements are not actionable and thus disregard them henceforth. In short, the pronouncement that generalized statements of optimism are immaterial as a matter of law is a self-fulfilling prophecy.

b. The Potential Legal Circularity of the Bespeaks Caution Doctrine

Under the bespeaks caution doctrine, a forward-looking statement is rendered immaterial as a matter of law if it is accompanied by meaningful cautionary statements.⁷⁵ As explained by the Tenth Circuit, “[f]orward-looking representations are also considered immaterial when the defendant has provided the investing public with sufficiently specific risk disclosures or other cautionary statements concerning the subject matter of the statements at issue to nullify any potentially misleading effect.”⁷⁶ This

(“This Article seeks to fill some of the void of empirical research in this area by reporting the results of an investor survey (the ‘Puffery Survey’), focusing on materiality determinations in the puffery context, and comparing these responses to judicial predictions that no reasonable investor could find the surveyed statements material. What the survey results show is that while the judges in the four surveyed cases concluded that no reasonable investor could find the statements challenged therein to be material because they constituted non-actionable puffery, between 33% and 84% of reasonable investors surveyed deemed the statements material.”); Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 119-20 (2002) (“Anecdotally, it does not take much time watching investment programs on television to notice that even quite vague statements of optimism by corporate managers are considered important by the investment news media.”); Langevoort, *Half-Truths*, *supra* note 65, at 122 (“To say that smart investors simply assume that optimism is a façade and discount it is no more obvious than saying that smart investors never rely on brokers’ recommendations because of the their temptations to promote purchases and sales.”).

75. *Grossman*, 120 F.3d at 1120 (“Forward-looking representations are also considered immaterial when the defendant has provided the investing public with sufficiently specific risk disclosures or other cautionary statements concerning the subject matter of the statements at issue to nullify any potentially misleading effect.”); *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (“[W]e can state as a general matter that, when an offering document’s forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the ‘total mix’ of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.”); Heminway, *Female Investors*, *supra* note 29, at 304 (“A defendant in a securities fraud action who asserts the ‘bespeaks caution’ defense argues that a particular misrepresented or omitted forward-looking statement of fact is immaterial as a matter of law because tailored cautionary statements have adequately qualified it.”).

76. *Grossman*, 120 F.3d at 1120.

doctrine affects the reliability of an alleged misrepresentation, and this effect is arguably legally circular.

The bespeaks caution doctrine states that forward-looking statements that are accompanied by sufficient cautionary language are inherently unreliable. For example, in *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litigation*, the Third Circuit held that the statement “[t]he Partnership believes that funds . . . will be sufficient to cover all of its debt service (interest and principal)” was immaterial as a matter of law.⁷⁷ The court explained:

[W]e believe that due to the disclaimers and warnings the prospectus contains, no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment which might yield a high rate of return, but which alternatively might result in no return or even a loss.⁷⁸

The bespeaks caution doctrine’s effect on the reliability of a forward-looking statement is arguably legally circular. As Professors Bainbridge and Gulati have aptly pointed out, the premise of the bespeaks caution doctrine is shaky:

The court, therefore, is not merely saying it is likely that investors read the offending statement in context. Instead, it is saying that there can be no disagreement, at least among reasonable people, that the cautionary statement negated the market impact of the CEO’s optimistic statement. Maybe, but how do the judges know this with such certainty? Even if it could be shown that cautionary statements always temper CEO bombast, moreover, such a showing could only be made on the basis of extensive and highly sophisticated information about how investors evaluate information and how they discount statements. As with puffery, however, judicial invocations of the bespeaks caution doctrine are almost never supported by any research evidence on the behavior of investors or markets.⁷⁹

77. *In re Donald J. Trump Casino*, 7 F.3d at 369 (“We believe that given this extensive yet specific cautionary language, a reasonable factfinder could not conclude that the inclusion of the statement ‘[t]he Partnership believes that funds . . . will be sufficient to cover all of its debt service (interest and principal)’ would influence a reasonable investor’s investment decision.”).

78. *Id.*

79. Bainbridge & Gulati, *supra* note 74, at 122-23.

Investors who know that courts routinely apply the bespeaks caution doctrine to insulate forward-looking statements from liability will reasonably conclude that forward-looking statements are consequently unreliable and should be disregarded. Therefore, the bespeaks caution doctrine, despite its shaky premise, arguably becomes true.

c. The Potential Legal Circularity of the Trivial Matters Doctrine

Under the trivial matters doctrine, a misstatement or omission regarding a small percentage of total sales or revenues is immaterial as a matter of law. This doctrine recognizes that some information is substantively unimportant to investors because “investors only care about big pieces of the firm.”⁸⁰ This component of the trivial matters doctrine is not legally circular because whether a reasonable investor would actually care about the substance of a piece of data does not depend on prior precedent.

This doctrine also affects the reliability factor of materiality, however, and this effect is arguably legally circular. The trivial matters doctrine states that reasonable investors do not rely on statements to be exact and do not expect to be told about small variations from expectations.⁸¹ In short, according to this doctrine, reasonable investors read in some wiggle room. The premise of the doctrine is certainly debatable. Scholars have identified various scenarios in which a small change in numbers would arguably be important to investors, including when the misstatement is persistent,⁸² when a statistically tiny percentage is nonetheless worth a large amount of money,⁸³ when a small loss serves as a bellwether,⁸⁴ and when the market is

80. See Bainbridge & Gulati, *supra* note 74, at 125 (citing cases applying the trivial matters doctrine, “[t]he final materiality heuristic posits that claims of nondisclosures or misstatements with respect to matters involving no more than small percentage of total sales or revenues (or some other variable) fail because the information at issue is immaterial as a matter of law. The rationale, once again, is simple. Such trivial bits of information do not play a role in the investment decisions of reasonable investors because they relate to a small aspect of the business.”).

81. See David A. Hoffman, *The “Duty” to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 579 (2006) [hereinafter Hoffman, *The “Duty”*] (explaining that, under the “trivial matters” technique, “courts hold presumptively immaterial nondisclosures relating to small percentages of total sales or revenues.”).

82. See Park, *supra* note 42, at 540-46 (explaining that, under fundamental analysis, even a small financial misstatement can be important if it is persistent, thus affecting the market’s assessment of future earnings).

83. Bainbridge & Gulati, *supra* note 74, at 126 (“It is simply implausible that all reasonable investors ignore information about small aspects of the business. A statistically tiny percentage of a major corporation, moreover, can be worth hundreds of millions of

fragile.⁸⁵ Yet, once investors know that courts often apply the trivial matters doctrine, they reasonably should read in some wiggle room because they know that companies have no liability incentive to be exact. In short, the trivial matters doctrine, even if unfounded at one time, has become true.

2. The Two Analytical Steps Underlying the Potential Legal Circularity Materiality

As demonstrated in the previous section, the potential legal circularity of materiality is intuitive. This section delves deeper, identifying the two analytical steps that underlie the legal circularity of materiality. The first analytical step is the proposition that courts' materiality decisions influence the behavior of future investors. The second analytical step is that future investors act reasonably in being so influenced. This step completes the circle because the materiality test itself depends on the behavior of reasonable investors. Therefore, if courts' materiality decisions influence the behavior of future reasonable investors, courts' materiality decisions operate as self-fulfilling prophecies.

a. Step One: Courts' Materiality Rulings Potentially Influence the Behavior of Future Investors

The first analytical step in the legal circularity of materiality is the proposition that courts' materiality rulings potentially influence the behavior of future investors. This proposition is consistent with the general guidance function of adjudication, as explained by Professor Frederick Schauer:

Although it thus appears that the guidance function is one rarely treated as primary in the adjudicative process, there is no reason it could not be so, and no reason that a judge could not see her role primarily as an instructor or guider of future decisions by subordinate decisionmakers. Were that the case, and when that is

dollars.”).

84. *Id.* at 126 (“Finally, losses in small areas can provide investors with important information about the direction of the company’s fortunes. We may well be wrong about what investors think is important, but it seems implausible that nonexpert judges (and nonexpert clerks) have a more sophisticated understanding of investor behavior and market dynamics.”).

85. Sauer, *supra* note 12, at 329 (“The bubble market of the 1990s provided numerous examples of stocks so fragile they could be shattered by even a slight shortfall from expected earnings. Nor do we lack more recent instances of extreme investor sensitivity to numerically small disappointments.”).

the case, the judicial opinion takes on special importance, for it is no longer a mere justification for a decision already made, and no longer just part of an internal discourse among lawyers, judges, and law professors, but is rather a document having much the character of a statute or a regulation, and sharing the common statutory or regulatory goals of making clear in advance just what conduct is permitted and what is prohibited.⁸⁶

This guidance function is intuitive, and many securities scholars have recognized that courts' materiality rulings potentially guide the behavior of future investors.⁸⁷

The reasonable investor test for materiality is normative, based on how investors *should* act rather than how they actually act.⁸⁸ Like any normative standard with an incentive structure in place, the materiality standard "may be used to help channel investor behavior toward that norm."⁸⁹ The reasonable investor test, by granting recovery to those who act consistently with the normative standard and by denying recovery to those who do not, guides the behavior of investors.⁹⁰ In fact, Professor

86. Frederick Schauer, *Judicial Self-Understanding and the Internalization of Constitutional Rules*, 61 U. COLO. L. REV. 749, 766 (1990).

87. See *infra* notes 88-99.

88. Hoffman, *The "Duty," supra* note 81, at 563 ("Courts' equation of reasonableness with rationality is a normative move. It transforms materiality from a requirement that reflects ordinary behavior to one that may instead sanction it."); see also Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 184 (2002) [hereinafter Langevoort, *Taming*] (discussing the distinction between a normative standard of materiality and a descriptive one).

89. Heminway, *Female Investors, supra* note 29, at 323; see also Hoffman, *The "Duty," supra* note 79, at 586 ("These findings suggest that courts are not using materiality to effect mere conservative ends nor to change corporate behavior, but instead to change the behavior of prospective plaintiffs—ordinary investors in the capital markets. That is, because plaintiff identity is so important, and because materiality has moved toward a set of bright-line rules, ordinary investors will have strong incentives to conform their conduct to that deemed reasonable by courts or be denied recovery.").

90. Hoffman, *The "Duty," supra* note 81, at 594 ("The shift in the rationale for findings of presumed immateriality over time from standards to bright-line rules suggests that materiality is evolving toward a formal choice: investors must behave in a certain way or suffer the consequences."); see also Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 672 (1996) [hereinafter Langevoort, *Selling Hope*] (discussing the argument that "[p]enalizing undue trust is thus simply a way to create a legal incentive toward cognitive diligence and discourage reliance on motivated heuristics and biases.").

David A. Hoffman has gone so far as to suggest that this incentive structure creates a “legal duty to be a rational shareholder.”⁹¹

The guidance role of the materiality standard is consistent with the legislative history of the 1933 and 1934 Acts. After studying the floor debates on these acts, Mr. Walsh characterized the rhetoric about protecting only those investors who had exercised reasonable care as, in some ways, “didactic.”⁹² In other words, “[i]nvestors must be taught to conduct themselves properly.”⁹³ Indeed, one representative foreshadowed Professor Hoffman’s legal duty contention by explaining that the legislation “worked not by allowing but by ‘requiring’ the purchaser to exercise judgment in regards to his or her own investments.”⁹⁴

A higher materiality standard, which denies recovery to more investors, arguably encourages investors to be less trusting.⁹⁵ As explained by Professor Jennifer O’Hare, a court’s ruling that statements are non-actionable puffery “is sending a message to investors that they cannot believe the company’s disclosure[s].”⁹⁶ At the extreme, this is a return to the doctrine of caveat emptor.⁹⁷

A lower materiality standard, which grants recovery to more investors, arguably encourages investors to be more gullible. As Professor Barbara Black explained (albeit skeptically), “[c]ourts apparently believe that if we treat investors like children, nitwits, or rubes, they will act that way.”⁹⁸

91. Hoffman, *The “Duty,” supra* note 81, at 595 (“[W]e should see presumed immateriality as an attempt by courts to shape the ordinary relationship between corporations and investors, not merely the contours of recovery in litigation.”).

92. Walsh, *supra* note 9, at 219 (citing examples from the legislative history of the 1933 and 1934 Acts).

93. *Id.*

94. *Id.* (citing 77 CONG. REC. 2931 (1933) (statement of Rep Wolverton)).

95. O’Hare, *supra* note 54, at 1725-26 (“If courts continue to apply the puffery defense, investors will be forced to question the veracity of a company’s optimistic statements, leading to a distrustful investment environment based on the doctrine of caveat emptor.”); Padfield, *Is Puffery Material?*, *supra* note 74, at 360 (“In this way, the [puffery] doctrine may lead to an increase in speech that impedes the efficient flow of capital by reducing the trust investors have in the market.”).

96. O’Hare, *supra* note 54, at 1723 (“The company argues that the officer’s statement constituted non-actionable puffery. If a court agrees, then it is sending a message to investors that they cannot believe the company’s disclosure. It is saying that, even though the company’s officer said that the transaction was going ‘well,’ investors should have second-guessed the honesty of the officer and the accuracy of the statement.”).

97. *Id.* (“In effect, the court is signaling a return to the doctrine of caveat emptor, a result clearly at odds with the policies of the federal securities laws.”); Padfield, *Immaterial Lies*, *supra* note 40, at 147 (arguing that “overdependence on materiality safety valves . . . arguably sends the message to executives that it is often okay to embellish the truth—and sends the message to investors that they should adopt an attitude of caveat emptor (‘buyer beware’) when it comes to the statements of corporate executives.”).

98. Barbara Black, *Behavioral Economics and Investor Protection: Reasonable*

Professor Joan MacLeod Heminway similarly recognized this possibility, when discussing whether the materiality standard should be lowered to reflect the actual behavior of investors: “Assuming their behaviors are commonplace or normal, do we want to protect (and thereby *encourage*) behaviors exhibited by underclass investors, moody investors, moral investors, or female investors by terming their behaviors ‘reasonable’ or by otherwise altering the materiality standard to reflect their behaviors?”⁹⁹

Therefore, in sum, courts’ rulings on the element of materiality potentially influence the investment behavior of future investors, encouraging them to be more gullible or to be less trusting. This is the first step in the legal circularity of materiality.

b. Step Two: Reasonable Investors Are Arguably Influenced by Prior Courts’ Materiality Rulings

The second analytical step in the legal circularity of materiality is the proposition that reasonable investors are arguably influenced by prior court rulings on materiality. The first step explains that this influence exists; this second step explains that this influence is reasonable.

Reasonable investors, when assessing whether a representation is important to their investment decisions, arguably consider whether the speaker would be subject to securities fraud liability if the representation were false. If so, a reasonable investor is more likely to give the representation credence; if not, a reasonable investor is more likely to disregard it. Professor O’Hare explained why the potential for securities fraud liability matters to reasonable investors as follows:

[T]he anti-fraud provisions of the federal securities laws make it more likely that a reasonable investor would believe the company’s optimistic statements. Investors know that the securities industry is highly regulated. They understand that a company risks substantial liability for false or misleading statements. Therefore, it is more reasonable for investors to believe a company’s statements made in connection with the purchase or sale of a security than statements made by a seller in

Investors, Efficient Markets, 44 LOY. U. CHI. L.J. 1493, 1505 (2013) (acknowledging this policy consideration while not agreeing that it should govern) (“What then are the policy considerations to support a ‘reasonable investor’ standard that requires greater rationality than most investors possess? Courts have not engaged in extensive policy analysis, but it appears that courts want people to make sensible investment decisions, and so they will deny them any recovery for their losses unless they live up to the ‘reasonable investor’ standard.”).

99. Heminway, *Female Investors*, *supra* note 29, at 326 (emphasis added).

connection with the sale of a tangible product.¹⁰⁰

Therefore, a reasonable investor potentially considers a speaker's potential liability for falsity when deciding whether to give the speaker's representations any weight.

Reasonable investors are already charged with certain skills and knowledge. For example, reasonable investors are assumed to grasp the time-value of money,¹⁰¹ the taxation of different investments,¹⁰² basic accounting treatment,¹⁰³ diversification and risk,¹⁰⁴ the nature of margin accounts,¹⁰⁵ and the security industry's compensation structure.¹⁰⁶ In addition, reasonable investors are assumed to know "all publicly available information" relevant to the investment,¹⁰⁷ including the economic conditions of various regions,¹⁰⁸ and to draw on that information to compare various investment options.¹⁰⁹

Reasonable investors could arguably likewise be charged with knowledge of how courts interpret the materiality element and how that interpretation affects a speaker's potential for securities fraud liability. Court opinions are public records,¹¹⁰ and legal commentary is publicly

100. O'Hare, *supra* note 54, at 1722.

101. Black, *supra* note 98, at 1494-95; Heminway, *Female Investors*, *supra* note 29, at 301 (citing authority); Sachs, *supra* note 42, at 475-76 (citing examples).

