CONTRACT-BASED DEFENSES IN SECURITIES FRAUD LITIGATION: A BEHAVIORAL ANALYSIS

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In this article, Professor Robert Prentice takes issue with the trend of courts honoring contract-based securities fraud defenses and advocates the maintenance of a tort-based approach. Contrary to the arguments of contractarian theorists who argue that investors should be able to contractually negotiate their desired level of risk, and consequently that disclaimers and no reliance clauses should be honored, the article uses behavioral principles to undermine the assumption that humans rationally contract.

Pointing to Carr v. CIGNA Securities, Inc.*, in which a contractual disclaimer of oral representations precluded a successful fraud suit, and* Rissman v. Rissman*, wherein a "no reliance" on oral representations clause was found dispositive, as examples of courts allowing contract-based defenses, Prentice argues that such defenses run counter to congressional intent. Securities fraud suits were intended to be tort-based and Congress intended to limit contract-based defenses.*

As evidence of investors' need for a purely tort-based securities law that cannot be contracted away, the article points to various behavioral instincts that advise against reading or questioning form contracts and support reliance on oral representations. The article then argues that such behavioral tendencies support not only preventing a contract-based defense for small investors but also eliminating the defense for sophisticated and institutional investors, who are equally susceptible to human behavioral tendencies.

In recognition that courts are reluctant to allow investors to break contractual promises and argue fraud, Prentice offers some behavioral tendencies that would compel investors to wrongly feel defrauded. Such tendencies are balanced by the tendency of juries to side with the defense. As alternatives to complete prohibition of contract-based defenses, Prentice suggests reviving the fraud exception to the parol evidence rule or requiring plaintiffs seeking to overturn no-

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reliance or merger clauses to support their position with objective evidence.

"[P]aper and ink possess no magic power to cause statements of fact to be true when they are actually untrue."[1]

I. INTRODUCTION

In a series of recent articles, I endeavored to use behavioral analysis to demonstrate that corporate officials and outside auditors have more motivation to defraud and investors have less ability to protect themselves from that fraud than is presumed by the law-and-economics advocates and contractarians who have been so persuasive in the securities regulation field in recent years.[2] The unfolding Enron/Arthur Andersen (WorldCom, Global Crossing, Tyco, Adelphia, and so on) scandal is surely illustrating my arguments more vividly and persuasively than I was able to do myself.[3]

Involving apparent corporate securities fraud and reckless auditing that cost investors and employees tens of billions of dollars,[4] the Enron scandal has prompted Congress and the Securities and Exchange Commission (SEC) to make broad-ranging reforms of the securities laws.[5] Overlooked in the current media frenzy and unaddressed by Enron-generated reforms, however, is a large amount of retail-level securities fraud that also undermines investor confidence in the securities markets, yet is currently largely shielded from liability by a string of arguably imprudent court decisions.

1. Arthur L. Corbin, *The Parol Evidence Rule*, 53 YALE L.J. 603, 620 (1944).

2. Robert A. Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002) [hereinafter Prentice, *Whither Securities Regulation?*] (using behavioral analysis to critique a proposal to essentially deregulate the securities industry and regulate investors instead); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000) [hereinafter Prentice, *Irrational Auditor*] (delving into twenty-five years worth of empirical behavioral analysis of accountants to demonstrate that auditors are not as constrained by reputational bonds from reckless activity or outright fraud as economists have argued); Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1604–53 (2000) [hereinafter Prentice, *SEC and MDP*] (using the self-serving bias as a lens to examine how auditors are often influenced to audit recklessly and even fraudulently).

3. For an indispensable look at a major slice of the Enron/Andersen scandal, see WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf [hereinafter POWERS REPORT].

4. The biggest impact of the Enron scandal is its undermining of general investor confidence in the American economy. *See* Bruce Nussbaum, *Can You Trust Anybody Anymore?*, BUS. WK., Jan. 28, 2002, at 31 ("The scope of the Enron debacle undermines the credibility of modern business culture.").

5. Most importantly, Congress passed the Sarbanes-Oxley Act of 2002 that made numerous changes in the federal securities laws and authorized the SEC to issue new rules and to study various issues that will lead to even more changes in the near future. However, a reading of the many provisions of Sarbanes-Oxley convinces me that the problems that I discuss in this Article were not remedied or even addressed by Sarbanes-Oxley.

Assume a scenario in which a promoter (or stockbroker) makes false oral representations to an investor about the bright prospects of ABC Co. and thereby induces the investor to buy ABC stock. Given the salience of the Enron scandal and the fact that $100 billion of fraud occurs annually in the financial services industry,[6] this should not take too much imagination. Assume further that at the same time, the seller places in the written contract a provision stating: "*ABC* Company (or *XYZ* Brokerage Firm) makes no representations other than those contained in writing in this document. Investor acknowledges that he or she relies on no other statements by *XYZ*'s employees or representatives in entering into this transaction. This document represents the entire agreement between the parties."

Should the combined disclaimer (defendant "makes no representations other than those contained in writing in this document"), no-reliance (plaintiff "acknowledges that he or she relies on no other statements by *XYZ*'s employees"), and merger ("This document represents the entire agreement between the parties") clauses bar a subsequent securities fraud suit by the investor?

At a pragmatic level, this is a very important issue. Investors in stocks and consumers of products commonly sign written contracts containing one or more such clauses. Many courts give effect to such provisions.[7] It seems unfair to allow fraudsters to hide behind boilerplate pro-

6. Rachel Witmer, *Antifraud: House Panel Divides on Antifraud Bill over Privacy, Confidentiality, Fairness*, BNA SEC. L. DAILY, May 10, 2001 (citing estimate of the Financial Services Roundtable); *see also* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1091 (1999) (noting a "pervasive run of [securities] fraud, theft, and malfeasance [that has recently] imposed astounding costs upon our economy"); Alison Beard, *Complaints Against Stockbrokers Likely to Reach Record Levels*, FIN. TIMES, Dec. 13, 2001, at 26; Kip Betz, *SEC Brought 484 Cases in FY 2001; Financial Fraud, Reporting Top Agenda*, BNA SEC. L. DAILY, Dec. 17, 2001. These numbers predated the Enron/WorldCom/Global Crossing/Tyco scandals of 2001–02. Fraudulent activity has clearly been accelerating in recent years. "[A]ccounting write-offs in excess of $148 billion erased virtually all of the profits reported by Nasdaq companies between 1995 and 2000." Eugene Spector, *Fraud Made Easy*, NAT'L L.J., Sept. 23, 2002, at A17.

7. *See, e.g.*, Harsco Corp. v. Segui, 91 F.3d 337, 345 (2d Cir. 1996) (finding that plaintiff cannot sue based on misrepresentations expressly excluded by writing); Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1033 (2d Cir. 1993) (holding that disclosure of risks in prospectus forecloses 10b-5 suit claiming security was unsuitable); Davidson v. Wilson, 973 F.2d 1391, 1401 (8th Cir. 1992) (holding that plaintiffs were not justified in relying on contradictory oral representations when the contract contained disclaimers); Ambrosino v. Rodman & Renshaw, Inc., 972 F.2d 776, 786 (7th Cir. 1992) (holding that written statements control oral statements in securities law); Assocs. in Adolescent Psychiatry v. Home Life Ins. Co., 941 F.2d 561, 571 (7th Cir. 1991) (same); Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 416 (1st Cir. 1989) (same); One-O-One Enters., Inc. v. Caruso, 848 F.2d 1283, 1286–87 (D.C. Cir. 1988) (same); Kennedy v. Josephthal & Co., 814 F.2d 798, 805 (1st Cir. 1987) (holding that plaintiffs cannot justifiably rely upon oral misrepresentation at odds with written disclaimer); Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 530 (7th Cir. 1985) (same); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518–19 (10th Cir. 1983) (same); AES Corp. v. Dow Chem. Co., 157 F. Supp. 2d 346, 351–53 (D. Del. 2001) (same); Am. Bankcard Int'l, Inc. v. Schlumberger Techs., Inc., No. 99-C6434, 2001 U.S. Dist. LEXIS 19011, at *9 (N.D. Ill. Nov. 15, 2001) (same); *In re* Hyperion Sec. Litig., No. 93 Civ. 7179, 1995 U.S. Dist. LEXIS 10020, at *25 (S.D.N.Y. July 14, 1995) (same).

visions in form contracts, but perhaps equally unfair to subject honest sellers to liability for oral statements that they did not make.

This issue also carries theoretical and policy implications that go to the very core of federal securities law. The key question is whether securities fraud actions should be viewed primarily through a tort lens or a contract lens. Recent proposals for major alterations in federal securities regulation have a strong contractarian flavor.[8] Proponents of a contract-based view of securities regulation have made substantial headway in court decisions,[9] in the writings of leading contractarian scholars,[10] and even in the halls of Congress.[11] Absent the distractions caused by the September 11, 2001 terrorist attack and the embarrassments arising from the Enron scandal, some of these proposals might already be law.[12]

8. *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (proposing virtual complete deregulation of the securities business); Edmund W. Kitch, *Proposals for Reform of Securities Regulation: An Overview*, 41 VA. J. INT'L L. 629 (2001) (analyzing and generally approving a draft of such proposals); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997) (proposing that exchange self-regulation play a much larger role in the regulatory scheme); A. C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999) (also proposing a greater role of the exchanges); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (proposing that state regulation of securities largely replace federal regulation).

9. *See, e.g.*, Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 23 (1996) ("Holding that contract reigns *uber alles*, federal judges have given defense lawyers another range of sticks and clubs to use against securities plaintiffs, including enforcement of clauses shifting attorney fees to investors who sue and lose, merger clauses excluding from view oral misrepresentations no matter how devious, choice of law clauses pointing to law favorable to defendants, and use of the statute of frauds to deny some plaintiffs standing altogether."); Darrell Hall, Note, *No Way Out: An Argument Against Permitting Parties to Opt Out of U.S. Securities Laws in International Transactions*, 97 COLUM. L. REV. 57 (1997) (arguing that investors should not be allowed to contractually opt out of coverage of the U.S. securities laws by agreeing to be bound by the laws of a different country).

10. *See, e.g.*, Choi, *supra* note 8.

11. In the bespeaks caution provisions of the Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as additions and amendments to 15 U.S.C. §§ 77–78 and 18 U.S.C. § 1964 (Supp. I 1995)), Congress authorized even knowing fraudsters to protect themselves contractually while making false forward-looking statements by use of the correct terminology. *See* Harris v. Ivax Corp., 182 F.3d 799, 807–08 (11th Cir. 1999) (holding that under the PSLRA a company can intentionally make falsely optimistic forward-looking statements, all the while intending to take a huge goodwill write down that will certainly cause its stock price to plummet, and yet protect itself from liability by including "adequate" cautionary language even if that language intentionally omits the specific factors that the defendant knows will prevent the forward-looking statements from being realized).

12. Early in the Bush administration, Senate Banking Committee Chair Phil Gramm announced that his committee would give the federal securities laws a "top-to-bottom" review. Mike McNamee, *Wanted: Another Investor-Friendly SEC Chief*, BUS. WK., Jan. 29, 2001, at 39; Jaret Seiberg, *Gramm Aims to Make Changes in Securities Law*, NAT'L L. J., Feb. 5, 2001, at B11.

After eight years of pro-investor administration, the SEC was clearly preparing to take a pro-industry turn under President George W. Bush's appointees. New SEC chair Harvey Pitt, a long-time securities defense lawyer brought a pro-industry philosophy to the position. Marcy Gordon, *Pit Bull for the SEC; Bush Choice Is an Industry Insider*, REC. (Bergen County, N.J.), May 30, 2001, at B1. Among his first acts was an attempt to make peace with accounting firms that his predecessor had often attacked for being too soft on their clients' questionable financial practices, *see* Floyd Norris, *Harvey Pitt's S.E.C.: From Guard Dog to Friendly Puppy?*, N.Y. TIMES, Oct. 26, 2001, at C1, and an announcement of guidelines to allow companies to escape liability for wrongs of their employees by

This article endeavors to demonstrate that although it is under attack from many quarters, a tort-based view of securities regulation is (a) most consistent with the statutory scheme established by Congress, and (b) preferable on a policy basis as may be demonstrated by behavioral analysis that contractarians and law-and-economics scholars tend to ignore. Behavioral theory has been termed "probably . . . the most exciting intellectual development [in corporate and securities law] of the last decade,"[13] and I intend to use the behavioral literature to examine the ramifications of this surprisingly thorny issue.

II. BACKGROUND

A. The Products Liability Precedent

The current debate over the future of securities regulation mirrors to an interesting degree a long-standing controversy about products liability law.[14] Before *Henningsen v. Bloomfield Motors, Inc.*,[15] products liability law was largely contract-based.[16] By the use of contractual disclaimers[17] or the contract-based defense of lack of privity,[18] sellers of de-

reporting misdeeds and cooperating with the Commission, Michael Schroeder & Jonathan Weil, *SEC Chooses a More Lenient Tack*, WALL ST. J., Oct. 24, 2001, at C1.

The Enron debacle has, at least for the moment, made it politically infeasible for President Bush to push either his proposals for general (pro-business) tort law reform, *see* Patti Waldmeir, *The Lost Cause of Law Reform*, FIN. TIMES, Feb. 7, 2002, at 11 (noting that President Bush's plans for tort law reform are a "collateral casualty" of the Enron scandal), or for deregulation of the securities business, *see* Ronald Brownstein, *Enron Mess Forcing Bush into Balancing Act: Need for Distance from Scandal Plays Against Philosophy*, CHARLESTON DAILY MAIL, Jan. 19, 2002, at 10A (noting that the need to distance itself from the scandal is forcing the Bush administration to move away from its antiregulatory ideological instincts).

13. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1058 (2000); *see also* Kyron Huigens, *Law, Economics, and the Skeleton of Value Fallacy*, 89 CAL. L. REV. 537, 538 (2001) ("Ultimately, these [behavioral] considerations undermine the economic analysis of law, and indicate the need for a fundamental re-orientation of legal theory."); JENNIFER ARLEN ET AL., ENDOWMENT EFFECTS, OTHER-REGARDING PREFERENCES, AND CORPORATE LAW (USC Law School, Olin Working Paper No. 00-2) (2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=224435 (noting that behavioral research has in the past five years "risen from virtually nowhere to occupy the center stage of interdisciplinary legal scholarship"). *But see* Bainbridge, *supra*, at 1059 (noting many cautions regarding behavioralism's usefulness in generating policy prescriptions).

14. *See* Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 MICH. L. REV. 683, 687 (1993) ("From its inception, modern products liability has occupied an uncertain position between contract law and tort law."). Thus, Grant Gilmore noted that products liability law evolved into "contort" law. *See* GRANT GILMORE, THE DEATH OF CONTRACT 89–99 (1974) (noting legal trends that blur distinctions between contract and tort).

15. 161 A.2d 69 (N.J. 1960).

16. Although *Henningsen* is a landmark case in the evolution of products liability law, a gradual chipping away at the defendant's solid block of nonliability began in 1916 with *MacPherson v. Buick Motor Co.*, 111 N.E. 1050 (N.Y. 1916). *See generally* Marc A. Franklin, *When Worlds Collide: Liability Theories and Disclaimers in Defective-Product Cases*, 18 STAN. L. REV. 974 (1966) (sketching a history of products liability evolution and noting the conceptual difficulty of drawing lines between contract-based and tort-based approaches).

17. *See, e.g.*, Diamond Alkali Co. v. Godwin, 112 S.E.2d 365, 367 (Ga. Ct. App. 1959); Buckley v. Shell Chem. Co., 89 P.2d 453, 455 (Cal. Dist. Ct. App. 1939).

fective products typically escaped liability for injuries that their defective goods caused. By placing sensible limits on the ability of sellers to disclaim liability for defective goods, *Henningsen* famously began "the fall of the citadel."[19]

With the broad adoption of strict liability, based primarily on the Restatement (Second) of Torts § 402A,[20] a tort-based view of products liability quickly gained ascendancy.[21] But it did not take long for contractarian theorists and others to begin chipping away at the new paradigm. Justifying their proposals via arguably overblown claims of a litigation crisis, an insurance crisis, and a punitive damages crisis, reformers contended that a superior system would entail simply allowing consumers to contract with sellers regarding their preferred degree of risk. Peter Huber, for example, argued that "a real law of disclaimability [is needed] to bring things back to a market optimum. Free contracting will then restore an optimal state of affairs . . . ."[22]

Some contractarian theorists[23] see absolutely no impediments to consumers' ability to establish, calculate, and bargain for their preferred degree of risk when purchasing products. They envision a world of private ordering in which consumers can willingly pay a little (or a lot) less if they are willing to incur greater product risk and a little (or a lot) more if they are more risk-averse. In their view, when a defective product injures a consumer, the fault lies with the consumer for not bargaining for a safer product.[24] When a worker is injured on the job by a defective product, it is his fault for not bargaining with his boss for a safer workplace.[25]

A decade ago in two articles with Mark Roszkowski, I criticized this contractarian view.[26] Now is not the time to review that entire contro-

18. *See, e.g.*, Davidson v. Montgomery Ward, 171 Ill. App. 355, 363–65 (1912) (noting three exceptions); Winterbottom v. Wright, 152 Eng. Rep. 402 (1842).

19. William L. Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791, 791–93 (1966).

20. RESTATEMENT (SECOND) OF TORTS § 402A (1965).

21. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS 690 (5th ed. 1984) ("What followed [*Henningsen*] was the most rapid and altogether spectacular overturn of an established rule in the entire history of the law of torts.").

22. *Session Three: Discussion of Paper by George L. Priest*, 10 CARDOZO L. REV. 2329, 2339 (1989) (statement of Peter Huber).

23. For arguments by other scholars in this vein, see, e.g., Richard A. Epstein, *The Unintended Revolution in Product Liability Law*, 10 CARDOZO L. REV. 2193 (1989); George L. Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985); Alan Schwartz, *The Case Against Strict Liability*, 60 FORDHAM L. REV. 819 (1992); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353 (1988). Priest certainly is not comfortably labeled a contractarian, and there is substantial difference in the specifics of the views of scholars such as Huber, Schwartz, Priest, and Epstein. Nonetheless, all are substantially more comfortable than I with a products liability system centered on private ordering.

24. PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 7 (1988).

25. *Id.* at 8.

26. Robert A. Prentice & Mark E. Roszkowski, *"Tort Reform" and the Liability "Revolution:" Defending Strict Liability in Tort for Defective Products*, 27 GONZAGA L. REV. 251 (1991–92); Mark E.

versy,[27] but our articles constituted one of the first attempts to bring behavioral insights into the products liability debate. We argued that, contrary to the contractarians' assumption, consumers are not *homo economicus*, perfectly rational maximizers of their own utility.[28] Rather, they are creatures of bounded rationality whose actions are limited by various behavioral heuristics and cognitive biases that prevent them from bargaining as effectively as the contractarians assume.[29]

Professor Latin followed our work with a behavioral analysis that focused more narrowly upon the efficacy of product warnings.[30] His essential point was that behavioral research shows that people simply do not act as contractarians as other law-and-economics scholars assume,[31] and therefore products liability doctrine "should not be grounded on a conception of 'rational behavior' or 'reasonable behavior' that is fundamentally incompatible with actual consumer behavior."[32]

Most recently, Hanson and Kysar chided both Latin and Roszkowski and me for being excessively timid in pointing out the implications of behavioral research for products liability law. Their essential point, explicated in a long theory piece[33] and then applied in a detailed article examining the tobacco industry's marketing practices,[34] was that not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cogni-

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Roszkowski & Robert A. Prentice, *Reconciling Comparative Negligence and Strict Liability: A Public Policy Analysis*, 33 ST. LOUIS U. L.J. 19 (1988).

27. Among other arguments we made at that time was that a "bargaining for risk" theory did precious little to protect "the multitude of users (employees, family members, friends) and bystanders (pedestrians walking near lawnmowers, victims of two-vehicle collisions, residents in buildings with defective boilers)" who never had an opportunity to bargain for safety. Roszkowski & Prentice, *supra* note 26, at 83.

28. *See* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 750–51 (1990) (explicating key assumptions of the standard economic model); W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 RUTGERS L. REV. 625, 636 (1996) (observing that the "foundation of economic analysis of choice is based on the rationality of individual decision making").

29. We pointed out, for example, that rather than being the perfectly informed negotiators that Huber and others assumed, product consumers often do not and cannot fully appreciate the risks presented by the complex products they buy. Roszkowski & Prentice, *supra* note 26, at 83–84. We noted that even knowledgeable consumers are typically presented with form contracts and have no realistic opportunity to bargain over their terms. Prentice & Roszkowski, *supra* note 26, at 289–90. Even if consumers have the opportunity to bargain, a persistent tendency to favor the current state of affairs (the status quo bias) usually prevents them from doing so. We presented behavioral evidence showing that because of various behavioral heuristics and biases discussed later in this article, *see infra* notes 101–220 and accompanying text, such as the overconfidence bias, the overoptimism bias, the illusion of control, the tendency to ignore low-probability events, and cognitive dissonance, even informed and motivated consumers have great difficulty bargaining for the level of product safety they desire.

30. Howard A. Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations*, 41 UCLA L. REV. 1193, 1194–95 (1994).

31. *Id.* at 1249–57.

32. *Id.* at 1294.

33. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999) [hereinafter Hanson & Kysar, *TBS I*].

34. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999) [hereinafter Hanson & Kysar, *TBS II*].

tion, but that competitive pressures almost guarantee that they will do so.[35]

B. The Securities Regulation Parallel

The debate between contractarians and behavioralists has now come to the securities law field. Contractarians who believe that consumers can bargain efficiently for safe products also believe that investors can bargain effectively for desired levels of investment safety. The strongest version of this viewpoint was recently advanced by Stephen Choi, who believes so strongly in the ability of investors (sophisticated investors, anyway) to protect themselves from fraud that he wants to deregulate almost completely the securities business and regulate investors instead.[36] Under Choi's proposed system, novice investors would be protected from themselves (they could invest only in passive mutual funds) but experienced investors would be allowed to bargain for whatever level of fraud protection they desired.[37] I have used behavioral principles to analyze Choi's proposal, arguing that its unrealistic law-and-economics-based assumptions and its virtual ignorance of behavioralist literature render it a risky policy prescription.[38]

In this article I am less concerned with theoretical proposals such as Choi's and more concerned with the actual rulings of courts. It appears that decisions of law-and-economics-oriented judges are already giving the contractarians their day in the sun in securities regulation.[39]

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35. Hanson and Kysar argue:

> The behavioralist literature reviewed here makes clear the potential for a new sort of market failure, *market manipulation*: Because individuals are subject to a host of nonrational yet systematic cognitive phenomena, any party who has control over a decisionmaking context can influence the perceptions of the decisionmaker. When a party to a transaction has the ability to assert this influence, the underlying transaction will not necessarily yield an increase in social welfare. Indeed, flipping Friedman's classic justification of the rational actor model, one might say that the evolutionary forces of the market will force the parties in the dominant position to behave "as if" they know and understand how best to use the teachings of the behavioral literature to manipulate other actors for gain.

Hanson & Kysar, *TBS I*, *supra* note 33, at 747.

36. Choi, *supra* note 8.

37. *Id.* at 284–326. In Choi's view:

> [R]egulation of any sort may be unnecessary for rational investors with good information on the risks and returns offered through particular issuers. These investors will price privately-supplied investor protections, paying more for securities from issuers offering valued protections. Market participants, in turn, will have an incentive to adopt investor safeguards to the extent the increase in the amount investors are willing to pay exceeds the cost of protections. The same incentive exists for all securities market participants that deal with rational investors, including issuers, broker-dealers, mutual funds, and exchanges. Although different participants pose varying risks to investors, rational investors can price these risks accordingly in their investment decisions. Thus, there is a strong argument for removing the many layers of regulation from market participants that deal with these investors.

Id. at 282–83 (emphasis added) (footnote omitted).

38. *See* Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1489–90.

39. I have previously criticized these judges for ignoring the behavioral literature that spotlights the unrealistic nature of so many of their basic analytical assumptions. *See* Prentice, *Irrational Auditor*, *supra* note 2.

C. Contractual Defenses to Securities Fraud

I offer two representative examples of cases that raise the issues that concern me.

1. Carr v. CIGNA Securities, Inc.

In *Carr v. CIGNA Securities, Inc.*,[40] the plaintiff, an unsophisticated investor, claimed that defendant CIGNA's agent had orally told him that the limited partnership interests he bought for $450,000 were safe and conservative investments. In fact, the opposite was true and plaintiff lost every penny.[41] Despite the alleged oral misrepresentations, plaintiff was barred from recovery in a section 10(b)[42] and Rule 10b-5[43] securities fraud action by disclosures contained in the 427 pages of documents that defendant's agent delivered to plaintiff. The documents, it turns out, contradicted the agent's oral statements and therefore, in the eyes of the redoubtable Judge Posner, virtual founder of the law-and-economics movement, rendered defendant CIGNA liability-proof:

> [I]t would be unreasonable to expect Carr to pore through 427 pages of legal and accounting mumbo-jumbo looking for nuggets of intelligible warnings. But the subscription agreements for each of the limited partnerships were only eight pages long and rich in lucid warnings, such as: "the Units [the limited-partner interests that he was buying] are speculative investments which involve a high de-

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My specific point in this article related to the unrealistic nature of Judge Easterbrook's ruling in *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990). In response to plaintiffs' claims of auditor wrongdoing, Easterbrook wrote:

> The complaint does not allege that [the audit firm] had anything to gain from any fraud by [its client]. An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the auditor] would suffer from a perception that it would muffle a client's fraud. And although the interests of [the audit firm's] partners and associates who worked on the . . . audits may have diverged from the firm's, . . . covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. [The audit firm's] partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. *It would have been irrational for any of them to have joined cause with [the client].*

Id. at 629 (emphasis added).

In my article, I attempted to show that all four assumptions upon which Easterbrook's holding was based—(a) that auditors are rational; (b) that audit firms are rational, (c) that it is necessarily irrational for auditors to act recklessly; and (d) that it is necessarily irrational for audit firms to act recklessly—are untrue. The first two parts of my argument were based upon behavioral literature. *See* Prentice, *Irrational Auditor*, *supra* note 2, at 139–86. My case may or may not be persuasive, but it draws substantial support from twenty-five years worth of behavioral research by accounting academics regarding the actions and motivations of auditors and from the events surrounding the collapse of Enron. *See* Robert A. Prentice, *Enron: A Brief Behavioral Autopsy*, AM. BUS. L.J. (forthcoming) (detailing a behavioral explanation for the Enron debacle).

40. 95 F.3d 544 (7th Cir. 1996).

41. This is what the plaintiff alleged, at least, and the court was bound to accept those allegations as true at the motion to dismiss stage. Cousins v. City Council of Chi., 503 F.2d 912, 923 (7th Cir. 1974).

42. 15 U.S.C. § 78j(b) (2000).

43. 17 C.F.R. § 240.10b-5 (2000).

gree of risk of loss by the undersigned of his entire investment in the Partnership."[44]

The plaintiff's attempt to prove that the defendant's agent made fraudulent oral statements was barred despite the fact that, unsurprisingly, the plaintiff had not read the documents after being told by the defendant's agent that they were just boilerplate. The defendant's agent gave no hint that any statements in the documents were inconsistent with his oral representations. Yet, Judge Posner announced that "a very simple, very basic, very sensible principle of the law of fraud" is that if a seller orally tells you "this is a safe investment" but gives you a document that says "this is a risky investment," you cannot sue for fraud.[45] Judge Posner held as a matter of law that *written representations trump oral representations.* He explained:

> This principle is necessary to provide sellers of goods and services, including investments, with a safe harbor against groundless, or at least indeterminate, claims of fraud by their customers. Without such a principle, sellers would have no protection against plausible liars and gullible jurors. The sale of risky investments would be itself a very risky enterprise—a very *legally* risky enterprise. Risky investments by definition often fizzle, and an investor who loses money is a prime candidate for a suit to recover it. If the documents he was given, warning him in capitals and bold face that it was a RISKY investment, do not preclude the suit, it will simply be his word against the seller's concerning the content of an unrecorded conversation.[46]

2. Rissman v. Rissman

In *Rissman v. Rissman*,[47] the plaintiff sold his one-third interest in a company for $17 million to his brother, who owned the other two-thirds. His decision to sell was based in part on the brother's statement that he did not intend to sell the company or take it public and therefore the plaintiff's stock would remain illiquid and would not pay dividends. Thirteen months later, the brother sold the company, and the plaintiff's one-third interest fetched almost $112 million. However, because the contract contained boilerplate language that "no promise or inducement for this agreement has been made to buyer except as set forth herein" and the "I don't intend to sell" language was not in the contract, the Seventh Circuit affirmed dismissal of plaintiff's Rule 10b-5 securities fraud claim.

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44. *Carr*, 95 F.3d at 548.
45. *Id.* at 547.
46. *Id.* At the end of this Article, I will rewrite this passage to reflect my analysis. *See infra* note 455.
47. 213 F.3d 381 (7th Cir. 2000).

Had Judge Posner penned the majority opinion, he likely would have said that "a very simple, very basic, very sensible principle of the law of fraud" is that if a seller orally makes promises to you but gives you a document that says that he made no promises, or that, if he did, you did not rely on them, you cannot sue for fraud.[48] Judge Easterbrook, another avid law-and-economics advocate, authored the *Rissman* opinion, and his ruling went even further. He held that if buyers sign such contracts, even if they have not read them after being told there was no reason to do so, they are barred from recovery because "[s]ecurities law does not permit a party to a stock transaction to disavow such representations—to say, in effect, 'I lied when I told you I wasn't relying on your prior statements' and then to seek damages for their contents."[49]

When the plaintiff cited a case holding that an integration clause does not preclude plaintiffs from proving prior oral fraud,[50] Judge Easterbrook distinguished the case largely because the *Rissman* contract contained a "no-reliance" clause as well.[51]

The plaintiff in *Rissman* was more sophisticated than the plaintiff in *Carr*. Also, he had asked the buyer to put in writing his promise not to sell the company, and the buyer refused to do so. Therefore, a jury certainly might have concluded that plaintiff's reliance was unreasonable.[52] Nonetheless, Judge Easterbrook's blind faith in the boilerplate no-reliance clause is troubling.[53]

3. The Task at Hand

Carr and *Rissman* frame the dilemma that I seek to analyze. As noted earlier, on the one hand, it seems unfair to put sellers in the potentially untenable position of telling the truth *in writing* but then being subjected to litigation anyway by a buyer who falsely claims that he was orally lied to. On the other hand, it seems to me (although apparently

48. *Carr*, 95 F.3d at 547.

49. *Rissman*, 213 F.3d at 383.

50. *Id.* at 385 (citing Contractor Utility Sales Co. v. Certain-Teed Prods. Corp., 638 F.2d 1061, 1083 (7th Cir. 1981) (applying Pennsylvania law)).

51. *Rissman*, 213 F.3d at 383–84.

52. Professor Sachs has argued that the courts have gone too far in allowing securities law defendants to raise "no reasonable reliance" defenses in 10b-5 cases. Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985). I generally concur in Professor Sachs's analysis, and I certainly agree with her conclusion.

53. Arthur Corbin observed many years ago: "A statement in the writing that it contains all terms agreed upon and that there are no promises, warranties, or other extrinsic provisions, is a statement of fact that may actually be untrue." Corbin, *Parol Evidence Rule*, *supra* note 1, at 621. The notion that an investor can easily induce a seller of securities to put all the seller's promises in writing "shows a remarkable lack of awareness of the facts of everyday commercial life . . . [where] inequality of bargaining power and the standardized form contract are the rule today, rather than the exception . . . [and p]romises made without the intention on the part of the promisor that they will be performed are unfortunately a facile and effective means of deception." Justin Sweet, *Promissory Fraud and the Parol Evidence Rule*, 49 CAL. L. REV. 877, 896 (1961).

not to Judges Posner and Easterbrook) equally unfair to allow sellers to lie orally and then to hide behind written provisions that they know full well the buyers are unlikely to read or to understand if they do read.[54]

To look at the dilemma in another way, the essence of Judge Posner's reasoning in *Carr* was his conclusion that a written contract must trump an oral representation almost as a matter of law. In the next section, I explore behavioral research indicating that in the world of human interactions, *oral representations trump written disclaimers*.

The crux of Judge Easterbrook's holding in *Rissman* is that courts should not allow a buyer to sign a contract saying that he did not rely on representations of the seller and then sue, saying, in effect, "I lied when I told you that I wasn't relying." But what Judge Easterbrook's reasoning allows is the equally plausible scenario in which a seller orally lies to a buyer about the features of the investment, lies to the buyer about the contents of a form contract, tells the buyer that he need not read the

54. Both courts and commentators widely assume that consumers do not read form contracts and this conclusion is supported by empirical studies. *See* Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1179 n.22 (1983). Rakoff notes:

> [F]or most consumer transactions, the close reading and comparison needed to make an intelligent choice among alternative forms seems grossly arduous. Moreover, many of the terms concern risks that in any individual transaction are unlikely to eventuate. It is notoriously difficult for most people, who lack legal advice and broad experience concerning the particular transaction type, to appraise these sorts of contingencies. And the standard forms—because they are drafted to cover many such contingencies—are likely to be long and complex, even if each term is plainly stated. . . . [I]t is clear that the near-universal failure of adherents to read and understand the documents they sign cannot be dismissed as mere laziness. In the circumstances, the rational course is to focus on the few terms that are generally well publicized and of immediate concern, and to ignore the rest. The ideal adherent who would read, understand, and compare several forms is unheard of in the legal literature and, I warrant, in life as well.

Id. at 1226.

Similarly, it is widely recognized that investors seldom read prospectuses and other disclosure documents that are provided. *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979) (arguing that SEC disclosure rules needed revamping in light of the fact that investors typically did not read the required disclosure documents); Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973) (same); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 682 (1996) [hereinafter Langevoort, *Selling Hope*] ("[A]necdotal evidence, supported by many people's assumptions about investment practices, indicates that most nonprofessional investors do not read the prospectuses and other legal disclosure documents they are given."); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures . . . ."); Kenneth B. Firtel, Note, *Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933*, 72 S. CAL. L. REV. 851, 870 (1999) ("[T]he average investor does not read the prospectus.").

I assume that even Posner and Easterbrook would not give effect to a written disclosure that was not delivered until *after* the sales contract has been entered into. *See, e.g.*, MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1255 (10th Cir. 1989) ("Under the circumstances of this case, where the oral representations were the inducement for the sale and the correct information was not provided to [buyer] MidAmerica prior to the first purchase in this transaction, we decline to impute constructive knowledge of the information contained in the prospectuses to MidAmerica."); Crowell v. Morgan Stanley Dean Witter Servs. Co., Inc., 87 F. Supp. 2d 1287, 1291 (S.D. Fla. 2000) (refusing to dismiss lawsuit where plaintiffs' claim was that defendants orally misled purchasers and purposely did not deliver the accurate prospectuses until after plaintiffs had purchased their shares).

form contract, and then hides successfully behind the unread written provisions in that form contract. Again, I believe that behavioral research will cast question upon the reasonableness of Easterbrook's contractarian approach.

Additionally, these opinions give would-be fraudsters a road map to avoiding the parol evidence rule's[55] fraud exception.[56] An integration clause, in the eyes of most courts, would be insufficient to preclude plaintiffs from adducing evidence that they had been defrauded in statements that did not appear in the written contract.[57] However, by simply adding a sentence of boilerplate in the form of a no-reliance clause ("plaintiff relies on no statements not contained herein") that seemingly adds nothing meaningful to a standard integration clause, defendants can prevent plaintiffs from even having the opportunity to prove they were defrauded, no matter how strong their evidence.