102. Hoffman, *The "Duty," supra* note 81, at 582 (citing examples)

103. *Id.*

104. Black, *supra* note 98, at 1494-95; Heminway, *Female Investors*, *supra* note 29, at 301 (citing authority).

105. Black, *supra* note 98, at 1494-95.

106. *Id.*; Heminway, *Female Investors*, *supra* note 29, at 301 (citing authority).

107. Heminway, *Female Investors*, *supra* note 29, at 306 ("Even if not sophisticated, a reasonable investor certainly is informed. In fact, the Securities Act of 1933, as amended ('1933 Act'), and the 1934 Act, by using disclosure as a vehicle for effectuating the promotion of investor protection and market integrity, effectively ordain that the reasonable investor must be informed. Accordingly, an informed investor incorporates all publicly available information into her decision making.").

108. *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d 357, 377 (3d Cir. 1993) ("As the reasonable investor should have known of the economic downturn in the Northeast at that time, the inclusion of this information would not have substantively altered the total mix of information the prospectus provided to investors.").

109. *Id.* at 375-76 ("The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors . . . [I]t is precisely and uniquely the function of the prudent *investor*, not the issuer of securities, to make such comparisons among investments.") (emphasis in original).

110. See, e.g., PACER, www.pacer.gov ("Public Access to Court Electronic Records (PACER) is an electronic public access service that allows users to obtain case and docket information online from federal appellate, district, and bankruptcy courts, and the PACER Case Locator. PACER is provided by the Federal Judiciary in keeping with its commitment to providing public access to court information via a centralized service.").

available in various fora, including in law journals. Moreover, it is not unprecedented to assume that various non-attorney actors have a nuanced understanding of the current state of the case law. For example, state officials' qualified immunity to suits under 42 U.S.C. § 1983 is lost "if the constitutional right allegedly infringed by them was clearly established at the time of their challenged conduct, if they knew or should have known of that right, and if they knew or should have known that their conduct violated the constitutional norm,"¹¹¹ as demonstrated by the case law at the time of the officials' conduct.¹¹² As another example, when considering a criminal defendant's claim that a statute is unconstitutionally vague, courts sometimes engage in a complex analysis of the state of the case law, rejecting vagueness claims when that case law backdrop supports a clear interpretation of the statute.¹¹³

This assumes, of course, that courts' treatment of materiality is sufficiently coherent to be helpful to investors. Indeed, many scholars have criticized courts' materiality decisions as incoherent and, hence, unhelpful for planning purposes.¹¹⁴ Just because courts' materiality assessments are

111. *Procunier v. Navarette*, 434 U.S. 555, 562 (1978).

112. *See id.* at 565 ("Whether the state of the law is evaluated by reference to the opinions of this Court, of the Courts of Appeals, or of the local District Court, there was no 'clearly established' First and Fourteenth Amendment right with respect to the correspondence of convicted prisoners in 1971-1972. As a matter of law, therefore, there was no basis for rejecting the immunity defense on the ground that petitioners knew or should have known that their alleged conduct violated a constitutional right."); *Cagle v. Gilley*, 957 F.2d 1347, 1348 (6th Cir. 1992) ("Ordinarily, to find a clearly established constitutional right, a district court within the Sixth Circuit must find binding precedent from the Supreme Court, the Sixth Circuit, or from itself. Although decisions of other courts can clearly establish the law, such decisions must both point unmistakably to the unconstitutionality of the conduct and be so clearly foreshadowed by applicable direct authority as to leave no doubt in the mind of a reasonable officer that his conduct was unconstitutional.").

113. *E.g.*, *Skilling v. United States*, 130 S.Ct. 2896, 2929-30 (2010) ("Satisfied that Congress, by enacting § 1346, 'meant to reinstate the body of pre-*McNally* honest-services law,' we have surveyed that case law. In parsing the Courts of Appeals decisions, we acknowledge that Skilling's vagueness challenge has force, for honest-services decisions preceding *McNally* were not models of clarity or consistency Although some applications of the pre-*McNally* honest-services doctrine occasioned disagreement among the Courts of Appeals, these cases do not cloud the doctrine's solid core: The 'vast majority' of the honest-services cases involved offenders who, in violation of a fiduciary duty, participated in bribery or kickback schemes.").

114. Heminway, *Materiality Guidance*, *supra* note 14, at 1153 ("[A]pplicable decisional law and scholarship often do not permit a definitive determination as to the materiality of facts or events, even if recurring. Accordingly, the widespread acceptance of the *TSC Industries* standard is of small comfort."); *id.* at 1165 ("Because cases are fact-specific, a conclusive determination regarding materiality only can be made if one locates a case completely on point with the fact scenario in the case being analyzed. While occasionally (and luckily) a case on point can be located, it is a relatively rare occurrence. Even an

not always crystalline does not mean, however, that certain fact patterns have not been repeated often enough to provide guidance.¹¹⁵

In sum, then, there is support for both analytical steps underlying the legal circularity of materiality. Courts' materiality decisions arguably influence the behavior of future investors, and that influence is arguably reasonable on the part of future investors. Therefore, courts' materiality determinations potentially operate as self-fulfilling prophecies.

3. An Assessment of the Descriptiveness of the Legal Circularity of Materiality

The potential legal circularity of materiality begs the question of whether courts are presently treating materiality as circular. Namely, when making materiality determinations, are courts assuming that their hypothetical reasonable investors are adjusting their behavior based on the state of the law of materiality?

The evidence is mixed. No court has explicitly recognized the potential legal circularity of materiality. Courts do, however, frequently rely on long string cites of previous precedent when ruling that certain representations are immaterial as a matter of law.¹¹⁶ Certainly, courts could merely be citing this precedent as a guide to their own assessments of representations' materiality, but the implication is that—in light of many previous courts that have so ruled—reasonable investors would have known better than to rely on these representations.

Moreover, several scholars have noted that courts engage in very little analysis of materiality, instead relying on rules of thumb.¹¹⁷ Again, this lack of extensive analysis by the courts—rather than a symptom of courts'

exhausting and exhaustive search for decisional law may not yield a case or group of cases affording a clear answer."); Sauer, *supra* note 12, at 319 ("Materiality determinations in individual cases tend to be so fact-specific that the accumulated body of published case law provides limited guidance for decision-making.").

115. Heminway, *Materiality Guidance*, *supra* note 14, at 1198-99 ("Existing decisional law is another valuable source for more concrete materiality measurement principles. For example, certain fact patterns repeat themselves in cases decided by a number of different federal district or circuit courts. These courts may have identified applicable materiality elements and used methods of measurement that Congress, the SEC, or other courts can use in providing more specific advice on materiality.").

116. *E.g.*, *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119-20 (10th Cir. 1997) (citing a string of eight other opinions in support of the puffery doctrine); *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (citing six other opinions in support of adoption of the bespeaks caution doctrine) ("We are persuaded by the *ratio decidendi* of these cases and will apply bespeaks caution to the facts before us.").

117. *See infra* notes 118-119.

taking shortcuts¹¹⁸ or of courts' engaging in herding behavior¹¹⁹—could instead be evidence that courts are charging their hypothetical reasonable investors with knowledge of these rules of thumb. What scholars have identified as substantive law heuristics and herding could actually be courts applying the legal circularity of materiality.

Of course, separate and apart from whether courts are actually applying the legal circularity of materiality is whether courts should be doing so. This Article now turns to that question, first by positing a broader Theory of Legal Circularity and then by applying that theory in the context of materiality.

II. A THEORY OF LEGAL CIRCULARITY

Materiality is not the only potentially circular legal doctrine. Indeed, other scholars, most notably Professor Michael Abramowicz in his seminal article titled “Constitutional Circularity,”¹²⁰ have identified other legal doctrines that operate as self-fulfilling prophecies. No scholar has proposed an overarching theory to identify and assess potentially circular legal doctrines, and this Article seeks to fill this void.

In particular, this Article proposes a two-step Theory of Legal Circularity. The first step is a Legal Circularity Test to identify doctrines that are potentially legally circular. Various legal doctrines satisfy this test, including materiality and the doctrines identified by Professor Abramowicz

118. Bainbridge & Gulati, *supra* note 74, at 119-26 (arguing that the materiality doctrines of puffery, bespeaks caution, and trivial matters are substantive law heuristics because courts apply these doctrines with almost no analysis, instead merely citing to the fact that other courts have so held).

119. Langevoort, *Are Judges Motivated*, *supra* note 43, at 312-13 (“In this spirit, let me offer a slight modification of the authors’ story that seems less insulting to the judiciary but still captures their thrust. Assume that judges have substantially differing dispositions toward securities cases, with some highly motivated, some uninterested, and many in between. A defense is initially recognized, as I suggested above, in common sense form, perhaps even by the most motivated of judges. Thereafter, however, it is adopted and extended by a mindless judge or two. What happens then is that precedent builds that gradually attracts more of those in the middle. This attraction is mainly because of the institutionally legitimate pull of precedent, aided by only a slight dose of self-serving inference. As the attraction grows, the precedent gradually becomes more a self-fulfilling prophecy and begins to crowd out the efforts of the more diligent judges. In fact, this strikes me as an apt description of the doctrinal reality described earlier, wherein many judges today are explicitly critical of the heuristics and much hard work still gets done in securities cases, but those heuristics gradually exert more and more strength disproportionate to their logic as the case law evolves. In other words, one need not make strong assumptions about slothful judicial dispositions to get the effect we observe: a mild tendency in the judiciary as a whole is enough to generate a perceptible bias in the law over time.”).

120. Michael Abramowicz, *Constitutional Circularity*, 49 U.C.L.A. L. REV. 1 (2001).

and other scholars. Merely because a legal doctrine is potentially legally circular, however, does not mean that courts and scholars should embrace that circularity. Therefore, the second step is a Framework to Assess Legal Circularity. This framework, drawing from the rich scholarship on the distinct but similar concepts of *stare decisis*, substantive law heuristics, and herding, identifies three factors to assess in order to weigh the pros and cons of adopting legal circularity. This framework is comprehensive and complex, yielding a different result depending on the legal doctrine at issue. The two steps of the Theory of Legal Circularity are discussed below.

A. *Legal Circularity Test*

As the first step of the Theory of Legal Circularity, this Article proposes the following Legal Circularity Test to identify legal doctrines that are potentially circular. A legal doctrine is potentially circular if: (1) the legal doctrine incorporates the behavior or attitude of a population or person, either hypothetical or real; and (2) the subject population or person either would (if hypothetical) or does (if real) consider prior precedent interpreting the legal doctrine when choosing said behavior or when adopting said attitude.

Materiality fits within the Legal Circularity Test. First, the definition of materiality incorporates the investment behavior of a hypothetical reasonable investor. Second, a hypothetical reasonable investor would arguably consider prior precedent interpreting materiality when investing.¹²¹

Materiality is not alone, however. Indeed, Professor Abramowicz, drawing on the work of other scholars, has identified several constitutional doctrines that are likewise circular.¹²² He explained:

For the Court, the Constitution's meaning may depend not just on traditional factors like text and enactment history, but also on how citizens, either generally or as relevant groups, have come to understand the Constitution But a decision also may have an indirect effect, changing what the people *think* the provision means. If what a provision means depends in part on what people currently think it means, then constitutional law at times can be self-fulfilling prophecy.¹²³

121. *See supra* Part I.C.

122. Abramowicz, *supra* note 120.

123. Abramowicz, *supra* note 120, at 7-8.

Each of the following constitutional doctrines that Professor Abramowicz and other scholars have identified also satisfies the Legal Circularity Test. First, the Fourth Amendment analysis of whether a person has a “constitutionally protected reasonable expectation of privacy”¹²⁴ is arguably legally circular because “someone can have a reasonable expectation of privacy in an area if and only if the Court has held that a search in that area would be unreasonable.”¹²⁵ This Fourth Amendment analysis satisfies the Legal Circularity Test because it incorporates the privacy expectations of a reasonable person, and a reasonable person would consider prior Fourth Amendment precedent when considering whether he or she has an expectation of privacy.

Second, the takings analysis of whether governmental action has interfered with “reasonable investment backed expectations”¹²⁶ is arguably legally circular because the reasonableness of any such expectation is informed by prior takings precedent: “If case law indicates that the government can take a particular type of property (or opportunity for the use of property) without compensation, then the property owner ought not have expectations of profit.”¹²⁷ This takings analysis satisfies the Legal

124. *California v. Ciraolo*, 476 U.S. 207, 211 (1986) (citing *Katz v. United States*, 389 U.S. 347, 360 (1967) (Harlan, J., concurring)) (“The touchstone of Fourth Amendment analysis is whether a person has a ‘constitutionally protected reasonable expectation of privacy.’ *Katz* posits a two-part inquiry: first, has the individual manifested a subjective expectation of privacy in the object of the challenged search? Second, is society willing to recognize that expectation as reasonable?”).

125. Abramowicz, *supra* note 120, at 60-61 (citing the work of other scholars recognizing the potential circularity of the concept of a “reasonable expectation of privacy”) (“Thus, . . . the Court seems to be saying that what counts as reasonable depends on what the Court has previously held.”); *see also* Bailey H. Kuklin, *The Plausibility of Legally Protecting Reasonable Expectations*, 32 VAL. U. L. REV. 19, 33 (1997) (“The circularity of this grounding of the law on the principle of protecting reasonable expectations cannot, I believe, be eliminated altogether.”).

126. *Kaiser Aetna v. United States*, 444 U.S. 164, 174-75 (1979) (citation omitted) (“As was recently pointed out in *Penn Central Transportation Co. v. New York City*, this Court has generally ‘been unable to develop any ‘set formula’ for determining when ‘justice and fairness’ require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons.’ Rather, it has examined the ‘taking’ question by engaging in essentially ad hoc, factual inquiries that have identified several factors—such as the economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action—that have particular significance.”).

127. Abramowicz, *supra* note 120, at 63 (citing the work of other scholars recognizing the potential circularity of the concept of “reasonable investment-backed expectations”); *see also* Lynn E. Blais, *Takings, Statutes, and the Common Law: Considering Inherent Limitations on Title*, 70 S. CAL. L. REV. 1, 56 (1996) (“[T]he reasonable expectations model is hopelessly circular, both in theory and in practice. In theory, reasonable expectations are founded on perceptions of what the law will protect, so the law’s protections cannot be based on reasonable expectations.”).

Circularity Test because it incorporates the reasonable investment expectations of the property owner, and a reasonable property owner would consider prior takings precedent when formulating investment expectations.

Third, the due process “minimum contacts” analysis is potentially legally circular. That analysis depends on whether “the defendant’s conduct and connection with the forum State are such that he [or she] should reasonably anticipate being haled into court there.”¹²⁸ Yet, a defendant’s reasonable anticipation of being haled into court in a jurisdiction depends on prior precedent explaining the degree and nature of contacts that would subject one to personal jurisdiction.¹²⁹ The minimum contacts analysis satisfies the Legal Circularity Test because it depends on a person’s reasonable expectations of being subject to personal jurisdiction, and a reasonable person’s expectations are informed by prior precedent on the scope of personal jurisdiction.

Fourth, the Eighth Amendment’s prohibition on cruel and unusual punishment is arguably legally circular because it “must draw its meaning

128. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 296-97 (1980) (“This is not to say, of course, that foreseeability is wholly irrelevant. But the foreseeability that is critical to due process analysis is not the mere likelihood that a product will find its way into the forum State. Rather, it is that the defendant’s conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there.”); 4 FED. PRAC. & PROC. § 1067 (3d ed. 2013) (“As countless cases decided in the years since the *International Shoe* decision demonstrate, the Court’s reference to the defendant’s ‘minimum contacts’ with the forum and its invocation of ‘traditional notions of fair play and substantial justice’ have become centerpieces for the analysis and application of the Constitution’s due process limitations on attempts to assert in personam jurisdiction over an out-of-state defendant.”); *Int’l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (“[D]ue process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’”).

129. Abramowicz, *supra* note 120, at 64 (citing other scholars and courts recognizing the potential circularity of the personal jurisdiction analysis) (“A similar phenomenon exists in constitutional civil procedure. Whether a state may assert jurisdiction over a defendant consistent with the Due Process Clause depends in part on whether the defendant could justifiably have expected to be haled into that state’s courts. Commentators have noted that this formulation also seems to be circular.”); *see also*, David Wille, *Personal Jurisdiction and the Internet—Proposed Limits on State Jurisdiction over Data Communications in Tort Cases*, 87 KY. L.J. 95, 136 (1998) (“Defendants only have reasonable expectations about where they will be haled into court because courts have created such expectations. Planning and reliance thus result in an empty principle to define the boundaries of jurisdiction. Once a court changes those boundaries, expectations change. Thus, reasonable expectations are not useful in defining boundaries—only in maintaining the status quo. Carried to its extreme, a reasonable expectations principle would operate similarly to qualified immunity—no jurisdiction would exist over a defendant unless his or her actions established jurisdiction under clearly established doctrine.”).

from the evolving standards of decency that mark the progress of a maturing society,”¹³⁰ and “judicial doctrine that allows or prohibits certain forms of punishment affects whether these forms of punishment meet society’s evolving standards of decency.”¹³¹ The cruel and unusual punishment analysis satisfies the Legal Circularity Test because it depends on society’s standards of decency, and society considers prior precedent on cruel and unusual punishment when formulating its decency standards.

The potential for legal circularity is not limited to securities laws and the Constitution. For instance, the common law negligence standard is arguably circular. Under the Second Restatement of Torts’ conception of negligence, a non-negligent person must act like “a reasonable man under like circumstances.”¹³² An act is unreasonable if “the risk [of harm to another] is of such magnitude as to outweigh what the law regards as the utility of the act or of the particular manner in which it is done.”¹³³ The magnitude of the risk is measured by considering “the social value which the law attaches to the interests which are imperiled,”¹³⁴ and the utility of the action is measured by considering “the social value which the law attaches to the interest which is to be advanced or protected by the conduct.”¹³⁵ The referenced “law” includes decisional law.¹³⁶ The negligence analysis satisfies the Legal Circularity Test because it depends on the risk-utility assessment of a reasonable person, and a reasonable person would consider prior negligence precedent when calculating the risk of harm and the utility of the action.

130. Abramowicz, *supra* note 120, at 65 (citing other scholars recognizing the potential circularity of the cruel and unusual punishment analysis) (quoting *Trop v. Dulles*, 356 U.S. 86, 101 (1958)) (“The Supreme Court has held that the Eighth Amendment’s Cruel and Unusual Punishment Clause ‘must draw its meaning from the evolving standards of decency that mark the progress of a maturing society.’”).

131. *Id.*

132. RESTATEMENT (SECOND) OF TORTS § 283 (“Unless the actor is a child, the standard of conduct to which he must conform to avoid being negligent is that of a reasonable man under like circumstances.”).

133. *Id.* § 291 (“Where an act is one which a reasonable man would recognize as involving a risk of harm to another, the risk is unreasonable and the act is negligent if the risk is of such magnitude as to outweigh what the law regards as the utility of the act or of the particular manner in which it is done.”).

134. *Id.* § 293.

135. *Id.* § 292.

136. See *id.* § 292 cmt. (discussing the value attached by “a persistent course of decisions”). But see Stephen G. Gilles, *On Determining Negligence: Hand Formula Balancing, The Reasonable Person Standard, and the Jury*, 54 VAND. L. REV. 813, 830 (2001) (“Given the jury’s traditional role in applying the negligence standard, in most situations there will be no judicial decisions specifying the social value of particularly described interests. As a practical matter, therefore, the best way to ascertain what social value the law attaches to an interest will usually be to consult popular opinion.”).

Except for the Eighth Amendment prohibition on cruel and unusual punishment, each of the above-identified examples of potentially circular legal doctrines includes the concept of “reasonableness,” which begs the question of whether reasonableness inquiries are always potentially legally circular. This Article argues that, while the concept of reasonableness is especially susceptible to legal circularity because it depends on the hypothetical behavior of a rational actor (which often includes consideration of prior precedent), reasonableness inquiries are not *per se* legally circular. For example, an element of a Title VII hostile work environment claim is whether a reasonable person would find the harassing conduct to be sufficiently severe or pervasive to create an abusive working environment.¹³⁷ In this context, it is unlikely that a reasonable employee would consider prior Title VII precedent when assessing for him or herself whether conditions rise to the level of constituting an abusive environment. As a further example, an element of the common law affirmative defense to homicide of self-defense is whether the defendant “reasonably believes that he is in imminent danger of losing his life or suffering great bodily harm.”¹³⁸ It is unlikely that a reasonable person would consider prior self-defense precedent when deciding whether to act in self-defense.¹³⁹

As the above examples demonstrate, the Legal Circularity Test is helpful to identify legal doctrines that have the potential to be legally circular. Before moving on to the proposed Framework to Assess Legal Circularity, which analyzes whether courts and scholars should embrace a legal doctrine’s potential circularity, it is important for the sake of clarity to distinguish legal circularity from several similar, but different, concepts. In brief, as discussed below, legal circularity does not involve the logical flaw of circular reasoning. Additionally, although these related concepts shed light on the potential impacts of legal circularity, legal circularity differs from *stare decisis*, substantive law heuristics, and herding.

137. *Harris v. Forklift Sys., Inc.*, 510 U.S. 17, 21 (1993) (“Conduct that is not severe or pervasive enough to create an objectively hostile or abusive work environment—an environment that a reasonable person would find hostile or abusive—is beyond Title VII’s purview.”).

138. 2 WHARTON’S CRIMINAL LAW § 127 (15th ed. 2014).

139. *Accord* Andrew Ingram, Note, *Parsing the Reasonable Person: The Case of Self-Defense*, 39 AM. J. CRIM. L. 425, 441 (2012) (“[J]udges should be wary when applying *stare decisis* in these [self-defense] cases lest the general principle drown in a sea of *per se* rules and exceptions.”).

1. The Distinction Between Legal Circularity and Circular Reasoning

Circular reasoning is a logical flaw¹⁴⁰ in which “the arguer illicitly uses the conclusion itself (or a closely related proposition) as a crucial piece of support, instead of justifying the conclusion on the basis of agreed-upon facts and reasonable inferences.”¹⁴¹ Professor Lance J. Rips provides the following example of circular reasoning:

If sentence S_1 justifies sentence S_2 and S_2 justifies S_1 in the same argument, then it is likely that the argument is circular. But circularity can occur even when the arguer does not repeat S_1 verbatim. At the very least, we must make room for the case in which S_1 justifies S_2 justifies S'_1 , where S_1 and S'_1 express the same proposition or claim.¹⁴²

The legal circularity identified by the Legal Circularity Test does not implicate this logical flaw because there is a temporal distinction between the earlier court decision establishing a proposition and the later court decision incorporating that earlier proposition into its analysis. The earlier court decision changes the universe in which the later court operates. Using a shorthand similar to the one used by Professor Rips, the following is an example of legal circularity: An earlier court analyzes issue X and concludes S_1 . A later court analyzes issue X, which depends on the fact that an earlier court concluded S_1 , and therefore likewise concludes S_1 .

The legal circularity identified by the Legal Circularity Test does not use circular reasoning. Rather, it refers to circularity in the sense of being a self-fulfilling prophecy.¹⁴³ That being said, however, as discussed below in the proposed Framework to Assess Legal Circularity,¹⁴⁴ legal circularity poses a similar risk of self-authentication of a “wrong” result to that posed by circular reasoning.¹⁴⁵

140. See Lance J. Rips, *Circular Reasoning*, 26 COGNITIVE SCI. 767, 768 (2002) (“Circularity is a defect in reasoning because it undermines correct attempts to justify a claim or an action.”).

141. *Id.* at 767; see also DAVID KELLEY, *THE ART OF REASONING* 154 (3d ed. 1998) (defining a “circular argument” as “trying to support a proposition with an argument in which that proposition is a premise”).

142. Rips, *supra* note 140, at 768.

143. See Abramowicz, *supra* note 120, at 62 (distinguishing between doctrine that is “circular in a logical sense” and doctrine that “may tend to be self-fulfilling in an empirical sense”).

144. See *infra* Part II.B.

145. See Rips, *supra* note 140, at 768 (explaining that circular reasoning can “lead to narrow-mindedness, or even delusions, in which one’s beliefs about a topic are self-

2. The Distinction Between Legal Circularity and Stare Decisis

Stare decisis, which translates as “to stand by things decided,”¹⁴⁶ encompasses two propositions. First, once a court has decided an issue, the court will not reexamine the decision in a later case, absent “urgent reasons and in exceptional cases;” second, lower courts are bound by the earlier-decided rulings of higher courts.¹⁴⁷

Legal circularity is stronger than stare decisis, operating like a super-charged stare decisis. For example, under stare decisis, an earlier ruling that certain cautionary language renders a specific projection immaterial as a matter of law would be binding in the future on the same and lower courts, absent exceptional circumstances compelling reversal. Under legal circularity, the earlier ruling would actually affect the later application of the materiality test because, in light of the earlier ruling that the projection was not actionable even if false, no reasonable investor would have considered the projection to be important in making an investment decision. Under legal circularity, the later court is not merely bound by the earlier ruling; the later court’s application of the test is impacted by the paradigm shift that the earlier ruling accomplished. Although stare decisis contains the potential for a later court to differentiate the earlier ruling or to overrule it under extraordinary circumstances, legal circularity is far stickier. Therefore, although legal circularity differs from stare decisis, the impacts of stare decisis are arguably present under, or even heightened by, legal circularity. As such, the rich scholarship on the pros and cons of stare decisis¹⁴⁸ informs the Framework to Assess Legal Circularity.¹⁴⁹

authenticating, sealed off from evidence that might cast doubt upon them”).

146. BLACK’S LAW DICTIONARY 1537 (9th ed. 2009).

147. WILLIAM M. LILE ET AL., BRIEF MAKING AND THE USE OF LAW BOOKS 321 (3d ed. 1914) (“The rule of adherence to judicial precedents finds its expression in the doctrine of stare decisis. This doctrine is simply that, when a point or principle of law has been once officially decided or settled by the ruling of a competent court in a case in which it is directly and necessarily involved, it will no longer be considered as open to examination or to a new ruling by the same tribunal, or by those which are bound to follow its adjudications, unless it be for urgent reasons and in exceptional cases.”); Goutam U. Jois, *Stare Decisis Is Cognition Error*, 75 BROOK. L. REV. 63, 71 (2009) (“Stare decisis may have a horizontal component (where a court follows its own earlier-decided cases) and a vertical component (where a lower court follows a higher court’s earlier decided cases.)”); Caleb Nelson, *Stare Decisis and Demonstrably Erroneous Precedents*, 87 VA. L. REV. 1, 1 (2001) (“American courts of last resort recognize a rebuttable presumption against overruling their own past decisions.”).

148. E.g., Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 601 (2001); Jois, *supra* note 147; Nelson, *supra* note 147.

149. See *infra* Part II.B (discussing the framework to assess legal circularity).

3. The Distinction Between Legal Circularity and Substantive Law Heuristics

Substantive law heuristics are “doctrinal rules of thumb enabling a judge to avoid analysis of a case’s full complexities.”¹⁵⁰ As explained by Professors Bainbridge and Gulati, judges are faced with myriad “institutional constraints that give judges incentives to eliminate securities cases from their dockets with minimal effort,” thus heightening the appeal of substantive heuristics.¹⁵¹ These constraints include workload, skill, and knowledge.¹⁵² In addition, as argued by Professor Hillary A. Sale, judges are tempted by the benefits of creating and using substantive heuristics, including popularity with a particular class of litigants (such as the defense bar) and subsequent citation by other courts.¹⁵³ Therefore, judges arguably have an incentive to rely on substantive heuristics to resolve cases.¹⁵⁴

Substantive heuristics develop in two steps. First, an appellate court creates a heuristic when faced with (1) a complex and vague substantive question, (2) factual findings from the district court, and (3) an intuitively sensible rule of thumb that allows for a quick and easy determination.¹⁵⁵ Second, the heuristic is adopted and used by other courts,¹⁵⁶ with its attractiveness growing as it becomes “well-established.”¹⁵⁷ The heuristic becomes widely used by courts, with the support of a long string-cite, without the need to engage in in-depth analysis.¹⁵⁸

150. Bainbridge & Gulati, *supra* note 74, at 83.

151. *Id.* at 88.

152. *Id.* at 100; Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 905 (2002) (“Judges are busy people. District court judges are especially busy people who exist in very noisy environments. They have crowded dockets and limited courtroom time. In addition to keeping track of their schedules and those of all the cases on their dockets, they must cope with motions and trials. Just like other busy “managers,” judges find ways to meet the demands of their jobs through the use of cognitive biases. These cognitive biases are the same types of shortcuts, or heuristics, that we all develop to cope with the multiple decisions we must make on a daily basis.”).

153. Sale, *supra* note 152, at 909-14.

154. Bainbridge & Gulati, *supra* note 74, at 90 (“[W]e argue that judges have an incentive to rely on standard-based doctrines that can be used to dispose of a wide variety of cases on simple threshold issues—such outcomes are ‘good enough,’ but avoid the need to decide more complex and difficult issues.”).

155. *Id.* at 114-15.

156. Sale, *supra* note 152, at 955-56 (“[I]t provides courts with a certain comfort level in the opinions they draft. That is, precedent allows courts to avoid mistakes and reversal. Combining their ease of application with the nature of precedent further explains why these heuristics have flourished and why they are likely to continue to do so.”).

157. Bainbridge & Gulati, *supra* note 74, at 116-17; *id.* at 117 (“[T]he legitimacy of using a specific heuristic increases as it becomes more widely adopted. In turn, as the heuristic becomes more legitimate, the incentive to use it increases.”).

158. *Id.* at 115-16.

Legal circularity differs from substantive heuristics, but its usage mimics that of substantive heuristics. Under legal circularity, subsequent courts look to courts' prior rulings—not for shortcuts—but because those rulings change the landscape under which the parties operate. When courts apply legal circularity, like when they apply substantive heuristics, it is more likely that later rulings will coincide with earlier rulings without the need for extensive analysis. Because courts' reliance on legal circularity and on substantive heuristics lead to similar results, the rich scholarship discussing the effects of substantive heuristics¹⁵⁹ informs the Framework to Assess Legal Circularity.¹⁶⁰

4. The Distinction Between Legal Circularity and Herding

Herding, which is also referred to as “informational cascades,” occurs “among agents when their decisions are decreasingly determined by their own information and increasingly determined by the actions of others.”¹⁶¹ Courts arguably engage in herding by relying on the weight of precedent, even when that precedent is merely persuasive, rather than engaging in independent decision-making.¹⁶² Professors Andrew W. Daughety and Jennifer F. Reinganum modeled the potential herding behavior of courts as follows:

We model appeal courts as Bayesian decision makers with private information about a supreme court's interpretation of the law; each court also observes the previous decisions of other appeals courts in similar cases. Such “persuasive influence” can cause “herding” behavior by later appeals courts as decisions progressively rely more on previous decisions and less on a court's private information.¹⁶³

159. *E.g., id.* (describing and explaining the substantive heuristics of securities class action cases); Sale, *supra* note 152 (detailing the relationship between judges' busy schedules and their cognitive biases).

160. *See infra* Part II.B (discussing the framework to assess legal circularity).

161. Andrew W. Daughety & Jennifer F. Reinganum, *Stampede to Judgment: Persuasive Influence and Herding Behavior by Courts*, 1 AM. L. & ECON. REV. 158, 159 (1999).

162. Eric Talley, *Precedential Cascades: An Appraisal*, 73 CAL. L. REV. 87, 94 (1999) (“[A]s judges learn information from previous holdings, they may rationally begin to treat such holdings as binding, *even if* not formally required to do so, and *even if* the case they actually hear suggests a contrary outcome.”).

163. Daughety & Reinganum, *supra* note 161, at 158.

It is debatable whether courts actually engage in herding behavior. Professors Daughety and Reinganum's model suggests that herding by courts is theoretically possible, and they identify one example where courts arguably did engage in herding. In that example, a series of United States Courts of Appeal held that although the Coal Industry Retiree Health Benefit Act applied retroactively, it did not violate the Constitution.¹⁶⁴ "Each succeeding appeals court opinion referenced all the previous decisions. Moreover, each opinion became progressively shorter . . . and applied progressively similar criteria to reach the same conclusion."¹⁶⁵ The Supreme Court subsequently ruled that the retroactive application of the Coal Act was indeed unconstitutional.¹⁶⁶ Professors Daughety and Reinganum conclude that the earlier appeals court decisions "*might* reflect overdependence on the public signals being created by the sequence of appeals courts' decisions."¹⁶⁷ Professor Eric Talley, on the other hand, acknowledges that herding by courts is conceivable but argues that "the necessary conditions for such phenomena to occur appear somewhat implausible."¹⁶⁸

Legal circularity differs from herding, but it mimics herding behavior. Under legal circularity, later courts do not follow persuasive authority because they are relying on the weight of precedent rather than engaging in independent decision-making. Rather, under legal circularity, later courts recognize the impact of earlier precedent on the behavior of the hypothetical or real actors on whose behavior or attitude the legal test depends. Legal circularity mimics herding, however, because later courts are likely to cite the weight of authority and then engage in little additional analysis. Therefore, the rich scholarship addressing the impacts of precedential herding¹⁶⁹ informs the Framework to Assess Legal Circularity, to which this Article now turns.

164. *Id.* at 162 (citing authority).

165. *Id.*

166. *Eastern Enterprises v. Apfel*, 524 U.S. 498, 537 (1998) (O'Connor, J., plurality opinion) ("Eastern cannot be forced to bear the expense of lifetime health benefits for miners based on its activities decades before those benefits were promised. Accordingly, in the specific circumstances of this case, we conclude that the Coal Act's application to Eastern effects an unconstitutional taking."); *id.* at 550 (Kennedy, J., concurring in the judgment and dissenting in part) ("Application of the Coal Act to Eastern would violate the proper bounds of settled due process principles, and I concur in the plurality's conclusion that the judgment of the Court of Appeals must be reversed.").