In the following sections, I intend to: (a) examine the consistency of these holdings with congressional intent under the securities laws;[58] (b) analyze the securities law implications of these holdings through a behavioral lens;[59] and (c) examine the broader policy implications of these holdings in light of behavioral scholarship.[60]

III. SAVINGS CLAUSES

A. Congressional Intent: Protect Investors

Before addressing the behavioral implications of these holdings, I must point out that they are inconsistent with the congressional intent that animated passage of the federal securities laws. Congress intended that federal securities law coverage be broadly applied[61] for the purpose

55. A recent summary of the parol evidence rule runs like this:

> As a general rule, extrinsic evidence, whether written or oral, is not admissible to prove either the intent of the parties to a contract or the meaning of contractual terms when the parties have executed an unambiguous, fully-integrated (i.e., final and all-inclusive) written agreement. The trial court may consider various types of extrinsic evidence, however, in determining whether a particular agreement is fully integrated or ambiguous, and even in choosing among rival interpretations of an agreement where ambiguity is not present. If the trial court determines that an agreement is not fully integrated, then the trier of fact may consider extrinsic proof that supplements it. If the trial court determines that an agreement is ambiguous, then the trier of fact may consider extrinsic proof of the parties' contractual intent.

Mark K. Glasser & Keith A. Rowley, *On Parol: The Construction and Interpretation of Written Agreements and the Role of Extrinsic Evidence in Contract Litigation*, 49 BAYLOR L. REV. 657, 660 (1997).

56. Town N. Nat'l Bank v. Broaddus, 569 S.W.2d 489, 494 (Tex. 1978) ("Extrinsic evidence may be admissible for the purpose of vitiating [or avoiding] a written contract where there has been fraud in the inducement.").

57. *See infra* note 85.

58. *See infra* notes 93–100 and accompanying text.

59. *See infra* Part IV.

60. *See infra* Part V.

61. *See generally* Elaine Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 535–39 (1999).

of protecting investors.[62] To that end, it defined the term "security" very broadly[63] and applied the antifraud provisions of section 10(b) of the 1934 Securities Exchange Act to *every* purchase and sale of a security.[64]

The investor protection provisions of section 10(b) and other 1933 and 1934 Act provisions such as sections 11,[65] 12(a)(1),[66] and 12(a)(2)[67] of the '33 Act and section 18(a)[68] of the '34 Act, were generally based upon the concepts underlying the tort of common-law fraud.[69] However, Congress intended the provisions of the '33 and '34 Acts to afford investors remedies that would be *more* effective than the remedies that the pre-1933 common-law provided.[70]

B. The Savings Clauses

Importantly, a Rule 10b-5 suit—or a suit under any of these other provisions—is a tort action.[71] Congress viewed these tort-based remedies

62. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 360–61 (1991) (noting that protecting investors is the main purpose of section 10(b) and other '34 Act provisions); SEC v. Rind, 991 F.2d 1486, 1489 (9th Cir. 1993) (noting that the central goal of the '34 Act was to protect investors); United States v. Bilzerian, 926 F.2d 1285, 1297 (2d Cir. 1991) (same).

63. *See* Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77b(a)(1) (Supp. II 1996); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2000); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967) (pointing out that Congress meant the term "securities" to be broadly defined to protect investors).

64. 15 U.S.C. § 78j(b) (2000). By its express terms, this antifraud provision applies to public companies and private companies, to exchange, over-the-counter, and private transactions, to primary markets and secondary markets, etc.

65. 15 U.S.C. § 77k (2000).

66. *Id*. § 77*l*(a)(1).

67. *Id*. § 77*l*(a)(2).

68. 15 U.S.C. § 78r (1997).

69. The courts have noted that the 10b-5 cause of action is patterned after the common-law *tort* of deceit. *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 546 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983). For example, Hazen notes that "as far back as 1946, the courts followed the normal *tort rule* that persons who violate a legislative enactment may be held civilly liable in damages if they invade an interest of another person that the legislation was intended to protect" in implying a private right of action under section 10(b) and Rule 10b-5. THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 769 (3d ed. 1996) (emphasis added). Hazen also notes the similarity of the elements of a 10b-5 claim and common-law fraud. *Id.* at 770–74; *see also* Legislation, *The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1228 (1933) (noting that section 12 of the 1933 Securities Act is also "susceptible of a construction assimilating the case to one of common law fraud").

70. Because of the broad remedial purposes of the 1934 Act, 10b-5 has been held to reach a wide scope of deceptive activities in securities transactions without regard to the limitations of a common-law action for fraud. Herman & Maclean v. Huddleston, 459 U.S. 375, 389 (1983) ("[A]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry."); James v. Gerber Prods. Co., 483 F.2d 944, 948 (6th Cir. 1973) ("[B]road purpose of investor protection is of course consistent with the broad language of both the statute and the rule."); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943). *See generally* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3857 (3d ed. 1991) ("[T]he common law does not set the outer limits of the SEC fraud provisions."); Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 248 (1933) (detailing the many ways in which section 11 of the 1933 Act eased the plaintiff's burden of proof as compared to a common-law fraud claim).

71. Michael Prozan, *Eliminating the Non-Trading Issuer's Duty to Update: A Proposal to Amend Rule 10b-5*, 1990 COLUM. BUS. L. REV. 339, 345 n.25. Any civil action based upon a statutory violation

as sufficiently important that it provided savings clauses in both the '33 Securities Act and the '34 Exchange Act so that investors could not be induced to waive these remedies by contract. For example, section 14 of the '33 Act provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void."[72] Section 29(a) of the '34 Act is nearly identical.[73]

Thus, Congress did not wish to allow one party to a securities contract to be able to induce the other party to opt out of the securities law protection that the '33 and '34 Acts provide.[74] Congress was particularly concerned with the plight of investors. As the Supreme Court noted in a case involving the '33 Act's savings clause:

> [T]he Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers.[75]

These savings clauses reconfirm that Congress thought it more important to stop fraudulent sellers than to coax investors to be cautious.[76] Judge Posner may be worried about making the securities selling business too risky, but Congress was more concerned with making securities investing activity much safer and thereby restoring national confidence in the securities markets.[77] Therefore, it expressly provided that even intentional waivers of legal protection are ineffective.[78]

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is essentially a tort claim. Swift v. United States, 866 F.2d 507, 509 (1st Cir. 1989); CSX Transp., Inc. v. PKV, Ltd., 906 F. Supp. 339, 341 (S.D. W. Va. 1995); *In re* Cohen, 107 B.R. 453, 455 (Bankr. S.D.N.Y. 1989).

72. 15 U.S.C. § 77n (2000).

73. *Id*. § 78cc(a).

74. *See* Welle, *supra* note 61, at 546 n.159 ("Congress recognized the need for mandatory constraints in securities transactions and adopted the antiwaiver provisions that expressly forbid waiver to protect one party from taking undue advantage of another.").

Apparently the English Company Law upon which the '33 and '34 Acts were based provided that investors could theoretically contract away the protections of the statute. *See* Cacket v. Keswick, [1902] 2 Ch. 456, 476 (Ch. App.) (1901); Greenwood v. Leather Shod Wheel Co., [1900] 1 Ch. 421, 435–38 (Ch. App.) (1899). The enforceability of the waiver seems very constricted in both cases. In any event, Congress was determined to eliminate the possibility of investors opting out of the protections of the '33 and '34 Acts.

75. Wilko v. Swan, 346 U.S. 427, 435 (1953).

76. Sachs, *supra* note 52, at 127.

77. The Senate Report accompanying the '33 Act, for example, provided:

> The aim [of the 1933 Securities Act] is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

Naturally, these provisions prevent not only express waivers, but also contractual provisions that operate to accomplish the same result indirectly.[79] Surely that is what is happening in *Carr* and *Rissman*. By holding that even if investors can prove oral misrepresentations by the sellers of securities, they cannot invoke the antifraud protections of the '34 Act if the sellers' form contract contains a provision that no such misrepresentations were made, or that if they were made plaintiff investors did not rely on them, or that if the investors relied on the representations the representations still were not part of the agreement, the same waiver of remedies functionally occurs. Many cases so hold.[80]

As the First Circuit has noted in *Rogen v. Ilikon Corp.*:[81]

> [W]e see no fundamental difference between saying, for example, "I waive any rights I might have because of your representations or obligations to make full disclosure" and "I am not relying on your representations or obligations to make full disclosure." Were we to hold that the existence of this [non-reliance] provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating section 29(a).[82]

Numerous cases hold that merger clauses and no-reliance clauses are simply ineffective in light of section 29(a).[83] Indeed, to make oral

COMM. ON BANKING AND CURRENCY, REGULATION OF SECURITIES, S. REP. NO. 73-47, at 1 (1933), *reprinted in* I FED. BAR ASS'N SEC. LAW COMM., FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY 1933–1982, at 89 (1983).

78. Numerous cases have applied this provision. *See, e.g.*, Pearlstein v. Scudder & German, 429 F.2d 1136, 1143 (2d Cir. 1970) (dictum), *cert. denied*, 401 U.S. 1013 (1971); Hughes v. Dempsey-Tegeler & Co., No. 71-1299-MML, 1973 U.S. Dist. LEXIS 12055, at *103 (C.D. Cal. Sept. 4, 1973); Special Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185, 1187 (D. Minn. 1971); Allied Artists Pictures Corp. v. Giroux, 312 F. Supp. 450, 451 (S.D.N.Y. 1970); Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569, 572 (E.D. Pa. 1962); Jefferson Lake Sulphur Co. v. Walet, 104 F. Supp. 20, 24 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir. 1953), *cert. denied*, 346 U.S. 820 (1953).

Although some courts advise caution in the matter, e.g., Fox v. Kane-Miller Corp., 398 F. Supp. 609, 624 (D. Md. 1975), *aff'd on other grounds*, 542 F.2d 915 (4th Cir. 1976), most courts hold that *mature* claims may be intentionally waived. Goodman v. Epstein, 582 F.2d 388, 402 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Neuman v. Pike, 456 F. Supp. 1192, 1207 (S.D.N.Y. 1978), *rev'd in part on other grounds*, 591 F.2d 191 (2d Cir. 1979). Otherwise, cases could never be settled.

79. *Special Transp. Servs., Inc.*, 325 F. Supp. at 1187.

80. *See* Esposito v. Sweeney, No. 80-C2861, 1982 U.S. Dist. LEXIS 12753, at *4 (N.D. Ill. May 13, 1982) ("A buyer is not bound by a non-reliance clause simply because it is part of a signed contract.").

81. 361 F.2d 260 (1st Cir. 1966).

82. *Id.* at 268.

83. *See* FS Photo, Inc. v. PictureVision, Inc., 61 F. Supp. 2d 473, 480 (E.D. Va. 1999) (noting that "courts have broadly construed [section 29(a)] to cover not just explicit waivers, but also contractual provisions stating one party's non-reliance on representations made by another party"); Burnett v. Physicians' Online, Inc., No. 94 Civ. 2731, 1997 U.S. Dist. LEXIS 12111, at *21–22 (S.D.N.Y. Aug. 14, 1997) (refusing in light of section 29(a) to grant a motion to dismiss based on a vague merger clause); Folger Adam Co. v. PMI Indus., Inc., No. 87 Civ. 9272, 1990 U.S. Dist. LEXIS 3349, at *15 (S.D.N.Y. Mar. 29, 1990) (holding that section 29(a) prevents defendants from immunizing themselves from federal securities liability via general merger clauses); *Esposito*, 1982 U.S. Dist LEXIS 12753, at *5 ("[I]t is immaterial that a non-reliance or integration clause is part of an agreement. The question of the validity of the clause turns on whether it violates or is prohibited by the federal securities laws.");

misrepresentations to a purchaser of securities and then to induce that purchaser to sign a writing indicating that no such statements had been made should not only be ineffective and void under section 29(a), but should be treated as a "scheme or artifice to defraud."[84] These savings clause provisions are consistent with a long line of cases holding that one may not contract against his fraud.[85] "The law should not and does not

Lanza v. Drexel & Co., No. 64 Civ. 3557, 1970 U.S. Dist. LEXIS 9920, at *42 n.14 (S.D.N.Y. Oct. 9, 1970) (finding that section 29(a) prevents a boilerplate integration clause from barring recovery under the federal securities laws); Schine v. Schine, 254 F. Supp. 986, 988 (S.D.N.Y. 1966) (noting in dicta that "it would be at least highly anomalous . . . to hold under section 29(a) that a party, without knowing the facts, could effectively bar himself by a release from suing for fraud in the transaction of which the release was part").

State law seems to frown on such disclaimers as well. Meason v. Gilbert, 226 S.E.2d 49, 50 (Ga. 1976) ("If in fact there were representations other than those in the prospectus that induced the purchase, the use or misuse of this type of integration clause might in itself be a 'scheme or artifice to defraud' prohibited by the [Georgia securities code]."); Foreman v. Holsman, 141 N.E.2d 31, 32–33 (Ill. 1957) (invalidating a contractual provision wherein plaintiffs agreed to release seller "'from the provisions of the Illinois Securities Act'"); Bridger v. Goldsmith, 38 N.E. 458, 459 (N.Y. 1894) (rejecting the "proposition that a party who has perpetrated a fraud upon his neighbor may nevertheless contract with him, in the very instrument by means of which it was perpetrated, for immunity against its consequences, close his mouth from complaining of it, and bind him never to seek redress").

Many state franchise laws invalidate such disclaimers in franchise agreements for the purpose of protecting franchisees who are, after all, in a situation analogous to securities investors. Peter C. Lagarias, *The Misuse of Integration, No Representation, and No Reliance Clauses in the Name of Contract Certainty*, 18 FRANCHISE L.J. 3, 3 (1998).

84. Federal courts have so ruled. *Esposito*, 1982 U.S. Dist. LEXIS 12753, at *7. State courts have agreed. *Meason*, 226 S.E.2d at 51 (applying Georgia law). The SEC concurs. *In re* Linder, Bilotti & Co., 42 S.E.C. 407, 409 (1964). Indeed, in various releases over the years the SEC has condemned such practices as deceptive. *See, e.g.*, Opinion of General Counsel Relating to Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisers, and Others, Securities Act Release No. 3411, 16 Fed. Reg. 3387 (Apr. 10, 1951) ("[I]n the opinion of [SEC General Counsel Roger S. Foster], the antifraud provisions of the SEC statutes are violated by the employment of any legend, hedge clause or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have . . . ."). Similarly, when arbitration clauses in securities contracts were viewed by courts as generally unenforceable, the SEC issued rulings that it was deceptive to place such clauses in these contracts. C. Edward Fletcher, III, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 442–43 (1987).

85. *See, e.g.*, Dunbar Med. Sys., Inc. v. Gammex, Inc., 216 F.3d 441, 449 (5th Cir. 2000) (applying Texas law to hold that a "sold as is" clause coupled with a clause providing that no other oral representations had been made did not prevent plaintiff from proving defendant's fraud); Turkish v. Kasenetz, 27 F.3d 23, 28 (2d Cir. 1994) (holding that disclaimers do not shield defendants from their fraudulent conduct); *In re* Detlefsen, 610 F.2d 512, 520 n.22 (8th Cir. 1979) (finding that disclaimers are ineffective if the disclaimant fraudulently receives a benefit of his action under Illinois law); RepublicBank Dallas v. First Wis. Nat'l Bank, 636 F. Supp. 1470, 1473 (E.D. Wis. 1986) (applying Wisconsin law to hold in a fraud case that a contractual provision stating that defendant made no representations to plaintiff was void as against public policy in face of a fraud claim by plaintiff); Sperau v. Ford Motor Co., 674 So. 2d 24, 35 (Ala. 1995), *vacated as to punitive damages*, 517 U.S. 1217 (1996) (allowing plaintiffs to prove that defendants had misrepresented the profitability of a franchise notwithstanding a written contractual provision that no representations had been made regarding profitability, because "'[t]o refuse relief [on grounds of the disclaimer] would result in a multitude of frauds and in thwarting the general policy of the law'" (citation omitted)); Reece v. Finch, 562 So. 2d 195, 200 (Ala. 1990) (holding that "releases as to future intentional [torts are] prohibital"); Burton v. Linotype Co., 556 So. 2d 1126, 1127 (Fla. Dist. Ct. App. 1990) ("'Fraud is an intentional tort and thus not subject to the cathartic effect of exculpatory clauses found in contracts.'" (quoting L. Luria & Son, Inc. v. Honeywell, Inc., 460 So. 2d 521, 523 (Fla. Dist. Ct. App. 1984))); Hall v. Crow, 34 N.W.2d 195, 199 (Iowa 1948) (refusing to give effect to a contractual provision providing that defendant had made no representations to plaintiff); Bryant v. Troutman, 287 S.W.2d 918, 920–21 (Ky. 1956) (refusing to give effect to a

permit a covenant of immunity to be drawn that will protect a person against his own fraud. . . . Language is not strong enough to write such a contract. Fraud destroys all consent."[86]

Certainly there are courts that disagree with *Rogen.*[87] These courts draw support from the Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*,[88] which held that an arbitration agreement was enforceable even though plaintiff claimed that it violated section 29(a). These courts often quote *McMahon's* observation that "[w]hat the antiwaiver provision of § 29(a) forbids is enforcement of agreements to waive 'compliance' with the provisions of the statute."[89] The Supreme Court reasoned that merely taking a claim to arbitrators who presumably would enforce the plaintiff's substantive rights rather than to judges did not waive compliance with the statute in violation of section 29(a).

However, the Supreme Court in *McMahon* went on to say that "[s]ection 29(a) is concerned, not with whether brokers 'maneuver[ed customers] into' an agreement, but with whether the agreement

provision in a contract wherein plaintiffs stated that they were not relying on the defendant's verbal statements regarding the property being purchased); Bates v. Southgate, 31 N.E.2d 551, 558 (Mass. 1941) (noting in a fraud case involving a contract providing that defendant made no representations that "'[a]ttempts under the form of contract to secure total or partial immunity from liability for fraud are all under the ban of the law'"); Gibb v. Citicorp Mortgage, Inc., 518 N.W.2d 910, 918 (Neb. 1994) (holding that a contract cannot free a principal from fraud by his agents); Bunting v. Creglow, 168 N.W. 727, 729 (N.D. 1918) (fraud case giving no effect to a contract provision wherein plaintiff represented that he did not rely upon any representations by defendants); Neihaus v. Haven Park West, 440 N.E.2d 584, 586 (Ohio Ct. App. 1981) ("'Fraud which enters into the actual making of a contract cannot be excluded from the reach of the law by any formal phrase inserted in the contract itself.'" (citation omitted)); Carty v. McMenamin, 216 P. 228, 230–31 (Or. 1923) (noting in a case involving a contractual provision stating that defendants made no representation about the subject of the fraud that "[i]f a party is guilty of fraud in making a contract, he cannot exculpate himself from the consequences of his own wrong by a provision in writing that his fraudulent oral representations shall not be used as evidence against him in a case in which fraud and deceit is the gist of the cause"); Dallas Farm Mach. Co. v. Reaves, 307 S.W.2d 233, 239 (Tex. 1957) (noting that the great weight of authority refuses to give effect in fraud cases to written representations in contracts that no oral representations were made); Dieterich v. Rice, 197 P. 1, 13 (Wash. 1921) (stating that a contractual provision wherein plaintiff represented that he had not relied on any sayings or inducements by defendant was worth no more than a piece of waste paper in a fraud case); Baylies v. Vanden Boom, 278 P. 551, 556–59 (Wyo. 1929) (giving no efficacy to a contractual provision stating that plaintiff relied on no statements by defendant not contained in the writing).

86. Ganley Bros., Inc. v. Butler Bros. Bldg. Co., 212 N.W. 602, 603 (Minn. 1927) (involving a provision in a contract wherein plaintiff supposedly represented that it did not rely upon any statement made by defendant).

87. The leading case is *Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996). The decision is curious in that the court: (a) notes in light of *McMahon* that the key question "boils down to whether [the written agreement's 'no other representations' and merger clauses] weaken Harsco's ability to recover under § 10(b);" and (b) states that "[t]here can be no question that the Agreement 'weakens' Harsco's ability to recover," and then, contradictorily, decides that section 29(a) has not been violated. *Id*. The court emphasizes that Harsco was a sophisticated commercial entity that willingly agreed to sign the contract, although this is clearly irrelevant under the statute. *Id.; see also* AES Corp. v. Dow Chem. Co., 157 F. Supp. 2d 346, 353 (D. Del. 2001) (stressing the sophisticated nature of both parties); Dimon, Inc. v. Folium, Inc., 48 F. Supp. 2d 359, 367–71 (S.D.N.Y. 1999) (recognizing an exception to the *Harsco* rule when the information that was the subject of the alleged oral fraud was within the peculiar knowledge of defendant).

88. 482 U.S. 220 (1987).

89. *Id.* at 228.

'weaken[s] their ability to recover under the [Exchange] Act.'"[90] A contractual provision that asks investors to take their claims before arbitrators who (the Supreme Court was willing to assume) will enforce the substantive law of the '34 Act does not "weaken their ability to recover." In contrast, a contractual provision that denies investors even the opportunity to attempt to prove that they were defrauded undeniably does weaken their ability to recover.[91]

Additionally, a major underpinning of *McMahon* was the strong federal policy in favor of arbitration embodied in the Federal Arbitration Act.[92] There is no comparable countervailing federal policy at stake in the case of the no-reliance clauses that would justify overriding the investor protection policy of the federal securities laws.

C. Undermining Congressional Intent

Providing contractual cover for fraudsters is a particularly questionable notion because strong enforcement of antifraud provisions (a) has been empirically linked to efficient equity markets,[93] and (b) develops

90. *Id.* at 230 (quoting Wilko v. Swan, 346 U.S. 427, 432 (1953)).

91. Kevin Davis, *Licensing Lies: Merger Clauses, The Parol Evidence Rule and Pre-Contractual Misrepresentations*, 33 VAL. U. L. REV. 485, 528 (1999) (noting that a court that enforces an arbitration clause is not condoning fraud, but simply allowing a body other than a court to make the necessary factual and legal determinations).

92. 482 U.S. at 226.

93. Cross-national empirical comparisons have: (a) linked better investor protections with more valuable stock markets, larger quantities of listed securities per capita, and higher IPO activity, Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1132–33 (1997); (b) found that firms in countries with better protection of minority shareholders from the depredations of majority shareholders tend to be valued higher, RAFAEL LA PORTA ET AL., INVESTOR PROTECTION AND CORPORATE VALUATION 4 (Working Paper, Oct. 1999), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=192549; (c) discovered that in Poland strict enforcement of U.S.-style securities laws was associated with rapid development of a new western-style stock market whereas in the neighboring Czech Republic hands-off regulation was associated with a near-collapse of a similarly new stock market, Edward Glaeser, *Coase Versus the Coasians*, 116 Q. J. ECON. 853 (2001); (d) learned that countries that enforced insider trading laws had a lower cost of equity, Utpal Bhattacharya & Hazen Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002), and more liquid equity markets, LAURA N. BENY, A COMPARATIVE EMPIRICAL INVESTIGATION OF AGENCY AND MARKET THEORIES OF INSIDER TRADING 19 (Harv. John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 264, 1999), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/264.pdf; and (e) found that firms in countries with active stock markets and high compliance with legal norms are able to grow faster and more readily access outside equity, Alsi Demirgüç-Kunt & Vojislav Maksimovic, *Law, Finance, and Firm Growth*, 53 J. FIN. 2107, 2134 (1998). Other studies have made similar findings. *See, e.g.*, Bernard S. Black, *Information Asymmetry, the Internet, and Its Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91 (1998) (arguing that control of information asymmetries is critical for building efficient stock markets); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1999) ("[O]nly those legal systems that provide significant protections for minority shareholders can develop active equity markets."); Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141 (2000) (finding evidence that countries with better protections for minority shareholders suffered milder financial crises in 1997–98); Maria Maher & Thomas Andersson, *Corporate Governance: Effects on Firm Performance and Economic Growth*, *in* CONVERGENCE AND DIVERSITY IN CORPORATE GOVERNANCE REGIMES AND CAPITAL MARKETS 36 (Joseph A. McCahery et al. eds., forthcoming) (on file with University of Illinois Law Review) (observing that "the empirical evi-

the norms that are so helpful in promoting trust which is, in turn, critical to the performance of honest and efficient equity markets.[94] Welle agrees:

> By prohibiting fraud and mandating disclosure, the securities laws protect investors and promote honesty, trust, and ethical behavior in commercial transactions. The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior. The antiwaiver provisions and the mandatory nature of the securities laws send a strong signal that certain behavior will not be tolerated in any transaction involving a security.[95]

A contractarian approach that allows unfettered private ordering of securities transactions is clearly inconsistent with Congress's inclusion of savings clauses in the '33 and '34 Acts. Just as clearly, it undermines the efficiency goals Congress envisioned by reducing the confidence that in-

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dence to date [from OECD countries] seems to suggest that . . . protection of minority shareholders is critical to the development of equity markets"); KATHARINA PISTOR ET AL., LAW AND FINANCE IN TRANSITION ECONOMIES 15–16 (European Bank for Reconstr. & Dev., Working Paper No. 49, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214648 (finding that both written laws and effective legal institutions are necessary to allow firms to gain optimal access to external finance); Edward B. Rock, *Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century*, 2 THEORETICAL INQUIRIES IN LAW 237 (2001) (arguing that neither private ordering nor self-help, but corporate-law protections account for the elimination of many of the frauds and schemes that occurred in stock markets a century ago but do not occur today). All this has led La Porta and his colleagues to recently conclude that "[s]uch diverse elements of a countries' financial systems as the breadth and depth of their capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation appear to be explained both conceptually and empirically by how well the laws in these countries protect outside investors." Rafael La Porta et al., Investor Protection and Corporate Governance 1 (unpublished working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183908 (last visited Dec. 3, 2002). Similarly, they note that whether private contracting is a better approach than government-enforced regulations is an empirical question and all the recent studies "reject[] the hypothesis that private contracting is sufficient." *Id.* at 6. *See generally* Prentice, *Whither Securities Regulation?*, *supra* note 2, at 495–99; *supra* note 2 and accompanying text (discussing these and other studies). *But see* Amir N. Licht et al., Culture, Law, and Finance: Cultural Dimensions of Corporate Governance Laws (June 2001) (unpublished working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=277613 (challenging methodology and conclusions of a variety of La Porta's studies).

94. *See* Branson, *supra* note 9, at 4 (noting that reducing investor protection from fraud will ultimately "have an effect inimical to capital formation in this country"); Davis, *supra* note 91, at 514 ("A society in which internalization of norms of honesty is widespread will benefit by having less need to choose between resorting to the legal system to coerce honesty or else incurring the losses that flow from having members of a distrustful society take costly precautions against being victimized. These benefits are virtually impossible to measure but may be substantial. These factors weigh against adopting any legal rule that allows individuals to escape personal liability for fraud." (footnotes omitted)); PETER H. HUANG, REGULATING SECURITIES PROFESSIONALS: EMOTIONAL AND MORAL ASPECTS OF FIDUCIARY INVESTING 4–5 (USC CLEO Research Paper No. C01-6, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276119 (noting that imposition of a fiduciary duty upon securities professionals will improve their behavior by adding a sense of guilt to other motivations, such as reputational concerns, to act in the clients' best interests); Steven Shavell, *Law Versus Morality as Regulators of Conduct*, 4 AM. L. & ECON. REV. 227, 254 (2002) (noting that "legal rules can affect our moral beliefs as well as the operation of the moral sanctions"). *See generally* Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1500–02; *supra* note 2 and accompanying text (discussing evidence supporting the argument that a lack of integrity pervades equity markets).

95. Welle, *supra* note 61, at 541 (footnotes omitted).

vestors can reasonably have in the securities markets. Although the 1933 and 1934 Senators and Representatives could not have been conversant with the literature of modern behavioral theory, they did have decades, if not centuries, of economic history to draw upon to conclude, as they apparently did, that all investors are susceptible to fraud and sharp practices and that government should provide protection from such practices and prevent investors from forfeiting such protection.[96]

Just as a party who can extort money from another can just as easily also extort from the victim a waiver of the right to complain about the extortion, a party who can induce another to enter into a fraudulent transaction can easily induce the victim to waive his rights to complain about the fraud. To amend Judge Posner's phraseology, "a very simple, very basic, very sensible principle" of the practice of fraud is that if your lies can convince an investor to purchase bogus stock, they can convince the investor to sign a contract representing that the lies were never made or not relied upon.[97] Judge Augustus Hand noted some time ago:

> It is worth remembering that the ingenuity of draftsmen is sure to keep pace with the demands of wrongdoers, and if a deliberate fraud may be shielded by a clause in a contract that the writing contains every representation made by way of inducement, or that utterances shown to be untrue were not an inducement to the agreement, sellers of bogus securities may defraud the public with impunity, through the simple expedient of placing such a clause in the prospectus which they put out, or in the contracts which their dupes are asked to sign.[98]

The most fraudulent actors are the most likely to include such disclaimers and integration clauses in their contracts and the most inexperienced investors are the most likely to sign them without protest.[99] Congress clearly intended to protect those innocent investors.[100] *Carr* and *Rissman* just as clearly strip that protection away, doing violence to a congressional policy that neither case even mentions. These decisions erect a large sign that tells fraudsters: "Don't place in the contract 'I

96. *See id.* at 533–39.

97. Fortunately, some courts recognize this. For example, in *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974), defendants allegedly told plaintiff investor that the shares she was purchasing were easily negotiable. However, on the face of the certificates that were later delivered to her was a legend indicating nonnegotiability. The court, framing the matter as whether plaintiff had justifiably relied on the oral misrepresentations, held for the investor, noting that plaintiff's

> reliance on the statements of these two men would not seem to indicate a lack of diligence but rather a justifiable reliance. As to her alleged receipt of actual notice from the legend, the oral statement indicating the stock was negotiable could easily have satisfied any question the legend raised in the mind of this unsophisticated investor.

Id. at 552–53; *see also* Hackbart v. Holmes, No. 77-F-1149, 1978 U.S. Dist. LEXIS 7074, at *9 (D. Colo. Dec. 21, 1978) (similar holding).

98. Arnold v. Nat'l Aniline & Chem. Co., 20 F.2d 364, 369 (2d Cir. 1927). In another context, Eric Posner notes that attorneys who draft contracts pay attention to court rulings and draft accordingly. ERIC A. POSNER, LAW AND SOCIAL NORMS 163 (2000).

99. Welle, *supra* note 61, at 546.

100. *Id.* at 547.

waive my rights.' Include instead, 'I didn't rely on your promises.'" Either clause is easily inserted into contractual boilerplate. Both are virtually meaningless to a purchaser confronted with a form contract. Both, if enforced, effectively eliminate any protection for investors under section 10(b) in direct and blatant violation of section 29(a).

IV. Behavioral Analysis

What would lead an investor who has received and relied upon oral factual representations and/or promises from her broker or some other seller (e.g., "this company will go public next quarter," "this company is in merger negotiations," "this company will soon announce record profits," "this company is about to launch a new product," etc.) to sign a contract containing a disclaimer, and/or a merger clause? Stupidity and laziness are obvious candidates. Even if those are the only explanations, the securities laws should not allow liars to take advantage of the stupid and the lazy.[101] Fraud is a worse sin than sloth or gullibility, and it is more injurious to the securities markets. We need not worry about which is the lesser evil, however, because behavioral factors provide much less blameworthy explanations for this common investor behavior.

A. Rational Ignorance

Personally, I neither read most of the contracts I sign nor know anyone who does. I do not believe that this makes me unusually irrational, particularly stupid, or unreasonably lazy.[102] Unlike the hypothetical *homo economicus* of traditional economic analysis,[103] most people re-

101. The Supreme Court has stated, somewhat harshly perhaps, that the securities laws are aimed at "protect[ing] the weak, the uninformed, the unsuspecting, and the gullible from the exercise of their own volition." Paris Adult Theatre I v. Slaton, 413 U.S. 49, 64 (1973).

The securities laws are meant to protect even the sophisticated from fraud, as well they should be.

> Not even in the business world—that one area of social life where the "battle of wits" competitive-game model is most persuasive, and people match the shrewdness of their judgments and the cleverness of their stratagems for getting the better of one another—not even here do rivals voluntarily assume the risk that the other party to an agreement is an outright liar, getting the better of one by plain deceit.

3 Joel Feinberg, The Moral Limits of the Criminal Law: Harm to Self 285 (1986).

102. It does, apparently, put me in the same class with other lawyers and law professors (and most everyone else). *See* Rakoff, *supra* note 54, at 1179 n.22 (noting that author's informal survey indicates that lawyers and law professors do not typically read most form contracts they sign); *see also* Richard L. Hasen, Comment, *Efficiency Under Informational Asymmetry: The Effect of Framing on Legal Rules*, 38 UCLA L. Rev. 391, 412–13 (1990) ("[E]mpirical data suggest that consumers frequently do not read, understand, or remember product warnings.").

103. Economic analysis is largely built upon the premise that man is a completely rational decision maker. As Waller has described this assumption:

> Individuals are assumed to act *as if* they maximize expected utility. That is, an individual's preferences are taken as given, consistent, and representable in the form of a utility function. An individual knows a priori the set of alternative actions and chooses the action with the highest utility or expectation thereof. When uncertainty exists as to the actions' consequences, an individual can assess the probability distribution corresponding to his or her knowledge. When new information may be collected from the environment, an individual knows the information's possible

alize that they have neither the time nor the energy to read and comprehend all the contracts they sign, so they remain "rationally ignorant."[104] As Herbert Simon put it, most people sensibly "satisfice" rather than strive for optimal decision making.[105] Given the high costs of gathering *all* relevant information, time constraints on studying that information, and other human limitations, "it [is] clear that in some cases, paradoxically, *it would be irrational to become fully informed.*"[106]

Although some courts have explicitly imposed a "duty to read" upon parties to contracts[107] (as the *Carr-Rissman* line of cases does im-

> content and can assess, in accord with Bayes' theorem, the probability distribution conditioned on the conjunction of such content and his or her prior knowledge.

William S. Waller, *Decision-Making Research in Managerial Accounting: Return to Behavioral-Economics Foundations*, *in* JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING 29, 32 (Robert H. Ashton & Alison H. Ashton eds., 1995).

The rational economic man is as mythical as the common law's "reasonable man":

> [The reasonable man] is one who invariably looks where he is going, and is careful to examine the immediate foreground before he executes a leap or bound; who neither star-gazes nor is lost in meditation when approaching trap doors or the margin of a dock; . . . who never mounts a moving omnibus, and does not alight from any car while the train is in motion; . . . and who informs himself of the history and habits of a dog before administering a caress . . . .

A. P. HERBERT, UNCOMMON LAW 3–4 (1991 ed.).

104. Goldberg notes initially that "the cost of acquiring and processing information on contract terms is much greater than for price; unless the firm intentionally makes the particular term an important selling point—as is sometimes the case with the length or inclusiveness of the warranty—few, if any, customers will perceive the existence of variations in terms." Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 485 (1974) [hereinafter Goldberg, *Institutional Changes*].

105. HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR, at xxiv (2d ed. 1957).

Although it is clear beyond cavil that real people are not rational in the way that traditional economic analysis assumes (or anywhere near it), there is a strong line of research indicating that many of the heuristics and biases of human decision making that vary from the hypothesized rational economic man are adaptive and quite effective in some circumstances. *See generally* GERD GIGERENZER, ADAPTIVE THINKING: RATIONALITY IN THE REAL WORLD (1999); GERD GIGERENZER & REINHARD SELTEN, BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX (2001).

106. Owen D. Jones, *Time-Shifted Rationality and the Law of Law's Leverage: Behavioral Economics Meets Behavioral Biology*, 95 NW. U. L. REV. 1141, 1151 (2001) (emphasis added).