167. Daughety & Reinganum, *supra* note 161, at 165.

168. Talley, *supra* note 162, at 92; *id.* at 105-14 (arguing that rule-boundedness, decisional opacity, judicial homogeneity, short judicial terms, flat hierarchies, and population stationarity are "necessary for a theory of precedential cascades to be both viable and significant").

169. *E.g., id.*; Daughety & Reinganum, *supra* note 161.

B. Framework to Assess Legal Circularity

Under the Theory of Legal Circularity, the first step is to apply the Legal Circularity Test to identify legal doctrines that are potentially circular. Merely because a legal doctrine is potentially legally circular, however, does not mean that courts and scholars should embrace that circularity. Indeed, courts and scholars could affirmatively disavow the relevance of prior decisions on the decision-making of future actors, rejecting a doctrine's potential legal circularity. Therefore, the second step of the Theory of Legal Circularity is a proposed Framework to Assess Legal Circularity. This framework draws from the rich scholarship on the similar impacts of stare decisis,¹⁷⁰ substantive law heuristics,¹⁷¹ and precedential herding¹⁷² in order to identify three factors courts and scholars should analyze with respect to each potentially circular legal doctrine.

In particular, in order to determine whether to embrace a legal doctrine's potential legal circularity, courts and scholars should weigh (1) the risk of a "wrong" rule, (2) the effects of greater predictability, and (3) the import of reconceiving the courts' role. As discussed below, this framework is comprehensive and complex, yielding a different result depending on the legal doctrine at issue.

1. Risk of a "Wrong" Rule

The first factor in the Framework to Assess Legal Circularity is the risk that embracing a legal doctrine's potential for circularity will lead to the entrenchment of a "wrong" rule, without sufficient means for correction.

Legal circularity is path dependent, creating a first mover advantage. When a doctrine is legally circular, earlier courts' rulings on an issue affect the landscape such that later courts are much more likely to rule accordingly. For example, under the legal circularity of materiality, early courts' rulings that a certain type of representation is per se immaterial would influence later courts' analyses of whether a reasonable investor would find such a representation to be material. Later reasonable investors would discount that type of representation as unreliable because the speaker bears no risk of liability for falsity, thus fulfilling the earlier courts' prophecy. A similar path dependency exists under stare decisis¹⁷³ and

170. See *supra* note 148.

171. See *supra* note 159.

172. See *supra* note 169.

173. Jois, *supra* note 147, at 99 (noting that stare decisis "entrenches a tremendous first mover advantage"); Hathaway, *supra* note 148, at 630 ("Because the path of the common

herding,¹⁷⁴ but the path dependency of legal circularity is arguably even more pronounced. Under *stare decisis* and herding, later courts are bound or persuaded by earlier holdings. Under legal circularity, later courts must actually incorporate the earlier courts' holdings into their analyses, making it even more likely that later courts' holdings will align with those of earlier courts.

As a consequence, legal circularity can lead to the entrenchment of a "wrong" rule, just because it is the first rule.¹⁷⁵ How early courts will rule, in the face of multiple possible outcomes, is unpredictable.¹⁷⁶ In fact, early courts are arguably more likely to rule erroneously than later courts because they do not have the benefit of other courts' guidance.¹⁷⁷ Scholars have recognized that *stare decisis*, substantive law heuristics, and herding can likewise operate to entrench an erroneous rule. Under *stare decisis* principles, even a demonstration of error is insufficient to overrule a past decision.¹⁷⁸ When courts rely on substantive heuristics, they replace in-depth analysis with cursory conclusions, potentially compounding earlier

law is locked in at an early stage, early decisions are crucial to the direction of the law.").

174. Daughety & Reinganum, *supra* note 161, at 159, 181 (explaining that "interjurisdictional path dependence" leads to "vastly different sequences of holdings for the same set of cases, depending only on the order in which they arise").

175. *Accord* Abramowicz, *supra* note 120, at 8 ("An invocation of *stare decisis* may represent an assertion that the self-fulfilling prophecy has come true, that even if the Court was originally erroneous in interpreting the Constitution, the Constitution has come to mean what the Court said as a result of the Court's having said it.").

176. *See* Hathaway, *supra* note 148, at 633-34 (arguing that the path dependency of *stare decisis* causes indeterminacy of outcome because it is unpredictable how early courts will rule on an issue) ("One might object to the claim that there are multiple possible outcomes and argue that there is usually (or at least often) one correct result in the law . . . [I]t may be true that there is one correct legal rule as a normative matter. But, as a descriptive matter, multiple outcomes are almost always possible. Moreover, when it comes to cases that make it to court, the 'right' legal rule is often a matter of interpretation; cases in which the result is abundantly clear generally are settled long before they arrive in the courtroom.").

177. Nelson, *supra* note 147, at 57-58 (arguing that courts are "significantly more likely to be erroneous in cases of first impression than in later cases").

178. *Id.* at 1-2 ("American courts of last resort recognize a rebuttable presumption against overruling their own past decisions . . . [C]onventional wisdom now maintains that a purported demonstration of error is not enough to justify overruling a past decision."); *id.* at 53 ("Instead, the court will follow precedent unless the precedent has proved unworkable or is causing other problems. Only these sorts of practical disadvantages would justify overruling the precedent."); *id.* at 53 (arguing that courts should "also overrule precedents when they deem the precedents demonstrably erroneous and see no special reason for adherence"); *see also* Talley, *supra* note 162, at 94 ("[T]he incentive for judges to emulate one another may stagnate the learning process, creating a precedent that *fails* to coincide with the normative objectives of each judge.").

errors.¹⁷⁹ When courts engage in herding behavior, they likewise follow the herd, even if the herd is incorrect.¹⁸⁰

The risk that legal circularity will entrench a “wrong” rule depends on whether the legal doctrine at issue is meant to embody intrinsic values or whether the doctrine is an arbitrary choice meant to solve a coordination problem. In the former context, there is harm in the entrenchment of a “wrong” rule; in the latter context, there is no such thing as a “wrong” rule, as long as the rule allows parties to coordinate their behavior. Professor Goutum U. Jois recognized a similar distinction when assessing the entrenchment impact of *stare decisis*:

Maybe the law is “wrong” as measured against some idealized notion of humans’ preferences (if such an ideal could even be extrapolated), but this may not pose any practical problems. If the law is not meant to embody some intrinsic truth, but instead is merely meant to be stable and predictable, then this problem seems illusory.¹⁸¹

This analysis draws on the distinction between natural laws and positive laws,¹⁸² and the scholarship in that area is helpful in making this

179. Bainbridge & Gulati, *supra* note 74, at 137 (“Instead of reflecting insight and judgment, opinions will be formulaic and citation-driven. In terms of articulating and clarifying the law, such opinions do little or nothing Accordingly, to the extent that these securities opinions make empirical claims about the behavior of firms and markets, there is a good chance that the information being conveyed is wrong.”); Sale, *supra* note 152, at 906-07 (discussing how the usage of a heuristic can “incorporate a systemic error prejudicing a particular group”).

180. Daughety & Reinganum, *supra* note 161, at 159, 181 (explaining that erroneous decisions early in the herding model potentially remain uncorrected because the agreement discourages appeal); Talley, *supra* note 162, at 101 (“[O]nce a precedential cascade begins, the resulting legal rule may—with high probability—vary from the efficient legal rule, even though each judge was assumed to be efficiency-minded and rational.”).

181. Jois, *supra* note 147, at 128.

182. Robert P. George, *Kelsen and Aquinas on “The Natural-Law Doctrine,”* 75 NOTRE DAME L. REV. 1625, 1637 (2000) (“Some laws . . . are derived from the natural law by a process akin to the deduction of demonstrable conclusions from general premises in the sciences. Other positive laws, however, cannot be derived from the natural law in so direct and straightforward a fashion. Where law is required to resolve a coordination problem, it is often the case that a variety of possible solutions, all having certain incommensurable advantages and disadvantages, are rationally available as options. One solution, however, must be authoritatively chosen by the legislator if the problem is to be solved.”); see Note, *Natural Law for Today’s Lawyer*, 9 STAN. L. REV. 455, 481 (1957) [hereinafter Note, *Natural Law*] (“The natural law obligation to respect the lives of others, and the common good demand that *some* determination be authoritatively made; they do not prescribe or indicate any one choice. That choice may be arbitrary or dependent upon a host of psychological, sociological or economic considerations and data. Laws of this type draw

distinction.¹⁸³ Examples of natural laws, which are arguably capable of being “wrong,” include homicide,¹⁸⁴ rape, theft, and other “grave injustices which are straightforwardly contrary to natural law.”¹⁸⁵ Much of constitutional law arguably falls in this camp.¹⁸⁶ Examples of positive laws, which do not embody intrinsic values and instead merely coordinate behavior, are property rules that create reliance interests,¹⁸⁷ traffic laws requiring that individuals drive on a certain side of the street,¹⁸⁸ and a rule

their immediate force from the positive law and only depend indirectly upon the natural law, in that it is natural law which gives force to any positive law and may require that a problem be solved in *some* way, the most reasonable way for that time and place. There seems to be no feeling that positive law is in any way a derogation from natural law, but rather that it is a necessary fulfillment and complement.”).

183. Thomas Morawetz, *Understanding Disagreement, The Root Issue of Jurisprudence: Applying Wittgenstein to Positivism, Critical Theory, and Judging*, 141 U. PA. L. REV. 371, 413 (1992) (“Whatever their differences, positivists address the problem of identifying law by emphasizing the importance of distinguishing ‘law as it is’ from ‘law as it ought to be.’ Their basic intuition is that the process of identifying the law is separate conceptually from the process of projecting aspirations for what the law might become and the goals it might serve. The first process uses formal criteria to identify the events of law creation. The second process uses moral reasoning, prudential reasoning, and other kinds of normative argument to consider ways in which the law might change in the future.”); e.g., Brian Bix, *On the Dividing Line Between Natural Law Theory and Legal Positivism*, 75 NOTRE DAME L. REV. 1613, 1614-15 (2000) (“To summarize, briefly and a bit crudely, natural law theory considers the connections between the universe, human nature, and morality, usually deriving the last from some combination of the first two Legal positivism is the belief that it is both tenable and valuable to offer a purely conceptual and/or purely descriptive theory of law, in which the analysis of law is kept strictly separate from its evaluation.”).

184. Note, *Natural Law*, *supra* note 182, at 481 (“The law proscribing homicide, for example, is simply a detailed enactment of a natural law precept, taking into account a variety of fact situations which might arise, and incorporating in itself, to an extent, the natural law.”).

185. George, *supra* note 182, at 1637-38 (“Some laws, such as those prohibiting murder, rape, theft, and other grave injustices which are straightforwardly contrary to natural law, are derived from the natural law by a process akin to the deduction of demonstrable conclusions from general premises in the sciences.”).

186. Jois, *supra* note 147, at 77 (juxtaposing the reliance interests in property law against the importance of reaching the “right” answer to questions of constitutional law). *But see* Silas J. Wasserstrom & Louis Michael Seidman, *The Fourth Amendment as Constitutional Theory*, 77 GEO. L.J. 19, 69 (1988) (“Positivism explains much that otherwise seems mysterious about the Court’s treatment of the fourth amendment. The notorious circularity of the ‘reasonable expectation of privacy’ test, for example, comes as no surprise to a positivist. What is reasonable for people to expect depends upon how our society actually functions, and a positivist is comfortable with the assertion that the Constitution is embodied in these expectations.”).

187. Jois, *supra* note 147, at 77.

188. George, *supra* note 182, at 1637-38 (“Consider, for example, the regulation of highway traffic. From the basic principle of natural law which identifies human health and safety as goods to be preserved, together with the empirical fact that unregulated driving,

about whether a provision of the Sarbanes-Oxley Act affords shareholders a private right of action.¹⁸⁹

Finally, even if legal circularity risks entrenching an intrinsically “wrong” rule, entrenchment allows the pressure to build against the wrong rule, with the potential for that pressure to be vented by the adoption of a dramatically different rule at a time of “critical juncture.”¹⁹⁰ Indeed, Professor Bailey H. Kuklin has recognized the potential for course correction in the context of the legal circularity of the Fourth Amendment “reasonable expectations of privacy” rule:

Where the law is static, because the legal rule in a mature legal system is clear-cut, well-established, well-known and entrenched, the law on the books is enough to determine reasonable expectations. The reasonable person expects the existing rule to endure and determine prospective issues, and need not consider anything other than the law on the books. But where the law in a just legal system is under the stress of significant discontent, the expectations that are aroused, despite the known law on the books, pressure reform. The influences on the expectations are the broad factors of change: those events and states of affairs referred to in the definition which take place outside the law proper, or the law narrowly conceived. When these forces reach a certain level, the system often vents the pressure for legal change by modifying the rule accordingly.¹⁹¹

even among motorists of impeccable goodwill, places these human goods in jeopardy, it follows that a scheme of regulation (coordination) is necessary for the common good. Yet, typically, various reasonable but incompatible schemes are possible. For the sake of the common good, then, the relevant lawmaking authority must stipulate that *one* from among the various possible schemes shall be given the force of law.”); Note, *Natural Law*, *supra* note 182, at 481 (“On the other hand, a traffic law requiring that individuals drive on the right side of the street or stop at red lights is an arbitrary choice of one from among a number of morally indifferent possibilities.”).

189. Jois, *supra* note 147, at 128 (“For example, if we are not concerned about the substantive content of the law, then it does not matter whether there is an implied private right of action under section 304 or not. So long as a rule is established, and relatively unlikely to change over time, then the law is at least stable and corporations and shareholders can act accordingly. For example, instead of repeatedly litigating the section 304 question, shareholders might focus on other causes of action and thus save resources.”).

190. Hathaway, *supra* note 148, at 642 (“Each critical juncture, in other words, produces a distinct legacy that remains largely intact until the next critical juncture breaks down and reshapes the political and institutional arrangements anew.”).

191. Kuklin, *supra* note 125, at 34-35.

Therefore, initial entrenchment of a wrong rule might create the environment for a correction to a “right” rule, perhaps even more quickly than in an environment without legal circularity.

Whether the potential for “venting” of this pressure allays the concern about legal circularity’s entrenchment of an intrinsically wrong rule depends on whether there exist other actors (such as legislatures or regulators) empowered to correct course. For this reason, in the context of *stare decisis*, Professor Oona A. Hathaway has argued that adherence to precedent should depend on how often “punctuations” occur:

A strong rule of *stare decisis* in the constitutional law area would lock courts, and therefore the country, into continued adherence to a precedent that may be clearly inappropriate By contrast, in the statutory context, courts consistently subject decisions to a much stronger standard of *stare decisis* because legislatures can provide a check on court decisions.¹⁹²

Similarly, when analyzing whether to adopt the potential legal circularity of a doctrine that risks entrenchment of an intrinsically “wrong” rule, courts and scholars should assess whether sufficient checks are in place to correct course when needed.

In sum, therefore, when analyzing this factor in the Framework to Assess Legal Circularity, courts and scholars should recognize the potential that path dependency will entrench an early, possibly under-informed rule and consider whether the legal doctrine at issue embodies intrinsic principles or merely solves a coordination problem. If the former, this factor weighs against adopting legal circularity, but this weight is somewhat offset if there are actors empowered to correct course when pressure builds against an intrinsically wrong rule. If the latter, this factor is irrelevant to whether the doctrine’s potential legal circularity should be embraced.

2. Effects of Greater Predictability

The second factor in the Framework to Assess Legal Circularity is to analyze the pros and cons of the greater predictability afforded by embracing a legal doctrine’s potential for circularity.

Legal circularity causes the law to be more uniform and thus more predictable.¹⁹³ Under legal circularity, earlier courts’ rulings on an issue

192. Hathaway, *supra* note 148, at 655-57.

193. See Abramowicz, *supra* note 120, at 53 (“[C]onstitutional circularity seems likely to increase stability and reliance by making constitutional law more consistent with what the

affect later courts' analyses of the same issue, making it more likely that later courts will agree with earlier courts. The more courts that agree, the more likely that the rule will remain unchanged. In this way, legal circularity mimics heuristics¹⁹⁴ and herding¹⁹⁵ and operates as a sort of super-charged stare decisis.¹⁹⁶

The predictability of a legal doctrine has myriad effects—some positive and some negative—on actors operating under the legal regime, litigants, regulators, the public, and courts. The impacts of predictability depend on the doctrine at issue, and thus this factor will weigh in favor of legal circularity in some circumstances and against legal circularity in others.

First, greater predictability allows actors operating under a legal regime to plan accordingly, with confidence about how their behavior will be treated. On the positive side, to the extent that actors are planning value-enhancing transactions, greater stability is a benefit because it reduces transaction costs.¹⁹⁷ This benefit is more likely if the legal regime involves commercial law, for example, as opposed to constitutional law.¹⁹⁸ A major caveat to this benefit, however, is that it only accrues if the relevant actors are able to act rationally in response to this predictability, rather than acting under the sway of various cognitive biases.¹⁹⁹ On the

people think it already is.”).

194. Sale, *supra* note 152, at 954 (discussing how heuristics are self-reinforcing).

195. Daughety & Reinganum, *supra* note 161, at 180 (“[H]erding increases the likelihood of agreement and decreases the likelihood of conflict among the appeals courts.”).

196. *E.g.*, Jois, *supra* note 147, at 77 (explaining that “[stare decisis] prompts stability in the law, since judges cannot make arbitrary decisions”).

197. Nelson, *supra* note 147, at 63 (recognizing that a weaker form of stare decisis could increase uncertainty and “generate more systemic costs”); *id.* at 63 (“For instance, increased uncertainty may produce inefficient allocations of resources: People might devote too little attention to certain types of long-range planning . . .”).

198. *See* Schauer, *supra* note 86, at 761-62 (“When the domain of decisionmaking is constitutional law, however, it is commonly supposed that these ‘rule of law’ values are of lesser importance. And insofar as constitutional law is less transactional than much of commercial and contract law, involving fewer instances in which consistency *qua* consistency outweighs the substantive value or disvalue of the actual decision, then it is likely that these ruleness values will be less applicable. There is no reason to suppose that just because under-and over-inclusive rules are desirable in some decisionmaking domains they are desirable in all decision-making domains.”).

199. *E.g.*, Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 7-9 (identifying and citing authority regarding a number of cognitive biases, “including the hindsight bias, the (flawed) reliance on heuristics (including the availability heuristic), the presence of overconfidence and overoptimism, the endowment effect (and other framing related biases), and the confirmation bias”); Hoffman, *The “Duty,”* *supra* note 81, at 549-62 (exploring the impacts of hindsight bias, the representiveness heuristic, risk tolerance, overconfidence, experiential thinking, source blindness, the framing effect, information overload, and social

negative side, greater predictability for actors potentially allows actors to fit their harmful conduct into loopholes, thus undercutting the purposes of the legal regime.²⁰⁰ Moreover, as more actors are able to fit their harmful conduct into safe harbors, this can have a messaging effect that the legal regime is unimportant, undercutting respect for the regime itself.²⁰¹

Second, greater predictability will likely lead to lower litigation costs. If the law on an issue is settled, parties are less likely to spend resources litigating it.²⁰² Moreover, defendants will be less likely to enter into coercive settlements when legal doctrines are applied with greater consistency.²⁰³ If a legal doctrine has the potential to be the subject of frequent or high-value litigation, this benefit weighs in favor of adopting legal circularity.

Third, greater stability decreases the discretion of regulators, with both positive and negative impacts. On the positive side, less discretion decreases the likelihood of discriminatory enforcement.²⁰⁴ On the negative side, less discretion prevents regulators from responding nimbly to innovative attempts to evade the law.²⁰⁵ These dual potential impacts must

investing affect investors); Langevoort, *Taming*, *supra* note 88, at 144-47 (discussing the biases of loss aversion, cognitive conservatism, representativeness, and investor overconfidence).

200. *E.g.*, Bainbridge & Gulati, *supra* note 74, at 138 (“To the extent heuristics are based on erroneous assumptions about firm and market behavior, they potentially create safe harbors for bad behavior It nevertheless seems troubling that heuristics likely create safe harbors for fraud.”); *see also* Sale, *supra* note 152, at 907 (“Further, depending on the nature and explicitness of the heuristic, it can create a safe harbor for fraud”).

201. Sale, *supra* note 152, at 957-58 (“By applying the heuristics and using language and arguments that can appear as, at best, dismissive and, at worst, disdainful of the plaintiffs and their lawyers, the courts may send a message about their view of these cases The result is a message that counteracts the one intended by the law. Those stories then may influence the way people think about and internalize the law. People obey laws out of an internalized respect for them. Here people might reasonably conclude that the risk of being caught is low and that the community does not value the purposes of the securities laws.”).

202. Nelson, *supra* note 147, at 63 (“For instance, increased uncertainty may produce inefficient allocations of resources: . . . they might spend too much money relitigating issues that the judiciary has already decided.”).

203. *E.g.*, Park, *supra* note 42, at 530-31 (“Courts have fewer options for early dismissal without a clear materiality standard to apply. As a result, the pressure on companies to settle securities fraud cases regardless of their merit will increase under a qualitative standard.”).

204. *E.g.*, Wendy Gerwick Couture & B. Clifford Gerwick, *The Evolutionary Biology of Fungi and Fraud*, 5 J. MARSHALL L.J. 71, 88-89 (2011) (“Moreover, the vagueness necessitated by broad fraud statutes, even if within Constitutional constraints, imposes societal costs This delegation to prosecutors also enables discriminatory enforcement.”).

205. *E.g.*, *id.* at 78-79 (“A federal fraud statute’s susceptibility to resistance depends on whether it is drafted specifically or broadly, with the former being far more susceptible to

be weighed when assessing whether to embrace the potential circularity of a legal doctrine.

Fourth, greater uniformity among courts has the potential to enhance the legitimacy of the courts, preventing the public perception that the law depends on the whim of the judge who is deciding the issue.²⁰⁶ Indeed, the Supreme Court has advanced a similar rationale for adherence to stare decisis: “There is . . . a point beyond which frequent overruling would overtax the country’s belief in the Court’s good faith.”²⁰⁷ This potential benefit is undercut, however, if the law becomes so rote that courts appear to be merely filling in blanks, rather than engaging in thoughtful adjudication. Professor Sale identified a similar risk in the usage of heuristics:

Ultimately, the opinions may also undermine the public’s faith in the judges and judicial system they represent. One of the strengths of our legal system is its sensitivity to the particulars of legal disputes Instead, the simplistic, fill-in-the blank nature of, for example, the Percentage Heuristic, at best reduces the law to a system of bright-line rules that may be easy to apply, but that is “rigid, inflexible, or unworkable”. . . . Indeed, if the goal is to fashion reasoning to contribute to the legitimacy of the legal system, these heuristics may indicate that the courts are failing us. The continued proliferation of the heuristics also has the potential to cut the “heart” out of the “common law system . . . the written

resistance. As articulated by one commentator, ‘[f]raud is by its very nature bounded only by the versatility of the human imagination.’ As a consequence, . . . Chief Justice Burger noted that the ‘ever-inventive American ‘con artist’ can often evade the scope of a specific fraud statute by changing just one component of his or her fraudulent scheme.’”

206. Nelson, *supra* note 147, at 69 (quoting Earl M. Maltz, *Some Thoughts on the Death of Stare Decisis in Constitutional Law*, 1980 WIS. L. REV. 467, 484) (“If members of the Supreme Court were to overrule their predecessors’ decisions too often, however, the public would begin to reject this understanding of what judges do. In Earl Maltz’s words, people would conclude that instead of ‘speaking for the Constitution itself,’ the Court’s decisions simply reflect the changing preferences of ‘five or more lawyers in black robes.’ This loss of faith in the legitimacy of the Court’s decisions would jeopardize the Court’s ability to function effectively.”).

207. *Planned Parenthood of Southeastern Pennsylvania v. Casey*, 505 U.S. 833, 866 (1992) (“Despite the variety of reasons that may inform and justify a decision to overrule, we cannot forget that such a decision is usually perceived (and perceived correctly) as, at the least, a statement that a prior decision was wrong. There is a limit to the amount of error that can plausibly be imputed to prior Courts. If that limit should be exceeded, disturbance of prior rulings would be taken as evidence that justifiable reexamination of principle had given way to drives for particular results in the short term. The legitimacy of the Court would fade with the frequency of its vacillation.”).

judicial opinion.” Respect for judges arises, in part, out of the opinions that they write.²⁰⁸

Therefore, when analyzing whether to adopt the potential legal circularity of a doctrine, courts and scholars should weigh these opposing impacts.

Finally, greater predictability leads to easier decision-making by courts, with associated efficiencies.²⁰⁹ This has potential negative impacts as well, however. For one, this ease can start to operate more like a shortcut, preventing doctrinal innovations and stunting the evolution of the law.²¹⁰ In addition, when faced with multiple potential grounds on which to rule, courts will likely be drawn to the easiest, thus leaving sticky, unsettled questions unresolved.²¹¹ Finally, once a doctrine is viewed as well-settled, there is a risk of incremental expansion.²¹²

In sum, therefore, when analyzing this factor in the Framework to Assess Legal Circularity, courts and scholars should identify and weigh the

208. Sale, *supra* note 152, at 960-62.

209. See Hathaway, *supra* note 148, at 626 (discussing how stare decisis furthers judicial efficiency) (“By relying on past decisions, judges can save significant time and effort and thereby consider far more cases than would otherwise be possible.”).

210. Abramowicz, *supra* note 120, at 56 (“[I]f deviation from the status quo is viewed as change, then constitutional circularity may prevent some changes by ruling out doctrinal innovations based on other interpretive methods that would be at odds with public perceptions of the Constitution.”); *id.* at 64 (“That this circularity seems to freeze the law of jurisdiction is particularly odd in light of the dramatic revolution in such law symbolized by *International Shoe Co. v. Washington*.”); Sale, *supra* note 148, at 955-56 (“The use of precedent is self-reinforcing in several ways. First, it cabins the decision-makers’ approach to the problem from the beginning, making it more difficult for them to consider different approaches to the problems. Second, it affects the way that lawyers present their cases, such that they seek out and invoke precedent, again reinforcing the power of the precedent being used.”); *id.* at 951-52 (“However, because the heuristics function as shortcuts that eliminate cases and preempt the opportunity for the creation of substantive securities law, they actually have the potential to stunt the development of the common law beyond the pleading stage.”).

211. Bainbridge & Gulati, *supra* note 74, at 137 (“If correct in positing that judges and clerks are focused on heuristics based in materiality and scienter concepts, there will be a skew in the development of doctrine. The materiality and scienter doctrines will be highly developed, with an extensive body of precedent covering a variety of factual situations. In contrast, doctrines relating to more complex questions, such as affirmative duties to disclose, will remain underdeveloped. In turn, un-certainty as to the scope of disclosure duties will persist.”).

212. Langevoort, *Are Judges Motivated*, *supra* note 43, at 311 (“The first cases were highly fact-specific and not terribly controversial. Even a ‘wannabe’ can get it right in deciding that defendants should not be held liable for not disclosing some particular risk factor if, elsewhere in the same document, they did indeed caution that reader about that very kind of risk, which is how the bespeaks caution doctrine began. So, too, with puffery But, gradually, judges become far more aggressive in the way they draw inferences ‘as a matter of law’ that terminate plaintiffs’ cases as in *Eisenstadt*.”).

impacts of greater predictability on actors operating under the legal regime, litigants, regulators, the public, and courts.

3. Import of Reconceiving the Courts' Role

The third factor in the Framework to Assess Legal Circularity is the import of reconceiving the courts' role under legal circularity.

Traditionally, the debate about the role of the court within the rule of law has focused on whether, in addition to being a rule-applier, the court should be a rule-maker.²¹³ At the extremes, this debate has involved rhetoric that pits “activist judges [who] regularly overturn the will of the people” against “mere automatons.”²¹⁴ Chief Justice John G. Roberts, Jr. famously (and controversially)²¹⁵ invoked this debate in his confirmation

213. Christopher J. Peters, *Adjudication as Representation*, 97 COLUM. L. REV. 312, 319 (1997) (“Opponents of judicial activism, then, adopt the traditional assumption that adjudicative lawmaking is essentially nondemocratic. I think this assumption is wrong, at least much of the time, and it is my intention in this Article to demonstrate how it is wrong. My thesis is simply that under certain, paradigmatic conditions, adjudication produces law through a process of representation that is akin, in crucial ways, to the process at work in parliamentary legislation. This adjudicative process—what I will call *adjudication as representation*—imbues adjudicative lawmaking with the same kind (although perhaps not the same degree) of ‘democratic’ legitimacy that parliamentary lawmaking possesses; it renders adjudicative lawmaking legitimate in a way that is independent of the needs to fill legislative gaps and to check majoritarian excesses.”); Schauer, *supra* note 86, at 750 (“What is the purpose of constitutional decisionmaking, as seen by the constitutional decisionmaker? In asking these questions, I want to focus on the role of rules in this process. What role do rules play in the self-understanding of the judicial role? Do or should judges see themselves as the makers of rules to be applied by others? Or instead as the appliers of rules made by others? Or as resolvers of disputes whose goal is to reach the best result for the case at hand?”); Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U. L. REV. 781, 790 (1989) (“There is one traditional element of the Rule of Law in its substantive guise that is not explored by Rawls, yet it looms large in American jurisprudence. This element is the commitment to the separation of powers, and the connected ideas about judicial review and the constrained role of the judge. This commitment also figures in the instrumental conception from the instrumental point of view: rules as applied must not differ from the rules as made (Fuller’s precept of ‘congruence’). Otherwise, the system gives conflicting commands and fails in its purpose of guiding behavior of the addressees. In a system committed to the institutions of courts and judicial review as ways to apply law, this instrumental point takes the form of insisting that judges be constrained so that they strictly ‘apply,’ and do not ‘make,’ the law. In the substantive conception of the Rule of Law the constrained judicial role is more central because it is held to be required for democracy, a core substantive value.”).

214. Richard Lavoie, *Activist or Automaton: The Institutional Need to Reach a Middle Ground in American Jurisprudence*, 68 ALB. L. REV. 611, 611-12 (2005) (criticizing this rhetoric).

215. Morawetz, *supra* note 183, at 393-94 (“The difficulties that any theory has in coming to terms with the relationship of participant and theorist reflect the complex, Janus-like role of judges as appliers of rules and interpreters/creators of rules. If judging is like a

hearings by likening a judge's role to an umpire's role in calling balls and strikes.²¹⁶ Under both conceptions of the judge, as rule-maker and as rule-applier, the judge is independent, acting as a neutral third party.

Under legal circularity, however, the court has a third potential role: an active player affecting the conduct of actors under the rules.²¹⁷ When a court rules on a legally circular doctrine, the court's ruling directly affects the behavior of future parties. For example, under the circularity of materiality, a court's ruling that a certain type of statement is immaterial as a matter of law affects whether future reasonable investors will rely on similar statements or suffer the legal consequences. Adding this conception of a court's role to Chief Justice Roberts' baseball analogy, the court applying legal circularity would have a role in addition to that of umpire (or even of baseball commissioner): the court would heckle the pitcher, thus forcing the pitcher to adjust his or her behavior accordingly. Professor Neil S. Siegel recognized a similar active role for judges in the area of constitutional law:

A better view of judicial role begins with the understanding that Justices succeed over the long run when their judgments express fundamental social values That could occur because the Court ultimately proves effective in shaping popular commitments when the culture is divided, or because the Court is shaped by them. Typically, the lines of causation run in both directions. Those cultural values infuse the grand phrases of the Constitution with their contemporary meaning and help to imbue the Court's work with legitimacy. The umpire analogy, no matter how charitably it may be construed, erases the reality that the Court legitimates itself in history in significant part by functioning as an engaged participant in the constitutional culture

game, what role—that of rule-maker, umpire, or player—is performed by the judge? In true games, the distinction between participant and non-participant follows immediately from the rules. Theoretical discourse about the rules themselves, rather than about moves that apply the rules, is the activity of outsiders and not of participants. The fact that judges, who are obviously participants, engage in discourse about the rules *and* in applying the rules complicates the distinction between participant and theorist and underscores how problematic the metaphor of games is in this context.”); *id.* at 455 (“But the game metaphor cannibalizes itself, in part because the rules themselves are the subject of decision-making.”).

216. Chris Cillizza, *John Roberts, Umpire*, WASH. POST, (June 28, 2012), http://www.washingtonpost.com/blogs/the-fix/post/john-roberts-umpire/2012/06/28/gJQAx5ZM9V_blog.html.

217. See Morawetz, *supra* note 183, at 394 (“If judging is like a game, what role—that of rule-maker, umpire, or player—is performed by the judge?”).

of the nation, a culture in which competing visions of social order compete for popular allegiance.²¹⁸

This engaged participation by the court via legal circularity is a dramatic reconceived notion of the rule of law.

Whether this reconceived notion of a court's role is appropriate depends on whether the potentially circular legal doctrine would benefit from an additional active participant and, if so, whether the court is the appropriate party to play that role. In a less heavily regulated area that might benefit from additional active participants, like constitutional law, this role might be appropriate.²¹⁹ In a more heavily regulated area, however, this role might be unnecessary or even an inappropriate encroachment on the active roles of other players. Key to this analysis is whether the court is better situated than the other players, like Congress or a regulatory agency, to fill this role, examining factors including the degree of expertise and the potential for bias.²²⁰

4. Summary of the Framework to Assess Legal Circularity

In sum, therefore, once a potentially legally circular doctrine has been identified via the Legal Circularity Test, the next step is to assess whether that potential circularity should be embraced or rejected. Courts and scholars should use the Framework to Assess Legal Circularity to make that assessment.

In particular, courts and scholars should weigh three factors, as applied to the legal doctrine at issue. First, they should weigh the risk of a "wrong" rule. This risk is present if the legal doctrine at issue embodies intrinsic principles, but this risk is somewhat offset if other players are empowered to correct course. If the legal doctrine merely solves a coordination problem, however, this risk is probably not implicated.