This means, among other things, that the economic theory of the "rational man" is a poor description of how people, even smart, careful people, actually behave. *See* HERBERT SIMON, REASON IN HUMAN AFFAIRS 13 (1983) ("Conceptually, the SEU [Subjective Expected Utility] model is a beautiful object deserving a prominent place in Plato's heaven of ideas. But vast difficulties make it impossible to employ it in any literal way in making actual human decisions."); Kenneth G. Dau-Schmidt, *Law and Society & Law and Economics: Common Ground, Irreconcilable Differences, New Directions: Economics and Sociology: The Prospects for an Interdisciplinary Discourse on Law*, 1997 WIS. L. REV. 389, 397 ("The assumptions of the neoclassical model are clearly unrealistic, and the importance of this lack of realism has been a matter of some debate both within and outside the discipline."); Paul J. H. Schoemaker, *The Expected Utility Model: Its Variants, Purposes, Evidence and Limitations*, 20 J. ECON. LIT. 529, 530 (1982) ("[M]ost of the empirical evidence is difficult to reconcile with the principle of [expected utility] maximization.").

107. *See, e.g.*, Foremost Ins. Co. v. Parham, 693 So. 2d 409, 421 (Ala. 1997); Alarmani v. Conn. Humane Soc'y, No. CV990498685S, 2000 Conn. Super. LEXIS 3356 (Conn. Super. Dec. 8, 2000). *See generally* 1 SAMUEL WILLISTON & RICHARD A. LORD, WILLISTON ON CONTRACTS 4:16 (4th ed. 1990) ("It will not do for a man to enter into a contract and when called upon to respond to its obligations, to say that he did not read it when he signed it or knew what it contained.").

Notwithstanding the many cases noting the duty to read, Farnsworth observes:

> No simple pattern emerges from the cases. Some courts have denied relief on the basis of the recipient's "clear neglect in signing the contract without ascertaining its contents." However, the trend is in the other direction, particularly if some artifice has been used to prevent the recipient

plicitly), "[a] person today who refused to contract unless he understood what he was committing himself to would deny himself most of the means of living in society."[108] Sensible consumers/investors do not read most of the contracts they sign, and sellers and issuers know this so well that they often dispense with even showing the contract to the consumer/investor.[109] It is commonplace for form givers to tell form takers that the contract's terms are "just boilerplate" and not worth reading.[110]

Even Judge Posner has noted the informational costs that make rational ignorance so typically rational:

> Contracts are costly to make and . . . costs may well exceed the benefits . . . when the contingencies that would be regulated by contract—death or personal injury from using a product—are extremely remote. [When a consumer purchases an expensive item like a car] the greatest [contracting] cost [is] not the direct cost of drafting; it [is] the cost of information. The inclusion of . . . a clause [specifying rights and duties in the event of a remote contingency such as death or personal injury] would not serve its intended purpose unless the consumer knew something about the costs of alternative safety measures that the producer might take and about the safety of competing products and brands. But the cost of generating that information, and particularly the cost to the consumer of

> from reading the writing or if consumers are involved. There is appeal in the argument that, as one court expressed it, the fact that the fraud worked because the victim was "careless . . . did not render it any less a fraud."

E. ALLAN FARNSWORTH, CONTRACTS 248 (1982) (quoting Schupp v. Davey Tree Expert Co., 209 N.W. 85, 86 (Mich. 1926) (no duty to read); Dowagiac Mfg. Co. v. Schroeder, 84 N.W. 14, 14 (Wis. 1900) (duty to read)).

108. W. DAVID SLAWSON, BINDING PROMISES: THE LATE 20TH-CENTURY REFORMATION OF CONTRACT LAW 21 (1996) [hereinafter SLAWSON, BINDING PROMISES]. Rakoff agrees, noting:

> Once form documents are seen in the context of shopping (rather than bargaining) behavior, it is clear that the near-universal failure of adherents to read and understand the documents they sign cannot be dismissed as mere laziness. In the circumstances, the rational course is to focus on the few terms that are generally well publicized and of immediate concern, and to ignore the rest. The ideal adherent who would read, understand, and compare several forms is unheard of in the legal literature and, I warrant, in life as well.

Rakoff, *supra* note 54, at 1226.

109. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (1979) ("A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms."); SLAWSON, BINDING PROMISES, *supra* note 108, at 32 ("Consumers so regularly fail to read standard contracts that in industries with especially long and complicated contracts, producers often dispense even with the formality of showing the contract to the consumer and having him or her sign it.").

110. Sellers certainly have incentives to discourage buyers from reading the contracts. Individualized negotiation defeats desired uniformity and slows down the sales process. Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263, 1270 (1993) [hereinafter Meyerson, *Objective Theory*].

Branson notes: "One method many salespersons employ is, after allowing the customer to peruse the offering document for a short time, the salesperson intervenes by stating, 'Don't pay any attention to that. Now here's the deal.' The deal then presented is greatly exaggerated or consists of projections that have no basis in fact and no due diligence behind them." Branson, *supra* note 9, at 22.

absorbing it, may well be disproportionate to the benefit of a negotiated (as distinct from imposed-by-law) level of safety.[111]

When brokers or promoters present investors with lengthy written contracts to sign, investors, just like consumers of consumer products,[112] tend to sign without reading them in any detail,[113] especially after they have decided to trust the seller.[114] Typically it is simply not worth the commitment of time and mental energy for an investor to master all the details of a complex contract,[115] especially when the seller's agent likely does not know its provisions herself[116] and has no authority to alter them anyway.[117] Consumers and investors not only think that adhesion con-

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111. WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 280–81 (1987).

Some game theorists have posited that it is, in many factual scenarios, rational for buyers to decide not to read seller-provided form contracts. *See, e.g.*, Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 282–93 (1990) (noting "the fact that the decision to spend resources becoming informed must precede the information that reveals whether it is worth doing so, and that the drafters of form contracts have the incentive to take advantage of this. . . . [And] it is just this fact that makes reading [them] irrational.").

112. *See* Jennifer L. Gerner & W. Keith Bryant, *Appliance Warranties as a Market Signal*, 15 J. CONSUMER AFFAIRS 75, 78–79 (1981) (explaining why rational ignorance means that many consumers "can be expected to disregard actual warranty provisions"); Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 598 (1990) [hereinafter Meyerson, *Efficient Consumer*] ("[T]he sheer number of terms to be analyzed in the typical form contract imposes too great a burden for the consumer.").

113. They likely will read the few parts that have been actively bargained over—typically price and delivery terms. As for the rest, "the adhering party is in practice unlikely to have read the standard terms before signing the document and is unlikely to have understood them if he has read them. Virtually every scholar who has written about contracts of adhesion has accepted the truth of this assertion, and the few empirical studies that have been done have agreed." Rakoff, *supra* note 54, at 1179; *see also* Arthur Leff, *Contract as a Thing*, 19 AM. U. L. REV. 131, 157 (1970) ("Many people don't read contracts at all. . . . Some people would sign a contract even if 'THIS IS A SWINDLE' were embossed across its top in electric pink.").

114. Langevoort, *Selling Hope*, *supra* note 54, at 682–84 (noting that investors rely on brokers' oral representations rather than reading disclosure documents as a way to save time and expense and are particularly likely to do so where they trust the broker). Langevoort notes:

> Reading a prospectus after accepting the recommendation of a broker whom the customer is inclined to trust, then, is inconsistent with several phenomena: (1) the time-saving and responsibility-shifting reasons for using that broker in the first place, (2) the cognitive commitment to the broker as a credible source of recommendations, and (3) the preference for making the investment. The motivation is *not* to read unless suspicions have otherwise been aroused.

Id. at 683–84.

115. *See* Ronald A. Dye, *Costly Contract Contingencies*, 26 INT'L ECON. REV. 233, 236–37, 245–46 (1985) (noting that negotiation "costs" may justify a decision by parties to enter into incomplete contracts).

116. In his classic article on contracts in business, Macaulay noted that "salesmen and purchasing agents, the operating personnel, typically are unaware of what is said in the fine print on the back of the forms they use." Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOCIOLOGICAL REV. 55, 58 (1963).

117. *See* Rakoff, *supra* note 54, at 1225 ("Customers know well enough that they cannot alter any individual firm's standard document."). Form contracts often contain provisions stating that agents signing on behalf of the form providers have no authority to alter the form contract. *See, e.g.*, Velasquez v. Crown Life Ins. Co., No. CIV.A. 97-064-M, 1999 U.S. Dist. LEXIS 13186, at *9 (S.D. Tex. Aug. 10, 1999) (insurance contract); Gold Star v. Manshul Constr. Corp., No. CIV. 93-4213-SS, 1995 U.S. Dist. LEXIS 5120, at *21 (S.D.N.Y. Apr. 19, 1995) (construction contract); Miller v. Dobbs Mobile Bay, Inc., 661 So. 2d 203, 206 (Ala. 1995) (insurance contract).

tracts are generally nonnegotiable,[118] they are correct (practically speaking) in so thinking.[119] As Eisenberg has pointed out:

> The bottom line is simple: The verbal and legal obscurity of preprinted terms renders the cost of searching out and deliberating on these terms exceptionally high. In contrast, the low probability of these nonperformance terms' coming into play heavily discounts the benefits of search and deliberation. Furthermore, the length and complexity of form contracts is [sic] often not correlated to the dollar value of the transaction.[120]

B. Overoptimism, Overconfidence, and the Illusion of Control

Most people tend toward overoptimism[121] and overconfidence,[122] both generally and when they act as consumers or investors. These tendencies shape risk perception, causing people to underestimate the extent to which they are at risk.[123] Relatedly, because of the illusion of control,[124] people tend to think that they can exert control over purely

118. Arthur Leff pointed out that purchasers of insurance policies tend to think of the policy not as a contract but as the item that they are purchasing and as a result do not believe they are able to change the contract's terms. Leff, *supra* note 113, at 147–57.

119. Shell tells an interesting story regarding the heroic efforts that he, as a lawyer and an academic, had to undertake to change a brokerage firm adhesion contract's choice-of-law provision *that had already been ruled in violation of applicable rules by the New York Stock Exchange.* G. Richard Shell, *Fair Play, Consent and Securities Arbitration: A Comment on* Speidel, 62 BROOK. L. REV. 1365, 1369–70 (1996) [hereinafter Shell, *Fair Play*].

120. *See* Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 243 (1995).

121. *See, e.g.*, Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW & HUM. BEHAV. 439, 443 (1993) (reporting that people realize that half of married couples will divorce but place their own chance at zero); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 809–14 (1980) (finding, among other symptoms of overconfidence, that six times as many college students believed they were *more* likely to own their own home than the average person than believed they were less likely to do so).

122. *See* MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 95 (4th ed. 1998) ("[P]eople have been found to perceive themselves as being better than others across a number of traits, including honesty, cooperativeness, rationality, driving skill, health, and intelligence."). *But see* Peter Justin, *The Overconfidence Phenomenon as a Consequence of Informal Experimenter-Guided Selection of Almanac Items*, *in* JUDGMENT IN MANAGERIAL DECISION MAKING, *supra*, at 544, 553 (arguing that some of the studies cited as showing overconfidence have design flaws that inflate the amount of overconfidence); Joshua Klayman et al., *Overconfidence: It Depends on How, What, and Whom You Ask*, 79 ORG. BEHAV. & HUM. DECISION PROCESSES 216, 217 (1999) (reporting studies not finding as much overconfidence as many previous studies, but nonetheless confirming that "there are systematic differences between subjective confidence judgments and observed accuracy" and that "[t]he more confident people are, the more overconfident they are, and, overall, confidence tends to exceed accuracy").

123. *See, e.g.*, Weinstein, *supra* note 121, at 806.

124. People seem to have a psychological need to believe that they can control their surroundings, including random events. Studies show that people are willing to bet more in a lottery if they choose the numbers themselves than if someone else chooses the numbers, even though the statistical chance of winning is unaffected. People also tend to throw dice harder if they want high numbers and softer if they want low numbers. *See generally* BAZERMAN, *supra* note 122, at 95 (discussing "illusion of control"); Ellen J. Langer, *The Illusion of Control*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS

random events, leading them to conclude that their chances of avoiding injury are "inappropriately higher than the objective probability would probably warrant."[125]

In combination, overoptimism, overconfidence, and the illusion of control lead people to tend to believe that good things will happen to them and that they will escape the bad things that happen to other people. Consequently, investors tend toward overoptimism that their investments will do well[126] and overconfidence that they can avoid being victimized by the fraud that strikes others. These tendencies often prevent people from being sufficiently wary that they may be defrauded. These cognitive biases leave investors vulnerable to fraudsters and willing to sign contracts that do not truly reflect the reality of their agreement. Indeed, empirical studies show that they will believe that the terms of their contracts are more favorable to them than they actually are.[127]

C. Probabilities and Future Events

Behavioral research indicates that people are simply not especially skilled at calculating probabilities in general.[128] They tend to substitute simple rule-of-thumb heuristics for statistical accuracy.[129] In particular, they underestimate low probability risks, even when those risks carry, as securities fraud does, the potential for great loss.[130] For example, con-

AND BIASES 231, 238 (Daniel Kahneman et al. eds., 1982) [hereinafter JUDGMENT UNDER UNCERTAINTY].

125. PETER ASCH, CONSUMER SAFETY REGULATION 76 (1988).

126. *See* Werner I. M. De Bondt, *A Portrait of the Individual Investor*, 42 EUROPEAN ECON. REV. 831, 839 (1998) (finding that investors tend toward overoptimism).

127. *See* Warren Mueller, *Residential Tenants and Their Leases: An Empirical Study*, 69 MICH. L. REV. 247, 274–75 (1970) (finding that tenants did not understand their contracts, but perceived that the terms were more favorable to them than they actually were).

128. Paul Slovic & Sarah Lichtenstein, *Comparison of Bayesian and Regression Approaches to the Study of Information Processing in Judgment*, 6 ORG. BEHAV. & HUM. PERFORMANCE 649, 724 (1971) (noting that people have a very difficult time weighting and combining information to make probabilistic decisions and therefore "resort to simplified decision strategies, many of which lead them to ignore or misuse relevant information").

129. Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 124, at 32 ("[P]eople do not follow the principles of probability theory in judging the likelihood of uncertain events.").

130. Colin V. Camerer & Howard Kunreuther, *Decision Processes for Low Probability Risks: Policy Implications*, 8 J. POL'Y ANALYSIS & MGMT. 565, 570 (1987) (analyzing how people make judgments about unlikely events with potentially serious consequences); Paul Slovic et al., *Regulation of Risk: A Psychological Perspective*, *in* REGULATORY POLICY AND THE SOCIAL SCIENCES 241, 260 (Roger G. Noll ed., 1985) (discussing decision making in the face of low probability events).

Evidence of this tendency comes from the fact that most people do not use seatbelts absent legal requirements or buy flood insurance when it is available. *See* Richard J. Arnould & Henry Grabowski, *Auto Safety Regulation: An Analysis of Market Failure*, 12 BELL J. ECON. 27, 29 (1981) (seatbelts); Howard Kunreuther, *Limited Knowledge and Insurance Protection*, 24 PUB. POL'Y 227, 255 (1976) (flood insurance).

sumers tend to overdiscount the long-term risk of product failure in favor of the more immediate gratification of a product with a lower price.[131]

Just as product failures occur relatively infrequently,[132] so do investor frauds.[133] Thus, they are low-probability events that investors tend to ignore. This tendency is exacerbated by the tendency of investors and other people to discount the risk of things that might happen well into the future.[134] So, if at the time of contracting, investors see nothing but safety on the near horizon, they will strongly tend to underappreciate the risk of being defrauded.[135] Buyers "rarely consider even the possibility of a subsequent legal action. Courts and sellers should realize that consumers do not knowingly assent to terms that effectively discard their legal rights."[136] Investors are the same.[137] If they trust their securities seller, and therefore underestimate the likelihood of being defrauded, investors will, in turn, inadequately appreciate the danger of signing a contract containing disclaimers and related clauses, even if they happen to be aware of them.

D. False Consensus Effect and Personal Positivity Bias

The false consensus effect causes people to tend to believe that others see the world as they do.[138] Therefore, honest people do not tend to

131. William C. Whitford, *Comment on a Theory of the Consumer Product Warranty*, 91 YALE L.J. 1371, 1383 (1982); *see also* Hasen, *supra* note 102, at 414 ("[C]ognitive research demonstrates that consumers generally mistake low probabilities for zero probability, such as when they ignore the small but definite risk of contracting lung cancer.").

132. Meyerson, *Efficient Consumer*, *supra* note 112, at 599 (noting that "[b]ecause most contracts do not result in any loss to consumers, and because consumers lack knowledge about the likelihood of any particular loss, consumers tend to treat the risk as too insubstantial to protect against; therefore, they do not read the contract, let alone attempt to negotiate terms").

133. Even though Enron and related scandals prove that there is too much fraud in the American securities markets, there are literally millions of securities transactions every day so fraudulent events remain a relatively low probability for any individual transaction.

134. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1676 (1989) ("[I]ndividuals systematically underestimate future risk . . . [and] tend to discount excessively the risk of future exploitation."); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1184 (1997) ("People's judgments about their experience at the time of decision can be mistaken; they may have a hard time assessing what the experience will actually be like.").

135. In another context, Sunstein has hypothesized that because employees may engage in wishful thinking about their future relationship with their employer, they might well waive the right to be free from arbitrary discharge. Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. REV. 106, 122 (2002) [hereinafter Sunstein, *Switching the Default*].

136. Meyerson, *Objective Theory*, *supra* note 110, at 1301.

137. *See* Shell, *Fair Play*, *supra* note 119, at 1369 ("Even if customers do read the boilerplate [in a stockbroker's form contract], they are unlikely to focus on the seemingly remote contingency that they will someday want to sue their broker.").