218. Neil S. Siegel, *Umpires at Bat: On Integration and Legitimation*, 24 CONST. COMMENT. 701, 712 (2007).

219. *Id.* at 707-08 ("Roberts was presumably relying on the fact that a hit ball is either foul or fair, and that the baseball rule defining the strike zone seems relatively clear It turns out that Roberts was wrong about much of baseball (and about sports more generally), but that is not my main concern here. Rather, my primary concern is that Supreme Court Justices cannot even agree on the basic contours of the 'strike zone' when it comes to such fundamental matters as whether the equal protection clause presumptively prohibits racial classifications or instead targets practices of racial subordination. That is because the constitutional text itself is indeterminate and the potential source materials for gleaning its meaning in particular settings are both numerous and contested.").

220. See Abramowicz, *supra* note 120, at 8 ("The Supreme Court, of course, could abuse, and arguably has abused, the approach by claiming to find in public perception of the Constitution whatever provision the Justices wish the Framers had crafted.").

Second, they should consider the effects of greater predictability on actors operating under the legal regime, litigants, regulators, the public, and courts. These effects can be both positive and negative, depending on the legal doctrine at issue, and thus this factor's result will vary. Finally, they should consider the import of reconceiving the court's role as an active participant that affects the behavior of future litigants. This active role may be more appropriate in a less heavily regulated area and less so in a more heavily regulated area, especially if the other players have greater expertise and a lower potential for bias.

A comprehensive look at this framework reveals two interactions among factors that merit further discussion. First, the presence of other actors in the area who pose less risk of bias and who possess greater expertise has the potential to cut in both directions when the legal doctrine at issue embodies intrinsic values as opposed to solving a coordination problem. Under the first factor, if legal circularity poses the risk of entrenchment of an intrinsically "wrong" legal rule, this factor weighs against adoption of legal circularity; however, this factor is somewhat neutralized if other actors exist who are empowered to correct course.²²¹ Under the third factor, on the other hand, if others with less risk of bias and with more expertise are actively regulating an area, this factor weighs against courts' taking a more active role via legal circularity.²²² The application of the framework in this scenario is nuanced, depending on whether the other players are active or inactive. Under the first factor, the focus is on whether other players exist who are empowered to correct course if needed, not on whether other players are active in the area. Under the third factor, the focus is on whether others are actually actively regulating in the area. Therefore, if other players exist but are inactive, the first factor's weight against legal circularity is somewhat neutralized, and the third factor favors adoption of legal circularity. If other players with less risk of bias and with more expertise are actually actively regulating in the area, the first factor's weight against legal circularity continues to be somewhat neutralized, but the third factor weighs heavily against legal circularity.

Second, a legal doctrine's role as a coordination mechanism impacts the analysis of both the first and second factors. Under the first factor, if a legal doctrine merely coordinates behavior rather than embodying intrinsic values, there is no risk of "wrong" rule, and this factor is neutral with

221. *See supra* Part III.B.1 (discussing the risk of a legal doctrine's potential for circularity resulting in the entrenchment of the "wrong" rule).

222. *See supra* Part III.B.3 (arguing that when a court makes a ruling, it has the potential to affect the future behavior of other actors).

respect to the adoption of legal circularity.²²³ Under the second factor, if a legal doctrine coordinates behavior, actors operating under the legal regime will benefit from the enhanced predictability afforded by legal circularity, potentially engaging in beneficial transactions, thus weighing in favor of the adoption of legal circularity.²²⁴ Therefore, this framework suggests that the adoption of legal circularity may be more appropriate when a legal doctrine serves to coordinate behavior.

This framework is admittedly complex, and the outcome will depend on the unique attributes of each potentially circular legal doctrine. Similar debates about *stare decisis* often frame the issue as a binary choice between “truth” and “stability.”²²⁵ Regardless of whether this framing is helpful in the context of *stare decisis*, it is an over-simplification of the various competing considerations underlying the adoption of legal circularity. Moreover, as explained in the Framework to Assess Legal Circularity, there is not necessarily a tension between “truth” and “stability,” especially when the legal doctrine merely solves a coordination problem. In order to exemplify how the Framework to Assess Legal Circularity should be applied, this Article will now assess the potential legal circularity of materiality under this framework.

III. APPLICATION OF THE FRAMEWORK TO ASSESS LEGAL CIRCULARITY TO MATERIALITY

This section applies the above-proposed Framework to Assess Legal Circularity to the doctrine of materiality, for purposes both of exemplifying how this framework should be applied and of assessing whether the potential legal circularity of materiality should be embraced. This section concludes that the risk of a “wrong” materiality rule is slight because the materiality doctrine primarily operates as a coordination mechanism and because there are actors empowered to correct intrinsically wrong rules; that the potential positive effects of greater predictability outweigh the potential negative effects if legal circularity is coupled with increased investor education; and that, absent forthcoming materiality guidance from the SEC, courts should embrace this reconceived active role with respect to the materiality doctrine.

223. See *supra* Part III.B.1.

224. See *supra* Part III.B.2 (discussing how legal circularity increases predictability).

225. *Burnet v. Coronado Oil*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting) (“*Stare decisis* is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right.”); Jois, *supra* note 147, at 127 (posing the question: “Truth or Stability?”); *id.* at 77 (“*Stare decisis* prevents the disruption that would occur if judges were constantly seeking the ‘correct’ rule.”).

A. *Risk of a “Wrong” Materiality Rule*

The first factor in the Framework to Assess Legal Circularity is the risk that embracing a legal doctrine’s potential for circularity will lead to the entrenchment of a “wrong” rule because legal circularity is path dependent, affording a first mover advantage. If the first mover adopts the “wrong” rule, that rule becomes entrenched via the operation of legal circularity. Fundamental to this analysis is whether the legal doctrine at issue is meant to embody intrinsic values, akin to a natural law, or whether the doctrine is an arbitrary choice meant to solve a coordination problem, akin to a positive law. Under the former scenario, this factor weighs against embracing a doctrine’s potential legal circularity, offset somewhat if there are actors empowered to correct course when needed. Under the latter scenario, this factor is neutral.²²⁶

Materiality contains both natural and positive law components, complicating the analysis of this factor. Materiality, in essence, shields a speaker from liability for lies, as long as those lies are deemed unimportant.²²⁷ From this perspective, materiality does not seem to derive from any intrinsic values; if anything, it seems contrary to those values. As discussed above, however, materiality also serves a different role: it ensures disclosure of comprehensive and accurate information.²²⁸ From this perspective, materiality embodies some intrinsic values and a materiality standard that is off-base might undercut those values by disrupting the disclosure of comprehensive, accurate information.

To the extent an intrinsically wrong rule were entrenched, however, there are actors—namely, Congress and the SEC—empowered to correct course. Indeed, Congress has been extraordinarily active in regulating other components of securities fraud. For example, in 1995, Congress enacted the Private Securities Litigation Reform Act, which creates a statutory safe harbor from liability for certain forward-looking statements, thus incentivizing issuers to make these disclosures.²²⁹ Therefore, although the legal circularity of materiality risks entrenching an intrinsically

226. See *supra* Part III.B.1.

227. Padfield, *Immaterial Lies*, *supra* note 40, at 147 (“[W]hen a court grounds dismissal on a finding of immateriality, it is effectively saying that there is no basis for liability even if it were proven that an executive misstated the facts with intent to deceive (i.e., there was a lie).”).

228. See *supra* Part II.A.

229. 15 U.S.C. §§ 77z-2(c)(1), 78u-5(c)(1). See generally Couture, *Mixed Statements*, *supra* note 31, at 257 (explaining that the Private Securities Litigation Reform Act creates a safe harbor that protects companies and individuals, under certain circumstances, from liability under the securities acts for making misleading statements that qualify as “forward-looking.”).

“wrong” rule, this concern is somewhat allayed by the possibility of checks.

Materiality also serves a coordination function by drawing the line between what a speaker must disclose to investors and may keep private, between what a speaker must verify before saying and what he or she may say without concern about recourse, and between what an insider must disclose before trading and what the insider may keep private while trading. If speakers and investors are both aware of this line,²³⁰ they can coordinate their behavior accordingly, engaging in securities transactions.

Indeed, the materiality line could be drawn any number of places and still accomplish this coordination function, perhaps even more effectively. Accordingly, various scholars have argued that the materiality standard for securities fraud should be adjusted.²³¹ For example, Professor Margaret V. Sachs has argued that the “reasonable investor” standard should be replaced with a “least sophisticated investor” standard²³² when the plaintiff is an “underclass investor.”²³³ Professor Peter H. Huang has contended that determinations of materiality “should depend not just on the cognitive form and content of information, but also upon the affective form or presentation and emotional content of that information.”²³⁴ Professor James J. Park has argued that, when assessing a company’s liability for financial misstatements, the materiality standard should be quantitative rather than qualitative, with only quantitatively large misstatements deemed actionable.²³⁵ John M. Newman, Jr., Mark Herrmann, and Geoffrey J. Ritts have urged that, in fraud-on-the-market cases, materiality should be assessed from the perspective of a professional investor.²³⁶ Moreover, in

230. Admittedly, whether investors are aware of this line and whether they can act rationally in response to it is not a given, in light of investors’ cognitive biases. This issue is discussed below in Part IV.B.

231. Of note, if these scholars’ proposed alternative definitions of materiality were adopted, the materiality doctrine would no longer satisfy the Legal Circularity Test, rendering this question moot.

232. Sachs, *supra* note 42, at 481.

233. *Id.* at 476 (defining “underclass investors” as “unsophisticated investors trading in inefficient markets without an adviser”).

234. Huang, *supra* note 31, at 112; *id.* at 128 (“This Article also recommends expanding the so-called ‘total mix’ of information analysis by considering the ‘total affect’ of information.”).

235. Park, *supra* note 42, at 519.

236. John M. Newman, Jr., Mark Herrmann & Geoffrey J. Ritts, *Basic Truths: The Implications of the Fraud-on-the-Market Theory for Evaluating the “Misleading” and “Materiality” Elements of Securities Fraud Claims*, 20 J. CORP. L. 571, 584 (1995) (“If a professional investor would not care about the topic of the statement, or if the investor’s judgment of the stock’s proper price would not be changed by it, then the stock price could not have been affected by the misstatement. The fact that a non-professional investor might have found the misstatement to be important is irrelevant to the price of the security.”).

other areas of the law, including common law fraud,²³⁷ mail and wire fraud,²³⁸ and perhaps even criminal securities fraud,²³⁹ the materiality standard is subjective rather than objective. This authority suggests that the materiality line could be drawn in any number of places, so long as it is drawn somewhere.

Therefore, although materiality includes both natural and positive law components, its primary function is one of coordination. To the extent that materiality encompasses intrinsic values, Congress and the SEC are empowered to correct course. Therefore, this factor is neutral with respect to whether courts and scholars should embrace the potential legal circularity of materiality.

B. Effects of Greater Predictability about Materiality

The second factor in the Framework to Assess Legal Circularity is to analyze the pros and cons of the greater predictability afforded by embracing a legal doctrine's potential for circularity. The predictability of a legal doctrine has myriad effects—some positive and some negative—on actors operating under the legal regime, litigants, regulators, the public, and courts. On balance, these effects arguably support embracing the potential legal circularity of materiality if it is coupled with enhanced investor education and if courts apply it explicitly.

1. Effects on Actors Operating Under the Legal Regime

Looking at the impact on actors operating under the legal regime, greater predictability of materiality would affect the behavior of issuers and their insiders by lifting barriers to value-enhancing transactions, lowering compliance costs, and preventing management distraction. In the context of issuer statements, a more predictable materiality standard would prevent issuers from engaging in excessive checking and double-checking of minor

237. RESTATEMENT (SECOND) OF TORTS § 538 (1977) (defining materiality as follows: “(a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it”).

238. Couture, *Gray Area*, *supra* note 2, at 6-8 (explaining that materiality under the mail and wire fraud statutes is a subjective standard).

239. See Couture, *Criminal Securities Fraud*, *supra* note 34, at 78-84 (analyzing the materiality standard under 18 U.S.C. § 1348 and concluding that would probably be interpreted as subjective, consistent with the materiality standard under mail and wire fraud).

information²⁴⁰ and would prevent them from needlessly restating unimportant information.²⁴¹ In the context of issuer disclosures, a more predictable materiality standard would allow issuers to assess with greater certainty whether a particular piece of information must be disclosed to investors.²⁴² In the context of transactions in issuers' securities, greater clarity on the materiality standard would enable issuers to determine (1) whether any nonpublic information would have to be disclosed before engaging in the transaction; and (2) if so, whether that disclosure is feasible or whether to forego the transaction.²⁴³ Professor Heminway has explained how an unclear materiality standard, and the concomitant fear of second-guessing, operate to inhibit value-enhancing transactions:

When a corporate issuer desires to proceed with a transaction in the issuer's securities, the issuer's board of directors must identify the nonpublic facts in the issuer's possession, determine the materiality or immateriality of those facts, and consider the potential effects (positive or negative) of the possible public disclosure of those facts that are material. Based on this process of identification and consideration, the issuer can determine whether the desired securities trading transaction requires disclosure of any facts then in its possession, and, if so, whether it is willing or able to disclose those facts and proceed with the

240. Sauer, *supra* note 12, at 319 ("This continuing uncertainty has increased the cost of generating and verifying financial information and has added to the amount of litigation burdening the corporate world.").

241. Park, *supra* note 42, at 517 (limiting his discussion of materiality to financial misstatements) (citing authority) ("Legal commentators have almost uniformly argued that the standard is vague and impossible to implement. Some practitioners have asserted that the standard has increased compliance costs, leading to a significant rise in unnecessary restatements by public companies.").

242. Padfield, *Is Puffery Material?*, *supra* note 74, at 345 ("Both corporate managers and retail investors would be on notice that various types of material information must be disclosed, however they would be unclear whether a particular disclosure's materiality should be assessed vis-à-vis the average retail investor or the sophisticated institutional investor. This would likely lead to increased costs because both corporations and investors must factor in this uncertainty when deciding what information to disclose and how to weigh the information that is disclosed.").

243. Heminway, *Materiality Guidance*, *supra* note 14, at 1171 ("Yet, the ambiguities encountered by transaction planners in interpreting and applying the existing legal standard for materiality frequently discourage, rather than encourage, public disclosure of important issuer and transaction information. An issuer or insider may forego securities trading (and the attendant public disclosure obligation) rather than trade and assume the risk of a lawsuit that second-guesses, *ex post*, the issuer's or insider's *ex ante* materiality analysis.").

transaction. The concept of materiality is undeniably significant in the issuer's analysis.²⁴⁴

Examples of potentially inhibited value-enhancing transactions include “open market stock repurchase programs, self-tender offers to retire all or part of an outstanding class or series of economically disadvantageous securities, and private and public offerings at favorable prices.”²⁴⁵ In each of these contexts—issuer statements, issuer disclosures, and issuer transactions in securities—uncertainty about the materiality standard distracts management and increases the costs of internal compliance and of outside counsel.²⁴⁶

On the flip side, however, greater predictability would arguably enable issuers and their insiders to make misrepresentations and to engage in insider trading without fear, as long as they were to operate within the safe harbor provided by a clearer materiality standard.²⁴⁷ For example, in the context of affirmative misstatements, Professor Hoffman has argued that greater predictability, including that afforded by the materiality doctrines of puffery and bespeaks caution, enables disclosing entities to “shelter questionable information from fraud claims by making it part of optimistic predictions or pairing it with cautions.”²⁴⁸ Professor Park has likewise recognized that a quantitative materiality standard for financial statements would allow for earnings manipulation: “Aggressive companies could tweak their earnings at will to meet market expectations. As long as a financial misstatement was below the five percent quantitative threshold, the company would not be in violation of the securities law.”²⁴⁹ Likewise,

244. *Id.* at 1156.

245. *Id.* at 1175-76.

246. *Id.* at 1177-82 (arguing that additional clarity regarding the materiality assessment will prevent management distraction and lower the cost of outside counsel); Sauer, *supra* note 12, at 355 (“This development has contributed to an age of anxiety in the corporate boardroom and executive suite. To address the increased risks attending materiality judgments, companies have incurred substantial costs for internal monitoring and professional services.”).

247. Heminway, *Materiality Guidance*, *supra* note 14, at 1191 (“Of course, where definitions important to a rule of law are clarified, unintended loopholes are likely to be identified and exploited by those who desire to push that rule of law to its logical—or illogical—extreme.”).

248. Hoffman, *The “Duty,”* *supra* note 81, at 588 (“Notably, both doctrines create incentives for corporations to use words that they hope will induce reliance, but which may be rendered legally irrelevant; they are bright-line rules that enable fraud.”).

249. Park, *supra* note 42, at 516; *id.* at 526 (quoting SEC Chairman Arthur Levitt) (citing Arthur Levitt, Chairman, Sec. & Exch. Comm’n., Remarks at the NYU Center for Law and Business (Sept. 28, 1998), *available at* www.sec.gov/news/speech/speecharchive/1998/spch220.txt) (“[S]ome companies misuse the concept of materiality. They intentionally record errors within a defined percentage

in the context of insider trading, greater clarity with respect to materiality would afford issuers and their insiders “a clear roadmap to trade for personal gain without liability.”²⁵⁰ All together, enabling issuers and their insiders to operate within these loopholes would potentially send “the message to executives that it is often okay to embellish the truth”²⁵¹ and reduce investors’ faith in the markets. This behavior within the zone of materiality would be less harmful, however, if the other actors in the marketplace—namely, investors—operated under a similarly predictable regime, thus enabling them to anticipate and discount any such behavior by issuers, and it is to the effect on investors that this Article now turns.

Greater predictability about materiality would arguably lower investors’ costs, clarifying for them what information to expect, what information to discount or disregard, and what information to value. Professor Padfield has noted that uncertainty about the materiality standard could lead to increased costs for investors because they must “factor in this uncertainty when deciding . . . how to weigh the information that is disclosed.”²⁵² In addition, to the extent that a clearer materiality standard would enable an issuer to engage in beneficial transactions, to lower compliance and counsel costs, and to avoid management distraction, those value enhancements would inure to the benefit of the issuer’s investors.²⁵³

Whether investors would be able to realize fully this benefit depends, however, on their ability to learn the court-made materiality standard and to act thereon. Both of these conditions are potentially problematic. First, as discussed above,²⁵⁴ the current materiality standard already imposes a heavy “legal duty to be a rational shareholder”²⁵⁵ by requiring investors to know “all publicly available information” relevant to the investment²⁵⁶ and

ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that’s the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up the last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly . . . ‘It doesn’t matter. It’s immaterial.’”).

250. Heminway, *Materiality Guidance*, *supra* note 14, at 1154.

251. Padfield, *Immaterial Lies*, *supra* note 40, at 147.

252. Padfield, *Is Puffery Material?*, *supra* note 74, at 345.

253. Heminway, *Materiality Guidance*, *supra* note 14, at 1141 (“Inherent ambiguities in the interpretation and application of the existing materiality standard not only are nonessential to the achievement of applicable policy goals, but also create certain undeniable negative impacts on stockholder value that may undercut those policy goals. These impacts include, among other things, foregone value-enhancing transactions (including issuer offerings and stock repurchases), management distractions, and outside counsel fees and disbursements. Negative impacts on stockholder value might be reduced or eliminated if materiality were more precisely defined.”).

254. *See supra* Part II.C.2.b.

255. Hoffman, *The “Duty,” supra* note 81, at 595.

256. Heminway, *Female Investors*, *supra* note 29, at 306.

to grasp, among other concepts, the time-value of money,²⁵⁷ the taxation of different investments,²⁵⁸ basic accounting treatment,²⁵⁹ diversification and risk,²⁶⁰ the nature of margin accounts,²⁶¹ and the security industry's investment structure.²⁶² Indeed, Professor Langevoort has characterized the current depiction of "investors carefully perusing the details of regulation-mandated disclosure documents" as the "SEC's myth-story."²⁶³ Adding the requirement that investors be abreast of the case law about materiality would enhance this burden, potentially further widening the gap between investors' actual behavior²⁶⁴ and that of the mythical reasonable investor.

Second, even if investors were abreast of the current case law interpretation of materiality, they might not be able to act accordingly, in light of their cognitive biases. Indeed, a burgeoning area of scholarship about behavioral economics has identified so-called "moody investing"²⁶⁵ as a significant problem even under the current materiality standard, which does not embrace legal circularity.²⁶⁶ Professor Barbara Black has summarized this scholarship as follows:

257. Black, *supra* note 98, at 1494-95; Heminway, *Female Investors*, *supra* note 29, at 301; Sachs, *supra* note 42, at 475-76.

258. Hoffman, *The "Duty," supra* note 81, at 582.

259. *Id.*

260. Black, *supra* note 98, at 1494-95; Heminway, *Female Investors*, *supra* note 29, at 301.

261. Black, *supra* note 98, at 1494-95.

262. *Id.*; Heminway, *Female Investors*, *supra* note 29, at 301.

263. Langevoort, *Taming*, *supra* note 88, at 187.

264. Padfield, *Is Puffery Material?*, *supra* note 74, at 341 ("What the survey results show is that while the judges in the four surveyed cases concluded that no reasonable investor could find the statements challenged therein to be material because they constituted non-actionable puffery, between 33% and 84% of reasonable investors surveyed deemed the statements material."); Sachs, *supra* note 42, at 476-77 ("To be sure, underclass investors are sometimes deceived by fraud that would fool the reasonable investor. But they can also succumb to misrepresentations that the reasonable investor would dismiss as absurd. The risk of their doing so has always existed, but it has recently increased exponentially due to the pervasiveness of Internet fraud, telemarketing fraud, and the ready availability of 'mooch lists' of the unsophisticated, elderly, or otherwise vulnerable.").

265. Huang, *supra* note 31, at 102-03 ("[M]oody investing refers to investing that is (at least, partially) non-cognitive.").

266. Hoffman, *The "Duty," supra* note 81, at 549 ("Given that investors in the aggregate at least *sometimes* behave foolishly, materiality—which asks what a reasonable investor will do—may result in a divergence between 'what is commonplace or normal' and what the law requires of investors. That is, even if markets efficiently price assets over the long term, a materiality analysis which ignores the insights of BLE [Behavioral Law and Economics] threatens to disproportionately penalize individual investors, who (unlike institutions) are 'hopelessly disastrous decision-makers.'").

The research from behavioral economics on cognitive failings has much to offer in rethinking the artificial construct of a “reasonable investor” and its resulting lack of protection for investors, particularly unsophisticated retail investors. Despite their cognitive failings and their lack of training for the task, investors are forced to invest in the market to save for their retirement and for other expensive undertakings, such as their children’s college education. Behavioral economics thus supports the need for (at least some) paternalistic responses to cognitive biases. Disclosure is not the panacea that drafters of federal securities laws may have thought it to be.²⁶⁷

These cognitive biases include the hindsight bias, reliance on the representativeness heuristic, overconfidence, the endowment effect, the confirmation bias, risk tolerance, experiential thinking, source blindness, herd behavior, the framing effect, information overload, social investing, loss aversion, and cognitive conservatism.²⁶⁸ As such, contrary to the materiality doctrines of puffery, bespeaks caution, and triviality, investors are arguably already prone to rely on hyperbolic statements,²⁶⁹ forward-looking statements accompanied by cautionary language,²⁷⁰ and trivial information.²⁷¹ As Professor Jayne W. Barnard has documented, older

267. Black, *supra* note 98, at 1507-08.

268. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 7-9; Hoffman, *The “Duty,”* *supra* note 81, at 549-62; Langevoort, *Taming*, *supra* note 88, at 144-47.

269. Hoffman, *The Best Puffery*, *supra* note 32, at 1435 (“Marketing scholars have demonstrated that puffing statements are believed on their own terms and lead some individuals to further imply facts about the puffed speech that are untrue.”); Huang, *supra* note 31, at 115 (“Moody investing means that the puffery defense is flawed because vague, promotional, or hyperbolic statements can have real impacts on moods and therefore should not be deemed immaterial as a matter of law.”).

270. Hoffman, *The “Duty,”* *supra* note 81, at 587-88 (“Liberal use of the bespeaks-caution technique also contradicts BLE insights Not only do individuals have the problems of risk processing, endowment, experiential thinking, and information overload, they are also unable to make the subtle adjustment with respect to informational source, as courts applying the bespeaks-caution doctrine require them to do.”); Huang, *supra* note 31, at 125 (“Moody investing means that the ‘bespeaks caution’ doctrine is problematic because meaningful cautionary language concerns the probability of the optimistic forward-looking statements being realized. But, if those optimistic statements have induced positive moods or emotional reactions, such feelings are insensitive to probability variations. Because these positive feelings display probability insensitivity, merely disclosing the low probability of success or the high probability of losses will not have much of an impact on those who experience such feelings. Thus, even cautionary language that is cognitively meaningful may be neither affectively nor effectively meaningful.”).

271. Hoffman, *The “Duty,”* *supra* note 81, at 588-89 (“The triviality doctrine also contrasts with evidence from BLE. It boils down to an intuition that ‘trivial bits of information do not play a role in the investment decisions of reasonable investors because

investors, because of “neurobiological, psychosocial, and environmental factors,”²⁷² may be especially prone to relying on “misrepresentations or promises that are so implausible that most reasonable investors ‘would dismiss [them] as absurd.’”²⁷³

One possible solution, which would enable issuers, their insiders, and investors to reap the benefits of greater predictability afforded by the legal circularity of materiality while lessening the information-gathering burden on investors and counteracting the impacts of investors’ cognitive biases, is enhanced investor education. Professor Lawrence A. Cunningham has urged that investor education should include “exposition of the main biases associated with investing.”²⁷⁴ This Article argues that, especially if courts and scholars adopt the legal circularity of materiality, investor education should also address the concept of materiality, the legal implications of materiality, and the case law interpreting certain representations as immaterial as a matter of law. Because families and schools lack the time and expertise to educate about financial fraud, and because financial firms have conflicting interests that may inhibit effective antifraud education, regulators such as the SEC, the Financial Industry Regulatory Authority (“FINRA”), and state securities bureaus are best suited to provide this antifraud education.²⁷⁵ Indeed, these regulators are already engaging in antifraud education, but this education currently focuses on specific types of fraud (such as affinity fraud, Ponzi schemes, and pump-and-dump

they relate to a small aspect of the business.’ But, as BLE [Behavioral Law and Economics] teaches, investors are poor at making this type of comparison.”).

272. Jayne W. Barnard, *Deception, Decisions, and Investor Education*, 17 ELDER L.J. 201, 237 (2010).

273. *Id.* at 207 (“Still, many smart and well-educated older investors fall for these investment schemes.”).

274. Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 792 (2002) (“[T]he key cognitive biases that investor-education programs should address boil down to three basic categories: (1) reference-point-related issues (including conservatism, excessive loss aversion, and frame dependence), (2) probabilistic analysis issues (including representativeness and overconfidence), and (3) mental errors (the brain functioning outside of one’s awareness—namely, anchoring, regret, and addiction). In each category, the lessons would consist of identifying and describing the set of biases and introducing steps that can reduce their adverse effects.”).

275. James A. Fanto, *We’re All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 154 (1998) (“The government in one or more forms, through agencies and self-regulatory organizations, as well as in partnership with consumer groups, should therefore be the primary educator about financial abuse and fraud, including fraud and deception in firm investor education materials.”); *id.* at 158 (“While the SEC’s educational efforts have been useful, it could greatly improve them if it redirected its activities, in accordance with the Article’s guidance, to concentrate on anti-fraud education and to do more to promote and facilitate the educational services of financial and nonprofit firms.”).

schemes)²⁷⁶ and “red flags” of fraud (such as promises of “guaranteed” returns, the scarcity tactic, and the promise to share the “secrets” of the experts),²⁷⁷ without discussing the concept of materiality.

Investor education about materiality is not a perfect solution, however. First, investor education diverts resources from other uses,²⁷⁸ imposing opportunity costs.²⁷⁹ These regulatory costs would be ongoing because new investors are constantly entering the market.²⁸⁰ In addition, investor education is not a magic bullet. To the extent that investors are operating under cognitive biases, education might be ineffective because many of those cognitive biases are unconscious.²⁸¹ Even more troubling, some investors might respond to this education through the lens of the “false confidence” bias and thus, by learning more about securities fraud, overestimate the scope of its protection.²⁸²

276. SEC. & EXCH. COMM’N, *Investor Information Bulletins*, available at http://www.sec.gov/investor/pubs_subject.shtml#fraud; FIN. INDUS. REGULATORY AUTH., *Investor Alert: Avoiding Investment Scams*, available at <https://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P118010>; N. AM. SECS. ADMIN’RS. ASS’N, *Top Investor Threats*, available at <http://www.nasaa.org/3752/top-investor-threats/>.

277. SEC, *How to Avoid Fraud*, at <https://www.sec.gov/investor/pubs/avoidfraud.htm>; FINRA, *Fighting Fraud 101: Smart Tips for Investors*, at <http://www.bbb.org/smart-investing/assets/fighting-fraud-101.pdf>; NASAA, *Red Flags of Fraud*, at <http://www.nasaa.org/investor-education/nasaa-fraud-center/red-flags-of-fraud-2/>.

278. Heminway, *Female Investors*, *supra* note 29, at 331 (“Moreover, investor education adds cost to the regulatory framework that should be assessed in relation to its perceived benefits and other possible responses.”).

279. Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 267 (2008) (“What sorts of alternative public policies could we pursue if we were to move beyond the search for financial literacy? At least four possibilities are ripe for experimentation: (1) substantively regulating financial products; (2) increasing the resources with which consumers approach the market; (3) framing financial choices so as to invoke good decisions; and (4) aligning incentives of sellers with needs of consumers.”).

280. Huang, *supra* note 31, at 115 (“A response to such mood impacts is that over time, people may learn to ignore or discount puffery. But, such a response ignores the fact that investors are not a fixed group, but instead consist of an ever-changing pool of investors, who as they become older and if wiser are replaced by a new cohort still wet behind the ears and ready to be misled emotionally.”).

281. Hoffman, *The “Duty,” supra* note 81, at 598 (“Because irrationality is ‘sticky’ behavior, the normal consequences of creating legal duties—the modification of behavior—may not arise through the operation of the materiality doctrine. Even though the duty to be rational is increasingly specific and publicized, it would be very surprising if in the years post-*TSC Industries*, there was significantly less real-world price movement in reaction to disclosures that the law excludes as nonactionable.”); Huang, *supra* note 31, at 115-16 (“Also problematic for such a response is the vast empirical and experimental research finding that people are systematically wrong in their forecasts of how they will feel. In fact, people are unconscious of how they feel.”).

282. Barnard, *supra* note 272, at 228 (“Ironically, the pervasiveness of fraud prevention advice and education may cause some older adults to feel safer from fraud than they really are.”); Hoffman, *The Best Puffery, supra* note 32, at 1431 (“[W]hen authorities work to

2. Effects on Litigants, Regulators, the Public, and the Courts

Turning to the impact on litigants, greater predictability about the materiality standard would likely lead to lower litigation costs and more targeted, meritorious litigation. The more settled the law on materiality, the more likely that unmeritorious suits will be dismissed pretrial.²⁸³ As a consequence, a clearer materiality standard would lessen the incentive for companies to settle unmeritorious claims out of fear that the potential damages, even if unlikely to be imposed by the trier of fact, would be catastrophic for the firm.²⁸⁴ This dynamic would enhance shareholder value.²⁸⁵ In addition, because private securities litigation is an essential

increase protections from fraud, consumers feel a ‘false confidence,’ their defenses to puffery are reduced, and advertisers are encouraged to puff at greater rates.”); *id.* at 1430 (2006) (summarizing this economic argument, although disagreeing with it) (citing Richard J. Parmentier, *SIGNS IN SOCIETY: STUDIES IN SEMIOTIC ANTHROPOLOGY* 144-45 (1994)) (“When regulation is introduced, economists assume that consumers will (mistakenly) believe that government-run anti-fraud regimes are perfectly enforced.”); Langevoort, *Selling Hope*, *supra* note 90, at 672 (“In general, we can expect that individual investors will usually underestimate the risk that they would be disadvantaged by the law. The product of a successful sales interaction is the customer’s belief that she *is* acting prudently.”); Willis, *supra* note 279, at 272-73 (“Financial-literacy programs are not only premised on the idea that consumers can control their financial situation, but also promote this belief through their curricula to motivate participants. In reality, this education may do no more than increase overoptimism and the illusion of being able to control financial risk.”).

283. Heminway, *Materiality Guidance*, *supra* note 14, at 1183 (“[T]he current ill-defined legal standard governing materiality determinations makes pretrial dismissal of an insider trading class action difficult, regardless of the overall merits of the action. For similar reasons, a trial defense based on immateriality is risky at best. These factors likely contribute to the large number and percentage of settlements in insider trading actions. These settlements decrease corporate resources available to stockholders (as residual claimants on the issuer’s assets), without resulting in a proportional sharing among stockholders of the settlement payment or other benefits.”); Park, *supra* note 42, at 530 (limiting his discussion of materiality to financial misstatements) (“In addition to increasing potential liability, the qualitative materiality standard increases the probability that a securities fraud case will move beyond the motion to dismiss or summary judgment stage As a result, the pressure on companies to settle securities fraud cases regardless of their merit will increase under a qualitative standard.”).

284. Heminway, *Materiality Guidance*, *supra* note 14, at 1191 (“[B]y enhancing certainty and predictability of result, effective materiality guidance may result in fewer insider trading class action settlements, and the value of any settlements should better reflect actual, rather than speculative (or nuisance), measures of value.”); Sauer, *supra* note 12, at 319 (“This continuing uncertainty has increased the cost of generating and verifying financial information and has added to the amount of litigation burdening the corporate world.”).