138. *See generally* Colin F. Camerer, *Individual Decision Making*, *in* THE HANDBOOK OF EXPERIMENTAL ECONOMICS 587, 612–13 (John H. Kagel & Alvin E. Roth eds., 1995) (explaining the phenomenon); Lee Ross et al., *The "False Consensus Effect": An Egocentric Bias in Social Perception and Attribution Processes*, 13 J. EXPERIMENTAL SOC. PSYCHOL. 279 (1977) (same). One interesting impact of the false consensus effect is that it causes investors to tend to believe that other investors will

expect to be treated dishonestly.[139] Unsurprisingly, people who are less trustworthy themselves trust others less, and people who are more trustworthy themselves tend to trust others more and thereby to be more vulnerable to fraud.[140]

A customer who has chosen a stockbroker as his/her personal representative in the stock market, for example, will tend to believe that the stockbroker is honest. The judgments we make about other individuals tend to be favorable rather than unfavorable, in part because of what is known as the personal positivity bias.[141] For example, studies show that the public's attitude toward individual politicians has remained positive even as its views of the political process have become increasingly negative.[142] Similarly, investors will tend to perceive others in a generally positive light and specifically expect, sometimes naively, that they will be treated honestly. Furthermore, the concept of cognitive dissonance means that once investors have placed confidence in a seller of securities, they will be extremely reluctant to reach the conclusion that they made a mistake in reposing that confidence even when contrary evidence begins to come to light.[143]

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reach the same conclusions as to which stocks are promising. *See* ROBERT J. SHILLER, IRRATIONAL EXHUBERANCE 143 (2000).

139. *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 107 (1993) (explaining how this effect induces lawyers with crooked clients to overlook obvious frauds); Prentice, *Irrational Auditor*, *supra* note 2, at 163 (noting similar potential effect with auditors); *see also* James Surowiecki, *In No One We Trust*, NEW YORKER, July 29, 2002, at 33 (noting that studies show that "[w]hen it comes to doing business, people are habitually trusting at first, without any reason to be"). An example is the Crazy Eddie fraud case. Auditors left the key to their desk in a box of paperclips on top of the desk in full view. After they had left for the day, Crazy Eddie employees would unlock the desk, alter the auditor's workpapers, and photocopy the altered records. "Were the auditors stupid? No, just too trusting." Joseph T. Wells, *Crazy Eddie and the $120 Million Ripoff*, J. ACCT., Oct. 2000, at 93, 94.

140. Julian B. Rotter, *Impersonal Trust, Trustworthiness, and Gullibility*, 35 AM. PSYCHOLOGIST 1, 2 (1980) (citing study indicating that "low trusters had cheated significantly more often than had high trusters").

141. SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 186 (1993) (noting studies finding that in some circumstances people will tend to attribute positive behaviors primarily to dispositional factors and negative behaviors primarily to situational factors). Experts know that this phenomenon applies to investors. "Reasonable investors do not know that they should second-guess their broker. They don't know that they should be wary." TRACY P. STONEMAN & DOUGLAS J. SCHULZ, BROKERAGE FRAUD: WHAT WALL STREET DOESN'T WANT YOU TO KNOW 87 (2002).

142. Kathleen M. McGraw, *The Future of Fact: Manipulating Public Opinion with Moral Justification*, 560 ANNALS AM. ACAD. POL. & SOC. SCI. 129, 136–37 (1998); David O. Sears, *The Person-Positivity Bias*, 44 J. PERSONALITY & SOC. PSYCHOL. 233, 245 (1983) (finding evidence that people liked individual politicians and individual professors more than politicians as a whole or professors as a whole).

143. Cognitive dissonance is the tendency of people to avoid or minimize psychological inconsistencies. *See, e.g.*, LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1957); PLOUS, *supra* note 141, at 22–30 (explaining concept generally). Thus, someone who has made a particular decision will thereafter tend to look for evidence that supports the decision and tend to ignore evidence that undermines it.

E. Inability to Detect Deception

Investors are hindered by the fact that it is difficult for them to tell when they are being lied to, even though they do not realize it. Although there are some clues that can occasionally be employed successfully to detect whether a person is lying,[144] these are subtle and often unreliable, in part because our cultural stereotypes tell us to look for cues (mostly facial) that are relatively easy for liars to control.[145] Therefore, observers generally look for clues that are not indicative of deception instead of those that are.[146] Furthermore, the abilities to deceive and to detect deception are learned skills, and deceivers receive more direct feedback to help them refine their ability to deceive than do detectors of deception.[147]

Shell has noted that "human perception overall is not a reliable defense to opportunistic behavior,"[148] and Baier has observed that because the feelings, beliefs, and intentions upon which we often base our trust "sometimes can be faked,"[149] trust "is a notoriously vulnerable good."[150] The most reliable research in the area supports these observations by demonstrating that few people have any facility for detecting whether or not they are being deceived.[151] Numerous studies show that "the average person is not a particularly good lie-detector."[152] An extensive survey of experimental outcomes discovered that most results showed a lie-detection accuracy of between forty-five and sixty percent, with the

144. *See* SUZETTE H. ELGIN, THE LAST WORD ON THE GENTLE ART OF VERBAL SELF-DEFENSE 212–17 (1987); HIRSH GOLDBERG, THE BOOK OF LIES 233–36 (1990).

145. Joseph W. Rand, *The Demeanor Gap: Race, Lie Detection, and the Jury*, 33 CONN. L. REV. 1, 7–8 (2000).

146. Bella M. DePaulo et al., *Deceiving and Detecting Deceit*, *in* THE SELF AND SOCIAL LIFE 323, 343–44 (Barry R. Schlenker ed., 1985).

147. Howard S. Friedman & Joan S. Tucker, *Language and Deception*, *in* HANDBOOK OF LANGUAGE AND SOCIAL PSYCHOLOGY 257, 264 (Howard Giles & W. Peter Robinson eds., 1990).

148. G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 267 (1991); *see also* Daryl Koehn, *Should We Trust in Trust?*, 34 AM. BUS. L.J. 183, 201 (1996) ("If we are wise, we will treat our judgments of others' character as suspect."); McGraw, *supra* note 142, at 136 ("[T]he deception literature suggests that . . . people are simply not very good at detecting deception."); Peter Vallentyne, *The Rationality of Keeping Agreements*, *in* CONTRACTARIANISM AND RATIONAL CHOICE: ESSAYS ON DAVID GAUTHIER'S MORALS BY AGREEMENT 177 (Peter Vallentyne ed., 1991) ("[I]n the real world, people's dispositions are opaque enough that it is often possible to deceive others into thinking that one is trustworthy.").

149. Annette C. Baier, *Trust and Its Vulnerabilities*, *in* 13 TANNER LECTURES ON HUMAN VALUES 109, 112 (Grethe B. Peterson ed., 1992).

150. *Id.* at 110.

151. PAUL EKMAN, TELLING LIES 162 n.* (1985) ("[F]ew people do better than chance in judging whether someone is lying or truthful."); Peter J. DePaulo et al., *Lying and Detecting Lies in Organizations*, *in* IMPRESSION MANAGEMENT IN THE ORGANIZATION 377, 387 (Robert A. Giacalone & Paul Rosenfeld eds., 1989) (reporting an experiment in which participants had done no better than chance in guessing when sales representatives were pushing products in which they believed and when they were pushing products they disliked); Paul Ekman & Maureen O'Sullivan, *Who Can Catch a Liar?*, 46 AM. PSYCHOL. 913 (1991) (noting that even judges are not particularly good at detecting liars); Saul M. Kassin, *Human Judges of Truth, Deception, and Credibility: Confident but Erroneous*, 23 CARDOZO L. REV. 809, 809 (2002) (noting that dozens of studies show that "people are poor human lie detectors").

152. Rand, *supra* note 145, at 3.

chance level at fifty percent.[153] Furthermore, and very important in our context, the deceiver has a better chance of successfully deceiving in a face-to-face meeting.[154] Worse still, people tend to believe erroneously that they can detect when they are being lied to (the overconfidence bias?),[155] thus exacerbating their vulnerability.

F. *Insensitivity to Source*

One reason that people tend to be poor lie detectors is their insensitivity to the source of information.[156] Studies show that in making decisions, people often have difficulty disregarding information even when they discover that its source is questionable.[157] As DePaulo and colleagues have noted, people "tend to believe whatever affect or disposition the sender is claiming, even when they know that the senders may be deceiving. . . . [Also], when making judgments of truthfulness and deception [in experiments], perceivers report that most of the messages are truthful, even when lies and truths in fact equally occur."[158]

Therefore, investors are likely to be insufficiently cognizant of their seller's motivation to mislead. In the face of facts that seem to contradict a broker's representations, investors are likely to focus on the broker's

153. Miron Zuckerman et al., *Verbal and Nonverbal Communication of Deception*, *in* 14 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 1, 26–27 (1981); *see also* EVELIN SULLIVAN, THE CONCISE BOOK OF LYING 206 (2001) ("In scientifically conducted experiments, the success rate of people being asked to sort out lies from truths, say by watching people on videotape either lying or telling the truth, has been shown to be poor.").

In one prominent study, overall accuracy was .540 for factual content judgments, just slightly above chance. John E. Hocking et al., *Detecting Deceptive Communication from Verbal, Visual, and Paralinguistic Cues*, 6 HUM. COMM. RES. 33, 42 (1979). One study did indicate that secret service agents have some facility for detecting liars, but that other groups tested—polygraphists, federal judges, police officers, and psychiatrists—did not. Ekman & O'Sullivan, *supra* note 151, at 914–15. Another study of Canadian parole officers found that they had difficulty detecting deceit but their ability improved somewhat with training and feedback (which are not typically available to the average investor). Stephen Porter et al., *Truth, Lies, and Videotape: An Investigation of the Ability of Federal Parole Officers to Detect Deception*, 24 LAW & HUM. BEHAV. 643, 655 (2000).

154. Zuckerman et al., *supra* note 153, at 39 ("[P]erceivers are actually more accurate at detecting deception when they do not have access to facial cues than when they do.").

155. *See* ARTHUR A. LEFF, SWINDLING AND SELLING 84–87 (1976) (noting that people have great difficulty believing that they can be fooled); ALDERT VRIJ, DETECTING LIES AND DECEIT: THE PSYCHOLOGY OF LYING AND THE IMPLICATIONS FOR PROFESSIONAL PRACTICE 2 (2000) (noting that although most people claim to be poor liars but good at detecting other's attempts to deceive them, just the opposite tends to be true—"Generally, people are rather good at lying, but not very good at detecting lies."); Peter J. DePaulo et al., *The Accuracy-Confidence Correlation in the Detection of Deception*, 1 PERSONALITY & SOCIAL PSYCHOL. REV. 346 (1997) (reporting results of a meta analysis finding no relationship between confidence and accuracy in lie detection); Kassin, *supra* note 151, at 814 (reporting results of study finding that trained detectives could detect lies only at a random fifty-six percent rate, but were eighty-two percent confident in their conclusions).

156. *See infra* notes 157–69 and accompanying text.

157. *See generally* Kahneman & Tversky, *supra* note 129, at 7–11 (noting that people's predictions as to the profitability of a company tend to be the same regardless of whether they are basing their predictions on information that they know is reliable or that they know is unreliable).

158. DePaulo et al., *supra* note 146, at 327.

supposed integrity.[159] That supposed integrity often dominates the suspicious facts,[160] leading the investors to look for facts that support their original decision to trust their broker.[161] Because of all these factors, once customers decide that a particular person is honest and choose him to be their broker, their subsequent opinions of that person will be substantially colored.

In their study of consumer behavior, Hanson and Kysar noted that "consumers can be significantly influenced by their perceptions of a seller's conduct and intentions."[162] Indeed, research shows that people whose success depends on the efforts of others tend to form positive impressions of those upon whom they must rely.[163] Once that positive impression is established, and, for example, investors select a particular person as a stockbroker, the trusters tend to "overdraw" on the available information, believing that they can reliably predict the broker's future actions based on but a sliver of information.[164] Because of the representativeness heuristic,[165] investors will "tend to overestimate the extent to which the present relationship with the [broker] is a reliable index of the future relationship."[166] Langevoort observes that although courts often note that "any reasonable investor knows to be somewhat wary of a sell-

159. *See* Rand, *supra* note 145, at 40 (noting that people's tendency to give speakers an initial presumption of honesty "can skew the detection results by making that initial first impression a baseline for future behavior").

160. *See, e.g.*, Martha Brannigan, *Victims of Investment Scams Seem Condemned to Repeat Past Errors*, WALL ST. J., Mar. 24, 1988, at 33 (noting the case of a fraud victim who "continued to invest even though the saleswoman offered only excuses for why his prior ventures hadn't started paying off").

161. Both the confirmation bias and cognitive dissonance lead people who place their trust in others to search for data to confirm the wisdom of that action. *See* David Good, *Individuals, Interpersonal Relations, and Trust*, *in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 31, 42–43 (Diego Gambetta ed., 1988).

162. Hanson & Kysar, *TBS II*, *supra* note 34, at 1524.

163. *See* Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480, 486–87 (1990); Steven L. Neuberg & Susan T. Fiske, *Motivational Influences on Impression Formation: Outcome Dependency, Accuracy-Driven Attention, and Individuating Processes*, 53 J. PERS. & SOC. PSYCHOL. 431 (1987).

164. Klas Borell, *Trust and Fraud: Occupation and Resistance in Norway, 1940–1945*, 27 J. POL. & MIL. SOC. 39, 40 (1999).

165. The key aspects of the representativeness notion are: (a) that people expect samples to be highly similar to their parent population and to represent the randomness of the sampling process; and (b) that people frequently rely on representativeness as a guide in making judgments and predictions. Amos Tversky & Daniel Kahneman, *Judgments of and by Representativeness*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 124, at 84. *See generally* REID HASTIE & ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD: THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 66–89 (2001) (explaining applications of the representativeness heuristic); PLOUS, *supra* note 141, at 109–20 (same).

166. Eisenberg, *supra* note 120, at 249; *see also* Malcolm Gladwell, *The New-Boy Network*, NEW YORKER, May 29, 2000, at 68 (quoting University of Michigan psychologist Richard Nisbett as noting that "[t]he basis of the illusion is that we are somehow confident that we are getting what is there, that we are able to read off a person's disposition. . . . When you have an interview with someone and have an hour with them, you don't conceptualize that as taking a sample of a person's behavior, let alone a possibly biased sample, which is what it is. What you think is that you are seeing a hologram, a small and fuzzy image but still the whole person.").

ing agent's oral representations,"[167] these courts underestimate the pervasiveness of trust in the broker-investor relationship and how sellers can manipulate that trust to make sales.[168]

Eisenberg recommends that beneficiaries not be allowed to waive the fiduciary duty owed them by trustees, noting that:

> [b]eneficiaries would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid . . . ."[169]

These same principles obviously apply to investors who have just agreed to invest through a particular stockbroker.

G. Salience of Oral Communications

The role of oral persuasion in economic life should not be underestimated.[170] As Eisenberg observed, people are much more influenced by words, events, and experiences that are "vivid" than those that are "pallid."[171] For that reason, oral representations made by stockbrokers or other sellers, which make up the bulk of selling acts in the securities business,[172] will have significantly more persuasive impact than written disclaimers contained in a subsequently signed contract. After all, the written disclaimers, no-reliance clauses, and merger clauses are presented to the investor only after a positive image and a trusting relationship have been established and vivid promises made.

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167. Brown v. E.F. Hutton Group, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990), *aff'd*, 991 F.2d 1020 (2d Cir. 1993).

168. Langevoort, *Selling Hope*, *supra* note 54, at 671 (noting that "investors need and want to trust their brokers, and many brokers are skilled at establishing trust by exploiting these motivations").

169. Eisenberg, *supra* note 120, at 249.

170. *See generally* Donald McCloskey & Arjo Klamer, *One Quarter of GDP Is Persuasion*, 85 AM. ECON. REV. 191, 194 (1995) (noting the importance of oral persuasion, including stock brokers' sweet talk, to the functioning of our economy).

171. *See* Eugene Borgida & Richard E. Nisbett, *The Differential Impact of Abstract vs. Concrete Information on Decisions*, 7 J. APPLIED SOC. PSYCHOL. 258, 269 (1977) (finding that unreliable but vivid information had more impact than much more statistically reliable base rates); Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 30 (1998) ("A pervasive fact about human judgment is that people disproportionately *weigh salient, memorable*, or *vivid* evidence even when they have better sources of information."). People are also habitually overconfident in judging their own ability to gauge others' character. *See* DePaulo et al., *supra* note 151, at 377.

172. *See* Branson, *supra* note 9, at 21 ("Most securities transactions are effected by oral agreement, often over the telephone . . . ."); Langevoort, *Selling Hope*, *supra* note 54, at 629 ("Most investment sales interactions are oral, occurring either over the telephone or in face-to-face meetings.").

Brokerage firms could solve many problems by simply recording all conversations between their brokers and their clients. Then they could prove that no representations not contained in the written contract were made. However, none of the major firms (Merrill Lynch, Smith Barney, Paine Webber, Prudential) do record such conversations; the only firms that do have typically been in trouble with the SEC and are temporarily being required to do so. STONEMAN & SCHULZ, *supra* note 141, at 84–85.

The written disclaimer is unlikely to have much impact on an investor who has been softened up with oral promises because the best evidence is that oral communications are more persuasive than written communications.[173] Stockbrokers well know this; experts in marketing securities provide this advice to brokers:

> 55 percent of our communication is through posture, gestures, and facial expressions; 38 percent is through our tone of voice; and only 7 percent through words themselves. These percentages have proved themselves valid through scores of other studies that also indicate that 85 to 93 percent of communication occurs below the conscious level of awareness. Therefore, in a face-to-face presentation, you are able to deliver 100 percent of the message, while a telephone presentation allows you to deliver only 45 percent; and a letter only 7 percent.[174]

In light of this reality, Sachs correctly argues:

> [A]ny assessment of whether it is reasonable to rely on oral fraud must also reckon with the possibility that oral statements are by their nature more seductive than writings. Indeed, the interpersonal dimension may make an oral statement seem more persuasive than would a written statement, or it may reduce the likelihood that the investor will evaluate the statement dispassionately. Courts ought to assess the reasonableness of an investor's reliance in light of this psychological reality.[175]

Langevoort,[176] Branson,[177] and even the SEC[178] have made the same point. Written disclaimers on paper or computer screens will tend not to

173. *See generally supra* notes 170–72 and accompanying text.

174. STEVEN R. DROZDECK & KARL F. GRETZ, THE BROKER'S EDGE: HOW TO SELL SECURITIES IN *ANY* MARKET 222 (1995); *see also* Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 761–62 (1997) (noting that "the permissibility of oral selling efforts during the waiting period invites promoters to persuade buyers of the virtue of the investment before there is much of an opportunity for review of the required disclosures . . . [so that] salesmanship can readily trump the late-arriving prospectus (if the investor ever had any inclination to read it at all)").

175. Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 911 (1994).

176. Langevoort notes:

> Ready characterization [by the courts] of a failure to read a dense and detailed prospectus as "reckless" is troublesome on a number of levels. Most obviously, there is an empirical problem. It is awkward to use the term reckless to describe behavior that is quite normal and expected. Yet anecdotal evidence, supported by many people's assumptions about investment practices, indicates that most nonprofessional investors do not read the prospectuses and other legal disclosure documents they are given. If this perception is accurate, the court's assumption that reasonable investors know better than to rely on brokers' oral representations and selling brochures is a flight from reality.
>
> Our behavioral analysis demonstrates quite clearly why investors rarely read (or read carefully). Investors rely on brokers' recommendations as a way to save time and expense, and to avoid the overwhelming learning difficulties in evaluating investment options themselves.

See Langevoort, *Selling Hope*, *supra* note 54, at 682–83.

177. Branson, *supra* note 9, at 23 ("Around nine out of ten, or ninety-nine out of one hundred, times, the unschooled offeree is apt to place much more reliance on the oral 'sales pitch' than on the written document.").

have much impact upon people who have previously received oral promises from real live human beings.[179] *In real life, oral statements trump written representations.*[180] Yet *Carr* holds that in law, it must be just the opposite.[181]

H. Status Quo Bias

The Coase Theorem maintains that in the absence of transaction costs or income effects, people will bargain their way to an efficient allocation of rights.[182] The Coase Theorem, a central pillar of contractarian reasoning, assumes that the initial allocation of rights is irrelevant.[183] This assumption is wrong. All things being equal, people prefer the status quo.[184] The famed endowment effect[185] is one of the reasons for

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178. *In re* Robert A. Foster, 51 S.E.C. 1211, 1213 (1994) ("[I]nformation contained in prospectuses 'furnishes the background against which the salesman's [oral] representations may be tested. Those who sell securities by means of representations inconsistent with it do so at their peril.'" (quoting Ross Sec., Inc., 41 S.E.C. 509, 510 (1963))).

Several courts have held, consistent with the reasoning in *Carr* and *Rissman* that it is unreasonable for plaintiff investors to rely upon oral statements that are inconsistent with written documents that they are provided. *See, e.g.*, Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1033 (2d Cir. 1993). The SEC's view is more consistent with the behavioral research, obviously.

179. Shiller agrees:

> The channels of human communication that we know today seem to favor the interpersonal face-to-face and word-of-mouth communication that developed over millions of years of evolution, during times when such communication was virtually the only form of interpersonal communication. The patterns of communication hard-wired into our brains rely on there being another person's voice, another person's facial expressions, another person's emotions, and an associated environment of trust, loyalty, and cooperation. Because these elements are missing from the written or electronic word, people find it somewhat more difficult to react to these sources of information. They cannot give these other sources the same emotional weight, nor can they remember or use information from these other sources as well. This is an important reason why we still have teachers—why we cannot tell our children simply to sit down and read books or rely on computer-aided instruction.

SHILLER, *supra* note 138, at 155.

This is particularly true because investors probably act like consumers of products. There is a large body of research indicating that consumers pay little attention to product disclaimers and safety warnings. *See* Jacob Jacoby, *Is It Rational to Assume Consumer Rationality? Some Consumer Psychological Perspectives on Rational Choice Theory*, 6 ROGER WILLIAMS U. L. REV. 81, 121 (2000) (citing numerous studies).

180. I recently asked the students in my securities regulation class what they would think if I came in the first day of class and (a) told them orally that there would be no term paper this semester, and then (b) handed out a written syllabus that said a term paper would be required. All forty-five students in the class indicated that they would conclude that I was not requiring a term paper. *See also* Langevoort, *Selling Hope*, *supra* note 54, at 673 (noting that "trust trumps law").

181. Carr v. CIGNA Sec., Inc., 95 F.3d 544, 548 (7th Cir. 1996).

182. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

183. *Id.*

184. Most people have a strong preference for the status quo. *See, e.g.*, Colin F. Camerer, *Prospect Theory in the Wild*, *in* CHOICES, VALUES, AND FRAMES 294–95 (Daniel Kahneman & Amos Tversky eds., 2000) (finding that motorists' choices of insurance coverage were significantly affected by default legislative rules); Raymond S. Hartman et al., *Consumer Rationality and the Status Quo*, 106 Q. J. ECON. 141, 158–60 (1991) (finding that electricity consumers given a choice between higher rates with higher reliability service and lower rates with lower reliability tended to choose whichever choice was presented as representing the status quo); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 26–33 (1988) (finding that people tend to select whichever investment alternative or health plan is presented as the status quo); Maurice Schweitzer,

that preference. Because of the endowment effect, investors and consumers will tend to prefer the contract provisions that they view as encapsulating the status quo. Korobkin has shown that because of the status quo preference, lawmakers could, by changing the default rules via new statutes or new court decisions, alter the preferences of contracting parties.[186] Sunstein has made the same point regarding contractual relations between employers and employees.[187]

When form givers hand form contracts to form takers, the form takers are likely to view the contracts as embodying the status quo and will for this reason, among others, be reluctant to attempt to alter them.[188] This is particularly true because a dense form contract has an "authoritative legality" about it that induces deference.[189] Even if form takers were to attempt to bargain over the terms, they would likely give up after be-

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Disentangling Status Quo and Omission Effects: An Experimental Analysis, 58 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 457, 472–73 (1994) (reporting experiments finding that people prefer both the status quo and inaction and that these preferences can be additive).

In a recent article, Professor Koehler and I demonstrated empirically that the preference for the normal state of affairs, which is usually embodied in the status quo, is powerful indeed. *See* Robert A. Prentice & Jonathan J. Koehler, *A Normality Bias in Legal Decision Making*, 88 CORNELL L. REV. (forthcoming).

185. *See generally* Daniel L. Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990) (discussing the endowment effect generally); Jack L. Knetsch & J.A. Sinden, *Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value*, 99 Q. J. ECON. 507, 512–13 (1984) (reporting results of one of the most famous studies of the endowment effect); John K. Horowitz & Kenneth E. McConnell, *A Review of WTA/WTP Studies*, at 3 (Oct. 2000), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=257336 (finding in meta study of forty-five willing to accept/willing to pay studies the average WTA/WTP ratio was approximately seven and that this held over a wide variety of experimental designs, subjects, and products).

186. Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583, 1602 (1998) [hereinafter Korobkin, *Inertia and Preference*].

Korobkin argues:

> [W]hen lawmakers anoint a contract term the default, the substantive preferences of contracting parties shift—that term becomes more desirable, and other competing terms becoming less desirable. Put another way, contracting parties view default terms as part of the status quo, and they prefer the status quo to alternative states, all other things equal.

Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611–12 (1998) [hereinafter Korobkin, *Status Quo Bias*].

187. Sunstein, *Switching the Default, supra* note 135 (noting the strong impact of the endowment effect in many areas, including employer/employee relations).

188. POSNER, *supra* note 98, at 165 ("Most contractual terms, and contractual behavior, are a matter of custom . . . ."); Korobkin, *Inertia and Preference*, *supra* note 186, at 1606 (noting that "the use of a form contract as a basis for negotiations should create a similar bias in favor of the form terms").

189. *See* Shell, *Fair Play*, *supra* note 119, at 1368.

> The power of authority stems from the printed form contract and its appearance as authoritatively "legal." It is apparent to anyone looking at the printed form that someone in the legal department has given it a lot of thought—much more thought than any single customer wants to give it. Because customers have many other things to worry about other than the "boilerplate" of the standard customer-broker agreement, they tend to pass over it as they do boilerplate on everything from parking lot receipts to computer equipment warranties. . . .
>
> In the face of these densely typed provisions, none of which will have immediate economic consequences to the customer on monetary issues like commission rates, customers simply "defer" to the contract's printed authority.

Id.

ing told that the agent had no authority to alter them, that the forms came from the lawyers and could not be changed, or that an exception could not be made just for this particular investor.[190] Use of form contracts is so widespread and the status quo bias is so entrenched that those few who do attempt to bargain for changes in the forms are deemed eccentric.[191]

I. Social Proof

Social proof is the notion that people in a particular situation tend to take their cues for correct behavior from others they observe.[192] It accounts for why laugh tracks work on TV shows, why a person in trouble is often better off having only one person be nearby rather than fifty,[193] and why marketers often push their products as the "best-selling" or "fastest-growing." Social proof is a sensible heuristic, because common sense dictates that people can draw reasonable guidance from the actions of others as to the proper course of action in various circumstances. But it also leads people to accept standard forms presented to them. As Shell has suggested:

> To the extent customers think about the arbitration clause [in a broker's form contract] at all, my guess is that they say to themselves: "There are a lot of people like me investing in the stock market and they all signed this contract, too. Some of them must have given this some thought even if I am too busy to do so. It must be OK."[194]

J. Anchoring and Adjustment

Investors' judgments, like those of other decision makers, are often unduly influenced by the order in which they process information. Sometimes their judgment is unduly influenced by the primacy effect, the tendency to form strong first impressions.[195] The anchoring and adjustment heuristic then plays a role in that once decision makers focus on an

190. *See* Rakoff, *supra* note 54, at 1225.
191. *Id.* at 1228.
192. ROBERT B. CIALDINI, INFLUENCE: SCIENCE AND PRACTICE 95 (3d ed. 1993).
193. Consider the infamous Kitty Genovese case. A woman was attacked in broad daylight several times over a period of some minutes. Thirty-eight witnesses saw or heard the event and yet not one called for help. *See generally* A.M. ROSENTHAL, THIRTY-EIGHT WITNESSES 32–37 (1964) (recounting details of attack). In such a case, as in so many areas of human behavior, people take their cues from others, thinking: "If something were really wrong, someone else would be helping or calling the police. Since nobody else is concerned, nothing must be wrong."
194. Shell, *Fair Play*, *supra* note 119, at 1371.
195. *See* RICHARD E. NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF HUMAN JUDGMENT 172 (1980) ("Although order of presentation of information sometimes has no effect on final judgment, and recency effects sometimes are found, these are the exception; several decades of psychological research have shown that primacy effects are overwhelmingly more probable.").

initial value (the anchor), they tend in the face of additional information to adjust their responses in the right direction, but not far enough.[196]

Korobkin and Ulen have noted a potential impact of the anchoring and adjustment phenomenon on products liability law.[197] They argue that an advertisement for a sport-utility vehicle that shows it being driven at high speeds over irregular terrain anchors consumers' expectations, making it difficult for the same consumers to sufficiently adjust their safety estimates when they buy the vehicle and read the manufacturer's detailed warnings that it is dangerous to drive it at high speeds.[198] Marketing scholars have demonstrated how difficult it is to correct invalid inferences derived from advertising through even concurrent disclosures.[199] Similarly, sellers' oral representations about great returns, investment safety, and the like can easily anchor investors' expectations and then the natural human tendency to adjust insufficiently to new information will prevent the printed warnings in the subsequently signed written contract from sufficiently correcting the investors' judgment. *Rissman* and *Carr* assume that the writing has a bigger impact on the investor than the oral representations, but the reverse is more likely the case.[200]

K. Regret Theory

The status quo bias, social proof phenomenon, and the anchoring and adjustment bias all lead people to imbue the form contract that they are presented by form givers with a presumption of legitimacy and fairness that they are hesitant to challenge. This inclination is reinforced by emotional phenomena explained by regret theory. Many studies demonstrate that emotions play a substantial role in people's decision making.[201]

196. *See generally* Ward Edwards, *Conservatism in Human Information Processing*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 124, at 359 ("It turns out that opinion change is very orderly, and usually proportional to numbers calculated from Bayes' theorem—but it is insufficient in amount."); Joseph F. Funaro, *An Empirical Analysis of Five Descriptive Models for Cascaded Inference*, 14 ORG. BEHAV. & HUMAN PERFORMANCE 186, 186 (1975) (observing that most empirical evidence indicates that "intuitive opinion revisions are conservative in comparison to the optimal revisions specified by Bayes' theorem").

197. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1053, 1101–02 (2000).

198. *Id.* at 1102.

199. Gita V. Johar & Carolyn J. Simmons, *The Use of Concurrent Disclosures to Correct Invalid Inferences*, 26 J. CONSUMER RES. 307, 319–20 (2000) (finding that even when disclosures are read and encoded, they often are not utilized by consumers to correct invalid inferences).

200. The fact that the 1933 Securities Act was designed to ensure that investors in public offerings of securities have access to at least a preliminary prospectus before they can commit to buy securities is certainly consistent with this behavioral phenomenon. 15 U.S.C. § 77j(b)(2) (1997). *See generally* HAZEN, *supra* note 69, §§ 2.4–.5, at 92–106 (discussing the prospectus delivery and other rules).

201. *See, e.g.*, Peter H. Huang, *Reasons Within Passions: Emotions and Intentions in Property Rights Bargaining*, 79 OR. L. REV. 435, 435 (2000) ("[P]eople do not behave the way that rational actors do because people also feel emotions and those emotions drive behavior."); Bruce E. Kaufman, *Emotional Arousal as a Source of Bounded Rationality*, 38 J. ECON. BEHAV. & ORG. 135, 135 (1999) (noting that "an additional source of bounded rationality . . . [is] insufficient or excessive emotional arousal"); Barbara A. Mellers et al., *Decision Affect Theory: Emotional Reactions to the Outcomes of*

Even anticipating emotions that they might feel impacts humans' decision making.[202] The most studied of these emotions is regret, which "is [often] more than the pain of loss. It is the pain associated with feeling responsible for the loss."[203]

According to Loomes & Sugden:

> The essential notion underlying regret theory is that people tend to compare their actual situations with the ones they would have been in, had they made different choices in the past. If they realize that a different choice would have led to a better outcome, people may experience the painful sensation of regret; if the alternative would have led to a worse outcome, they may experience a pleasurable sensation we call "rejoicing." When faced with new choice situations, people remember their previous experiences and form expectations about rejoicing and regret that the present alternatives might entail. They then take these expectations into account when making their decisions.[204]

The impact of anticipated regret can be significant.[205] There are studies indicating that anticipated regret influences decisions in the context of consumer purchase decisions,[206] investment decisions,[207] gambling decisions,[208] negotiations,[209] sexual behavior,[210] and driving behavior.[211]

Risky Options, 8 PSYCHOL. SCI. 423, 423 (1997) (citing numerous sources); Eric A. Posner, *Law and the Emotions*, 89 GEO. L.J. 1977, 1977 (2001) ("The role of emotions is much neglected in legal theory. This should be puzzling, because emotions play an important role in many areas of the law."); Marcel Zeelenberg, *The Use of Crying over Spilled Milk: A Note on the Rationality and Functionality of Regret*, 12 PHIL. PSYCHOL. 325, 325–26 (1999) ("[D]ecision outcomes are known to be powerful antecedents of emotional experiences and these emotions may well influence the choices we make.").

202. Jonathan Baron, *The Effect of Normative Beliefs on Anticipated Emotions*, 63 J. PERSONALITY & SOC. PSYCHOL. 320, 320 (1992) ("Anticipation of emotions can affect decisions even when the emotion is not an inherent part of the desired or undesired outcomes."); René Richard et al., *Anticipated Affect and Behavioral Choice*, 18 BASIC & APPLIED SOC. PSYCHOL. 111, 125 (1996) (reporting results of studies finding that "anticipated affective reactions predicted a significant proportion of variance in behavioral expectations").

203. HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 30 (2000). While there is clearly overlap between the emotions of regret and disappointment, disappointment is keyed to the situation one finds oneself in; regret is keyed to the behavior one has engaged in. Marcel Zeelenberg et al., *Emotional Reactions to the Outcomes of Decisions: The Role of Counterfactual Thought in the Experience of Regret and Disappointment*, 75 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 117, 117 (1998).

204. Graham Loomes & Robert Sugden, *A Rationale for Preference Reversal*, 73 AM. ECON. REV. 428, 428 (1983).

205. Marcel Zeelenberg et al., *Regret and Responsibility Resolved? Evaluating Ordóñez and Connolly's (2000) Conclusions*, 81 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 143 (2000).

206. J. Jeffrey Inman & Leigh McAlister, *Do Coupon Expiration Dates Affect Consumer Behavior?*, 31 J. MARKETING RES. 423 (1994); Itamar Simonson, *The Influence of Anticipating Regret and Responsibility on Purchase Decisions*, 19 J. CONSUMER RES. 105 (1992).

207. Marcel Zeelenberg & Jane Beattie, *Consequences of Regret Aversion 2: Additional Evidence for Effects of Feedback on Decision Making*, 72 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 63, 75 (1997).

208. Robert A. Josephs et al., *Protecting the Self from the Negative Consequences of Risky Decisions*, 62 J. PERSONALITY & SOC. PSYCHOL. 26, 28 (1992).

209. Richard P. Larrick & Terry L. Boles, *Avoiding Regret in Decisions with Feedback: A Negotiation Example*, 63 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 87, 87 (1995).

Importantly, anticipated regret theory indicates that in most settings people tend to avoid regret by preferring inaction to action.[212] Gilovich and Medvec have reported that the fact that people experience more regret over negative outcomes stemming from action than negative outcomes stemming from inaction "is perhaps the clearest and most frequently replicated finding in the entire literature"[213] in the area.[214]

The impact of anticipated regret theory on use of form contracts is clear. Professor Korobkin has found in a recent study that law students chose either legal default terms over contrary contract form terms or vice versa, depending on which required no affirmative choice on their part, and suggested (correctly, I believe) that regret theory is part of the reason.[215]

210. Rene Richard et al., *Anticipated Regret and Time Perspective: Changing Sexual Risk-Taking Behavior*, 9 J. BEHAV. DECISION MAKING 185 (1996).

211. Dianne Parker et al., *Modifying Beliefs and Attitudes to Exceeding the Speed Limit: An Intervention Study Based on the Theory of Planned Behavior*, 26 J. APPLIED SOC. PSYCHOL. 1, 1 (1996).