285. Heminway, *Materiality Guidance*, *supra* note 14, at 1141 (“Moreover, it is probable that the existing legal standard for materiality enhances prospects for non-meritorious or marginal, speculative, settlement-focused, expensive, time-consuming class

component of securities regulation, with plaintiffs operating as private attorneys general,²⁸⁶ greater certainty would encourage plaintiffs (and their attorneys) to invest resources in meritorious cases, with greater confidence that the investment will pay off, and would encourage defendants in those cases to settle without incurring substantial litigation costs.²⁸⁷

The greater predictability afforded by embracing the legal circularity of materiality would have dual impacts on regulators. First, akin to private litigants, regulators operating under greater certainty would be more willing to devote their limited resources to cases with merit.²⁸⁸ Second, this greater certainty would translate to less discretion for regulators. Less discretion would lower the risk of biased enforcement.²⁸⁹ At the same time, however, less discretion would inhibit regulators' ability to respond nimbly to new types of securities fraud.²⁹⁰ This negative impact would be lessened somewhat, however, by the fact that securities regulation does not operate in a vacuum. In truly egregious cases, criminal mail and wire fraud, and perhaps even criminal securities fraud, would be able to fill in any gaps in the securities regulatory scheme.²⁹¹

action litigation against issuers and their insiders, further eroding stockholder value.”).

286. Barbara Black, *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance on Deceptive Conduct and the Future of Securities Fraud Class Actions*, 36 SEC. REG. L.J. 330, 338 (2008) (“[E]mpirical studies make clear that the SEC cannot investigate and bring enforcement actions against all corporate wrongdoers; the concept of the private plaintiffs acting as a ‘private attorney general’ as a necessary supplement to the SEC’s enforcement powers maintains its vitality.”) (citations omitted).

287. Heminway, *Materiality Guidance*, *supra* note 14, 1169-70 (“In an environment with limited resources, a prospective plaintiff, enforcement agency, or prosecutor logically would be more likely to invest those limited resources on a clear-cut case than a case that promises complex and difficult issues of proof. If public and private enforcement of the securities laws is to be an effective method of preventing and punishing fraud, manipulation, and deception as a means of assuring investors of the integrity of our securities markets, then U.S. securities regulation should allow for more straightforward identification and punishment of violators.”).

288. *Id.* at 1141.

289. Heminway, *Just Do It!*, *supra* note 30, at 1010-11 (“[T]he vagueness of aspects of the legal standard for insider trading liability under Rule 10b-5 (including the materiality element), when paired with the broad enforcement discretion available in the insider trading enforcement process, invites the introduction of enforcement biases.”).

290. *Id.* at 1011-12 (“The relationship between unclear regulation and enforcement discretion is advantageous to federal agencies charged with enforcing the law in the areas of regulatory mandate. It allows enforcement agents to use enforcement as a regulatory tool. As a result, the desire for broad enforcement discretion is not unique to insider trading regulation or the SEC. The obvious benefit of enforcement discretion in this context is that it affords enforcement agents the opportunity to mold their enforcement strategies and efforts to fit new, unforeseen factual contexts.”).

291. Couture, *Criminal Securities Fraud*, *supra* note 34, at 78-84 (explaining that the materiality standard under 18 U.S.C. § 1348, a criminal securities fraud provision, would potentially allow prosecution for conduct that is not actionable under § 10(b)); Couture,

With greater uniformity among courts under a more predictable materiality standard, the public would have greater faith that courts are not acting on whim and would be encouraged to enter the capital markets. Taken to an extreme, however, this predictability could undercut the public's respect for the courts if it appeared that judges were applying simple rules without any analysis. Therefore, if courts were to adopt the circularity of materiality, they should explain the role that prior precedent plays in the materiality analysis rather than doing so in a conclusory fashion.

Finally, as alluded to in the prior paragraph, greater predictability would ease the burden of courts' decision-making, leading to greater judicial efficiency. The benefits of greater efficiency would be offset somewhat, however, by the resultant skewing of courts' decision-making. Courts would be less likely to explore the nuances of materiality, potentially stunting the continued evolution of this doctrine that is central to the securities regulatory scheme, resulting in bright-line rules that are both over-inclusive and under-inclusive.²⁹² As a consequence, under the legal circularity of materiality, the materiality determination would be less likely to take into account the various factors that might influence whether a particular statement is important to investors. Professor Langevoort gave the following example of how the same statement, in different contexts, could have differing levels of importance:

It is no doubt true that if the management of a small company, with no established reputation, simply made optimistic remarks to an investor or business audience, investors would be unlikely to rely. That is indeed the setting in which many of these cases arise. But suppose that a more established company was experiencing known difficulties, leading to substantial anxiety about the company's prospects. A statement that "we are optimistic that our performance this quarter will be in line with expectations"—though not unlike statements that some courts have dismissed as a matter of law as too general to be reliable—probably would be viewed as meaningful by sophisticated investors. A simple "we are optimistic," on the other hand,

Gray Area, *supra* note 2, at 3-8 (explaining that the materiality standard under the mail and wire fraud statutes is lower than the standard under the securities fraud statute, thus allowing prosecution for conduct that is not civilly actionable as securities fraud).

292. *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988) ("Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive and underinclusive."); O'Hare, *supra* note 54, at 1700 ("I encourage courts faced with vague statements of corporate optimism to undertake a full materiality analysis rather than relying on a simple puffery review.").

would probably convey little, and indeed confirm some adverse suspicions. In sum, context really is crucial.²⁹³

Additionally, courts would be more likely to rule on the ground of materiality, thus resulting in the underdevelopment of important doctrines, such as the scope of disclosure duties.²⁹⁴ Finally, the circularity of materiality might operate to expand the scope of immateriality. Materiality holdings operate somewhat as a one-way lever because courts choose between holding that a representation is immaterial as a matter of law and holding that a representation is potentially material. Upon a holding of potential materiality, the question of materiality is left to the trier of fact. When cases are settled, this question is never reached. As a result, under legal circularity, holdings of immateriality would have a greater impact than holdings of potential materiality, thus potentially leading to ever-increasing zones of immateriality.²⁹⁵

3. Assessment of the Varying Effects of Greater Predictability About Materiality

In sum, therefore, applying this factor in the Framework to Assess Legal Circularity to materiality, there are positive and negative impacts of greater predictability. On the positive side, greater predictability about materiality would arguably lift barriers to value-enhancing transactions by issuers, lower issuers' compliance costs, prevent management distraction, provide greater clarity to investors about what information to expect and value, lower litigation costs, decrease the extortive effect of securities litigation on defendants, encourage litigants and regulators to devote their limited resources to meritorious litigation, decrease the potential for biased enforcement, increase the public's faith in the courts and thus their

293. Langevoort, *Half-Truths*, *supra* note 65, at 124.

294. Bainbridge & Gulati, *supra* note 74, at 137 ("If correct in positing that judges and clerks are focused on heuristics based in materiality and scienter concepts, there will be a skew in the development of doctrine. The materiality and scienter doctrines will be highly developed, with an extensive body of precedent covering a variety of factual situations. In contrast, doctrines relating to more complex questions, such as affirmative duties to disclose, will remain underdeveloped. In turn, un-certainty as to the scope of disclosure duties will persist.")

295. Langevoort, *Are Judges Motivated*, *supra* note 43, at 311 ("The first cases were highly fact-specific and not terribly controversial. Even a 'wannabe' can get it right in deciding that defendants should not be held liable for not disclosing some particular risk factor if, elsewhere in the same document, they did indeed caution the reader about that very kind of risk, which is how the bespeaks caution doctrine began. So, too, with puffery But gradually, judges become far more aggressive in the way they draw inferences 'as a matter of law' that terminate plaintiffs' cases, as in *Eisenstadt*.").

willingness to enter the markets, and enhance judicial efficiency. On the negative side, greater predictability about materiality would potentially create safe harbors for misrepresentations and insider trading, widen the gap between the hypothetical reasonable investor standard and the behavior of actual investors, lessen regulators' ability to respond nimbly to new types of securities fraud, suggest that courts are merely filling in the blanks, stunt the evolution of a nuanced materiality doctrine, skew courts' decisions away from underdeveloped issues, and lead to expanding zones of immateriality. Some of these potential negative impacts (such as providing issuers and insiders safe harbors within which to mislead investors and widening the gap between the materiality standard and the behavior of actual investors) could be offset by enhanced investor education, but, as discussed above, investor education is not a complete solution. Other potential negative impacts (such as the public's perception that courts are merely filling in blanks) could be allayed if courts were explicit in applying the legal circularity of materiality rather than doing so in a conclusory fashion. On balance, this factor arguably supports embracing the legal circularity of materiality. This conclusion is consistent with the recommendations of several other scholars, including Professors Heminway²⁹⁶ and Park,²⁹⁷ who have performed similar balancing tests and argued for the adoption of more predictable materiality standards.

C. Import of Reconceiving the Courts' Role in the Materiality Doctrine

The third factor in the Framework to Assess Legal Circularity is the import of reconceiving the courts' role under legal circularity as an active participant affecting the conduct of future actors. Whether this reconception of the courts' role is appropriate depends on whether the potentially circular legal doctrine would benefit from an additional active participant and, if so, whether courts are the appropriate party to play that role.

Securities regulation is heavily regulated, with Congress and the SEC making rules, the SEC, the Department of Justice, and private litigants

296. Heminway, *Materiality Guidance*, *supra* note 14, at 1135 ("This Article argues, based on applicable policy and related elements of stockholder value, that issuers, insiders, and their legal advisors, as well as investors and courts, would benefit from additional guidance in making materiality determinations in the insider trading context and suggests a method for constructing that guidance.").

297. Park, *supra* note 42, at 519 (arguing that within the context of financial misstatements only, companies should only be vicariously liable for quantitatively large misstatements, while individuals' liability should continue to be assessed using a qualitative materiality standard).

enforcing those rules, and the courts interpreting and applying those rules. At first glance, this would not seem to be an appropriate arena for courts to play an enhanced role, unlike perhaps in the arena of constitutional law.

Despite these various players, however, materiality remains murky and unsettled, and the benefits of greater predictability explained above remain unrealized. In 1999, the SEC issued Staff Accounting Bulletin 99 in an effort to provide guidance on the materiality of financial statements, but this guidance, which rejects solely using quantitative benchmarks in favor of also considering qualitative considerations,²⁹⁸ has been heavily criticized as nebulous.²⁹⁹ Indeed, scholars have urged the SEC to adopt clearer materiality guidance. For example, Professor Heminway has published a series of articles urging the adoption of materiality guidance for purposes of insider trading, titled, successively, “Materiality Guidance in the Context of Insider Trading: A Call for Action”³⁰⁰ and “Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading.”³⁰¹ The SEC has not heeded these calls, however, which suggests that there is a potential need for courts to play a more active role in clarifying the materiality standard.

The next question is whether courts, via the adoption of the legal circularity of materiality, are the appropriate party to accomplish this clarification. Arguing in favor of courts as the appropriate party is that they are less likely to be biased³⁰² and are less likely to be motivated by the desire to expand their authority.³⁰³ Arguing against courts (in favor of the SEC) is that the SEC has more expertise,³⁰⁴ is less likely to issue guidance

298. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 (Aug. 12, 1999).

299. Park, *supra* note 42, at 517 (citing authority) (“Legal commentators have almost uniformly argued that the standard is vague and impossible to implement.”).

300. Heminway, *Materiality Guidance*, *supra* note 14, at 1135.

301. Heminway, *Just Do It!*, *supra* note 30, at 1045.

302. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 42-43 (assessing whether various regulators should respond to correct market-based cognitive biases and proposing an intermediate presumption against such intervention by courts and a strong presumption against such regulation by the SEC); Heminway, *Just Do It!*, *supra* note 30, at 1045 (acknowledging that the “federal courts are, as a general principle, the most impartial sources of rulemaking”).

303. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 46 (“[D]ecentralized judge-made law poses less danger to the market than does the SEC’s centralized decisions. Although the SEC regulators may seek to expand their regulatory authority and prestige, judges are unlikely to share this motivation.”).

304. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 48 (“Dispersed nonexpert judges may lack expertise in evaluating intervention; while perhaps better motivated and less prone toward overconfidence than the SEC, the lack of expertise still leaves judicial regulation of the securities market prone to error.”); Heminway, *Just Do It!*, *supra* note 30, at 1043-44 (arguing that the SEC has the most substantive competence to

without due care,³⁰⁵ is more likely to incorporate input from various stakeholders (especially if such guidance is issued as a legislative rule subject to the notice and comment requirements of the Administrative Procedure Act rather than as an interpretive rule),³⁰⁶ and is more likely to assess materiality in a comprehensive fashion rather than merely drawing on personal investment experience.³⁰⁷ One traditional argument against relying on courts is that they are “ill equipped, as a general matter, to assemble the information and resources necessary to engage in comprehensive rulemaking in an area like materiality” because they are limited to deciding the case before them and are not formally coordinated except for stare decisis.³⁰⁸ This traditional argument would fall away if the legal circularity of materiality were embraced because a single court decision would have impacts beyond the litigants before the court, thereby enabling coordinated and comprehensive guidance by courts.

In sum, this factor is mixed. If the SEC continues to leave a materiality vacuum, it may be appropriate for courts to play an active role in developing the materiality doctrine by embracing its potential for legal circularity.

issue materiality guidance).

305. Choi & Pritchard, *Behavioral Economics*, *supra* note 31, at 48 (“Judges may prefer to dispose of cases quickly, particularly if securities law cases are a disfavored class due to their complexity or other reasons.”).

306. See 5 U.S.C. § 553(b) (“General notice of proposed rule making shall be published in the Federal Register Except when notice or hearing is required by statute, this subsection does not apply—to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice.”); Heminway, *Just Do It!*, *supra* note 30, at 1005 (“Accordingly, the status of the proposed materiality guidance as a legislative or interpretive rule under the APA is inconclusive.”).

307. Langevoort, *Are Judges Motivated*, *supra* note 43, at 317 (“More powerfully, the judge is likely to intuit the answer to a materiality question by asking herself whether *she* would have put much stock in the publicity. After all, she has made many investment decisions and has a sense about how reasonable people do these things. Most successful people, however, overestimate their own prudence, caution, reasonableness, etc., especially in hindsight.”); Padfield, *Is Puffery Material?*, *supra* note 74, at 347-48 (“A second point is that the reasonable investor standard may have nothing to do with actual investors at all, but rather is based upon some ‘normative idealized type of behavior.’ If that is to be the standard, however, it is highly questionable whether courts should be the ones deciding upon the norms—particularly without any express acknowledgement thereof.”).

308. Heminway, *Just Do It!*, *supra* note 30, at 1042 (“A court depends on having a case before it that allows it to rule on a particular matter; the manner of regulation of the judiciary is, therefore, by its nature, unpredictable and incremental rather than regular and comprehensive. In addition, the judiciary is independent. The activities of individual judges across the U.S. District Courts and the Circuit Courts of Appeal are not formally coordinated, except through stare decisis, when applicable. It would be very difficult for the federal courts, in spite of their expertise in materiality standards in insider trading, to fashion comprehensive materiality guidance with alternating presumptions over a range of facts.”).

D. Summary of the Application of the Framework to Assess Legal Circularity to Materiality

Application of the Framework to Assess Legal Circularity to the materiality doctrine leads to the conclusion that, if the SEC continues to decline to provide further guidance about materiality, courts should explicitly embrace the legal circularity of materiality. Because the primary function of the materiality doctrine is coordination, there is little risk of harm from the entrenchment of a “wrong” rule. Moreover, to the extent that an intrinsically wrong rule were entrenched via legal circularity, the coalescence created by legal circularity would allow the pressure to build, which would perhaps incentivize Congress or the SEC to correct course. Greater predictability would lead to numerous benefits and its potential harms could be at least partially offset by enhanced investor education. In addition, as Professor Abramowicz advised in the context of constitutional circularity, adoption of legal circularity should be explicit: “[C]andid acknowledgment of constitutional circularity might help discipline its application, and it might in any event be preferable than a world in which constitutional doctrine is separated from the Constitution altogether.”³⁰⁹ By the same token, if courts embrace the legal circularity of materiality, they should do so explicitly, after applying both the Legal Circularity Test and the Framework to Assess Legal Circularity.

CONCLUSION

In closing, this Article seeks to fill two voids in the extant scholarship. First, although securities scholars have engaged in a deep discussion about the materiality test, no one has discussed its potential for legal circularity, instead focusing on whether it imposes too high or low of a burden and on whether it is too ambiguous. This Article fills that gap and, moreover, argues that embracing the legal circularity of materiality would help to solve some of the problems identified by other scholars, albeit not perfectly. Second, although scholars in other disciplines have recognized the potential legal circularity of other doctrines, no one has crafted a comprehensive means of analyzing legal circularity across disciplines. This Article fills that hole by proposing a two-step Theory of Legal Circularity. The first step is a Legal Circularity Test, which should help courts and scholars identify other legal doctrines that are potentially legally circular. The second step is a Framework to Assess Legal Circularity, which should help guide courts and scholars in other disciplines in

309. Abramowicz, *supra* note 120, at 8.

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determining whether to embrace a particular doctrine's potential to be legally circular.