212. Thomas Gilovich & Victoria H. Medvec, *Some Counterfactual Determinants of Satisfaction and Regret*, *in* WHAT MIGHT HAVE BEEN: THE SOCIAL PSYCHOLOGY OF COUNTERFACTUAL THINKING 259, 264 (Neal J. Roese & James M. Olson eds., 1995) ("People apparently regret negative outcomes that stem from commissions, or actions taken, more than equivalent outcomes that stem from omissions, or actions foregone [sic]." (citation omitted)).

213. Thomas Gilovich & Victoria H. Medvec, *The Experience of Regret: What, When, and Why*, 102 PSYCHOL. REV. 379, 380 (1995).

214. Ilana Ritov & Jonathan Brand, *Outcome Knowledge, Regret, and Omission Bias*, 64 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 119, 126 (1995) ("[P]eople anticipate regret when they expect to be able to compare a bad outcome to a better outcome that would have resulted from a foregone [sic] option. They evaluate decisions as worse when such a situation exists, and they are reluctant to choose options that might lead to such a situation, *especially when these options involve action rather than inaction*. The effect of potential regret is reduced when people do not expect to know the outcome of the option they will choose or the option that they did not choose. In these cases, people may think more in terms of expected utility." (emphasis added)).

In one of the experiments, subjects were asked to place themselves in the position of public health officials in another nation who had to decide whether to vaccinate children against a type of flu. The vaccine was very cheap. Ten out of every 10,000 children would die of the flu if not vaccinated; however, the vaccine would also kill some children. Subjects were given a list of rates of 0, 1, 3, 5, 7, 9, and 11 out of a thousand (death rates caused by the vaccine) and asked if they would vaccinate all the children. In one condition (no knowledge), subjects would never know what happened after they made their decision. In a second condition (partial knowledge), subjects would know how many children died of the flu, but not what would have happened if they had decided differently. In a third condition (full knowledge), subjects would know who died from the flu and who died from the vaccine. The bias toward inaction was highest in the condition that presented the opportunity to feel the most regret—the full knowledge condition. Subjects were most willing to act, to undertake a risk, in the no knowledge condition. Subjects' explanations of their decisions made it clear that anticipation of regret from their actions was an important motivating factor for many subjects. *Id.* at 124–26; *see also* Ilana Ritov & Jonathan Baron, *Reluctance to Vaccinate: Omission Bias and Ambiguity*, 3 J. BEHAV. DECISION MAKING 263, 275 (1990) (finding that "[s]ubjects are reluctant to vaccinate . . . when the vaccination itself can cause death, even when this is much less likely than death from the disease prevented," and finding that many explanations of subjects for their decision are consistent with regret theory). This laboratory finding has been replicated in the real world. David A. Asch et al., *Omission Bias and Pertussis Vaccination*, 14 MED. DECISION MAKING 118, 121 (1994) (finding that survey participants' decisions whether or not to vaccinate their children with DPT was affected by the omission bias).

215. Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 637–47 (1998) (noting that the results of his study and others suggest that the negative utility consequences associated with undesirable *actions* are greater than those associated with undesirable *inactions*).

Furthermore, in addition to regretting actions more than inactions, people regret adverse consequences that stem from abnormal situations more than those that stem from normal situations.[216] They regret adverse consequences that arise from extraordinary behavior more than those that result from common behavior.[217] Therefore, to the extent that a pre-printed form contract appears to represent the normal condition (the contract that everyone else is signing), people will anticipate that they would suffer greater regret from adverse consequences stemming from an abnormal situation (forcing a rewriting of the contract) than those arising from a normal situation (simply accepting the form presented).

These and other behavioral factors[218] indicate why investors will sign

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Korobkin has also noted, in summarizing the interplay of regret theory and the omission bias:

> Holding [all] other things equal, people will prefer whatever will happen if they act passively to what will happen if they act affirmatively [even when acting affirmatively implies no measurable transaction costs]. In other words, default choices are preferred to nondefault choices because of the lower regret content of the former.

Russell Korobkin, *A Multi-Disciplinary Approach to Legal Scholarship: Economics, Behavioral Economics, and Evolutionary Psychology*, 41 JURIMETRICS 319, 334 (2001).

216. Janet Landman, *Through a Glass Darkly: Worldviews, Counterfactual Thought, and Emotion* [hereinafter Landman, *Through a Glass Darkly*], *in* WHAT MIGHT HAVE BEEN: THE SOCIAL PSYCHOLOGY OF COUNTERFACTUAL THINKING 233, 248 (Neal J. Roese & James M. Olson eds., 1995) [hereinafter WHAT MIGHT HAVE BEEN] (citing several studies); Dale T. Miller & Cathy McFarland, *Counterfactual Thinking and Victim Compensation: A Test of Norm Theory*, 12 PERSONALITY & SOC. PSYCHOL. BULL. 513, 516 (1986) (reporting studies showing that "victims whose negative fates follow abnormal actions receive more sympathy than victims whose negative fates follow normal actions").

217. John J. Hetts et al., *The Influence of Anticipated Counterfactual Regret on Behavior*, 17 PSYCHOL. & MARKETING 345, 364 (2000).

218. There are many other behavioral factors that work in this direction. For example, framing effects exert a pervasive influence upon human decision making. A simple example is that humans are much more likely to buy food labeled 75% fat free than food labeled 25% fat, although the rational economic actor would not differentiate. MAX SUTHERLAND, ADVERTISING AND THE MIND OF THE CONSUMER 21 (1993). *See generally* HASTIE & DAWES, *supra* note 165, at 34–47 (discussing basics of framing); PLOUS, *supra* note 141, at 69–76 (same). Framing effects are so substantial that a person's risk preferences can reverse completely depending on whether a chance is framed as a potential gain or a potential loss. *Id.* at 122–25 (discussing basics of preference reversals); Kris N. Kirby & R.J. Herrnstein, *Preference Reversals Due to Myopic Discounting of Delayed Reward*, 6 PSYCHOL. SCI. 83, 88 (1995) (same); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453 (1981) (finding that 84% of subjects would prefer (a) a 100% chance of gaining $240 over (b) a 25% chance of gaining $1,000 and a 75% chance of gaining nothing, but, inconsistently, 87% would prefer (a) a 75% chance of losing $1,000 and a 25% chance of losing nothing over (b) the statistically equal 100% chance of losing $750).

Hasen proffers several examples to make the point that even if consumers (or investors) do read contracts, because of framing effects they may not understand them. Hasen, *supra* note 102, at 431–35. While I think Hasen goes too far in implying that a seller's conscious use of framing effects in contracts is nearly automatically unconscionable, I join him in emphasizing that framing effects leave consumers and investors vulnerable to unfair selling practices, as Hanson and Kysar have emphasized in the products liability setting. *See* Hanson & Kysar, *TBS I*, *supra* note 33, at 724 ("Once it is acknowledged that consumer risk perceptions may be affected by, for instance, the manner in which information is framed, then it becomes inevitable that manufacturers will exploit those framing effects in a way that maximizes manufacturer profits."); Hanson & Kysar, *TBS II*, *supra* note 34, at 1507 ("The tobacco industry also seems to have developed ways to take advantage of framing effects by portraying the product so as to minimize smoker risk perceptions."); *see also* Gerald E. Smith & Thomas T. Nagle, *Frames of Reference and Buyers' Perceptions of Price and Value*, 38 CAL. MGMT. REV. 98, 100 (1995) (noting that "managers can . . . influence purchase decisions by how they present, or 'frame,' price and benefits relative to a reference point").

contracts with provisions that are inconsistent with their true agreement with the sellers. Unfettered private ordering leaves investors at the mercy of sellers who would take advantage of the investors' cognitive limitations and behavioral heuristics.[219] Welle has argued that "[g]iven the gross inequality in bargaining power, knowledge, and interest between buyers and sellers of securities, without regulation, buyers would be at the mercy of sellers. *Freedom of contract in an unregulated securities market is a naïve myth.*"[220]

V. Broader Implications

Because I realize that sophisticated investors tend to have the same behavioral and cognitive vulnerabilities as unsophisticated investors,[221] I am concerned with the contractualization of securities fraud jurisprudence even in cases involving corporate entities.[222] Although corporate entities are the contracting parties, the investing decisions are made by all-too-human beings who may have been misled by oral fraud that I do not countenance. Nonetheless, I realize that most observers will naturally be more concerned about frauds committed against individual investors through use of form contracts. Since the points I make implicate the law of adhesion contracts and merger clauses generally, transcending specific securities law applications, I shall examine them briefly.

A. Adhesion Contracts Generally

Carr is disconcerting in that it imports contract principles into an area where tort law should govern. As noted earlier, standard tort law

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There is no doubt that investor perceptions of risk and reward can be manipulated by promoters in this fashion. *See* Langevoort, *Selling Hope*, *supra* note 54, at 635–41 (making this point in some detail regarding even sophisticated investors). As I have noted elsewhere:

> By convincing investors, even intelligent and educated ones, that they are losing the opportunity for wealth that others are enjoying, industry professionals can induce excessive risk-taking by investors. What in hindsight appears to be greed is simply the natural human tendency to avoid a loss, especially relative to others.

Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1487 (citations omitted).

219. Thus, Korobkin points out that "[w]hile law-and-economics analysis predicts that individuals will maximize their expected utility in a free market, . . . a range of decisionmaking heuristics suggest that market regulation can actually increase individual utility under various circumstances." Russell Korobkin, *A Multi-Disciplinary Approach to Legal Scholarship: Economics, Behavioral Economics, and Evolutionary Psychology*, 41 JURIMETRICS 319, 323 (2001).

220. Welle, *supra* note 61, at 576 (emphasis added).

221. *See* Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases, and Organizational Behavior*, 63 BROOK. L. REV. 629, 659 n.84 (1997); Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1510 n.543; *see also* Riva D. Atlas, *Even the Smartest Money Can Slip Up*, N.Y. TIMES, Dec. 30, 2001, at BU1 (noting that in 2001, many sophisticated investors were hammered as hard as unsophisticated investors in the stock market because they made the same mistakes through overoptimism and other cognitive errors).

222. Two recent examples are *AES Corp. v. Dow Chem. Co.*, 157 F. Supp. 2d 346 (D. Del. 2001) and *American Bankcard International, Inc. v. Schlumberger Technology, Inc.*, No. 99-C6434, 2001 U.S. Dist. LEXIS 19011 (N.D. Ill. Nov. 8, 2001).

provides that parties cannot effectively disclaim liability for intentional torts.[223] By giving contractarian notions primacy, *Carr* allows such disclaimers even in the context of adhesion contracts, meaning that particularly inefficient and unfair results are likely to occur.[224] Worse still, *Carr* involved a classic adhesion contract.[225] *Rissman* involved more real bargaining between the parties, although, typically, the key phrases that ended up in the contract were simple boilerplate.[226]

Patterson introduced the term "adhesion contract" in 1919, noting that life insurance companies drafted standardized form contracts and people who wanted insurance had little choice but simply to "adhere" to their terms.[227] Kessler attributed the use of adhesion contracts to the monopoly or near-monopoly power of the form givers.[228] Although there is no doubt that in most instances in which adhesion contracts are used, the form giver has substantially more market power than the form taker, and this point should never be forgotten,[229] market power tells only part of the tale. Adhesion contracts are, after all, ubiquitous even in industries with substantial competition.[230]

1. Rationalizations for Adhesion Contracts

Economists attempt to justify form contracts on a number of grounds. First, they argue that adhesion contracts are generally necessary in that it is logistically impossible in our commercial world for both parties to negotiate the terms of each individual contract.[231] This is undeniably true. So long as surprising and unfair terms are judicially ex-

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223. RESTATEMENT (SECOND) OF TORTS § 496B (1965).

224. Carr v. CIGNA Sec., Inc. 95 F.3d 544, 548 (7th Cir. 1996).

225. *Id.*

226. Rissman v. Rissman, 213 F.3d 381, 385 (7th Cir. 2000) (noting that "transactions lawyers have language of this sort stored up for reuse").

227. Edwin W. Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198, 222 (1919).

228. Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 642 (1943).

229. John E. Murray, Jr., *The Standardized Agreement Phenomena in the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 735 (1982). Murray notes:

> Even if all non-drafting form-signers were forced to read and understand the last scintilla of each printed clause, the drafting party typically would be in a superior bargaining position. This would enable him to dictate the terms of the private law to an adhering party. This process does not deserve to be called contractual. It is not democratic and, in a society based on mass production which requires standardized forms even among competitors, it is essentially unfair.

Id. at 740.

230. Michael J. Trebilcock, *External Critiques of Laissez-Faire Contract Values* [hereinafter Trebilcock, *External Critiques*], *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 78, 96–97 (F.H. Buckley ed., 1999) [hereinafter FALL AND RISE].

231. DAVID D. FRIEDMAN, LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 156–57 (2000); MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 119 (1993) ("[T]he principal justification for standard form contracts is the dramatic reduction in transaction costs that they permit in many contexts.").

cised from adhesion contracts, as is usually the case,[232] they are perfectly useful, even necessary devices that grease the transactional wheels of our economy. But when surprising, unfair, or downright fraudulent terms are included in adhesion contracts, blind enforcement of the terms of adhesion contracts becomes much more difficult to justify.[233]

a. Efficiency Rationale

Contractarians initially defend unfettered freedom to contract on the Coasean notion that parties to contracts, freed of governmental interference, naturally negotiate the most efficient arrangement possible.[234] As applied to form contracts, this argument quickly collapses. It is difficult to argue plausibly that the parties are negotiating to an efficient end when one side does not negotiate nor, typically, even read the contract before signing it.[235] Also, fraud is inefficient.[236] When adhesion contracts are construed to facilitate one party's defrauding of the other, it is extremely unlikely that the two will bargain to an efficient result.

232. *See, e.g.*, Broemmer v. Abortion Servs. of Phoenix, Ltd., 840 P.2d 1013, 1016 (Ariz. 1992) ("To determine whether this contract of adhesion is enforceable, we look to two factors: the reasonable expectations of the adhering party and whether the contract is unconscionable."). This is the standard set forth in the Restatement's provisions for standardized contracts. *See* RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981).

233. *See* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 370 (1960).

> Instead of thinking about "assent" to boiler-plate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and the broad type of the transaction, and but one thing more. That one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms. The fine print which has not been read has no business to cut under the reasonable meaning of those dickered terms which constitute the dominant and only real expression of agreement, but much of it commonly belongs in.

Id.

234. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 17 (1991).

235. *See* Meyerson, *Efficient Consumer*, *supra* note 112, at 595 (noting that "businesses that draft these [form] contracts do so knowing that they will not be read by the typical consumer").

236. TREBILCOCK, *supra* note 231, at 104 ("[A] transaction induced by fraud is unlikely to make both parties better off."); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 705–06 (noting that securities fraud "produces substantial social costs and yields no social benefit . . . [and] therefore should be deterred completely"); Richard A. Epstein, *Contracts Small and Contracts Large: Contract Law Through the Lens of Laissez-Faire*, *in* FALL AND RISE, *supra* note 230, at 39 ("Neither defenders nor opponents of laissez-faire hold any brief for fraud."); Meyerson, *Efficient Consumer*, *supra* note 112, at 589 ("A party misled as to the utility to be derived from a proposed transaction cannot properly evaluate the true benefits and costs of the deal . . . [and t]he presumption that the agreement will lead to a value-increasing exchange, therefore, is rebutted."); Eric Rasmussen, *The Economics of Desecration: Flag Burning and Related Activities*, 27 J. LEGAL STUD. 245, 256 (1998) ("[T]he law frowns on fraud as ordinarily having inefficient results."). It follows that rules that shelter fraud promote inefficiency. *See* Davis, *supra* note 91, at 500 (noting that enforcing disclaimers of liability for fraud can be "undesirable from an economic perspective, because it involves expenditure of resources on unproductive activities").

b. Agency Rationale

Contractarians then argue that form contracts solve an agency problem for companies.[237] Most commonly, the argument is that principals are worried that their agents will be bribed by consumers/investors to alter the terms of the agreement in a manner inconsistent with the principal's instructions. Friedman hypothesizes that Avis uses take-it-or-leave-it form contracts primarily to prevent customers from paying clerks $5 to reduce the asked-for rental price from $30 to $20.[238] This seems fanciful. Do grocery stores that do not use form contracts have a major problem with customers paying the clerk $5 to reduce the price of a roast from $15 to $5? In contexts where big money is at stake and real opportunities exist to bribe agents with meaningful amounts, such as major construction contracts and big land deals, contracts are more, not less, likely to be individually negotiated. This version of the agency argument is a mere rationalization for the use of adhesion contracts, and a lame one at least.

A second form of the agency argument is that adhesion contracts "address an agency cost problem within the seller, whose sales representatives might be tempted to overpromise the consumer in order to get a sale, but for a standard form exclusion of oral representations and warranties."[239] Of course agents often overpromise to get sales and increase their compensation. That is exactly the point that plaintiffs are making in cases like *Carr.* The tendency of sales agents to lie to consumers and investors scarcely justifies use of adhesion clauses on either fairness or efficiency grounds.[240] Between an innocent buyer and the innocent principal of a fraudulent seller, the principal should clearly bear the loss (unless the buyer is in collusion with the agent) and it is simply unfair to allow that principal to contractually shift the loss to the innocent buyer.[241] It is also inefficient,[242] yet that is what enforcement of a no-reliance clause allows.

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237. FRIEDMAN, *supra* note 231, at 156–57.

238. *Id.*

239. F.H. Buckley, *Introduction*, *in* FALL AND RISE, *supra* note 230, at 11.

240. It may be urged that, if the provisions contained in the written offer to purchase [stating that there were no agreements between buyers and the seller's agent that did not appear in the writing] are not held to be binding upon the plaintiffs, there is no way in which a principal can protect himself against the unauthorized act of his agent. While something may be said in favor of such a proposition, I think the best answer is that one who takes proper care in the selection of his employees, and picks only those who are honest and reliable, will need no such protection. Of two innocent persons, he who has made damage possible by some act of his is the one who should suffer.

Angerosa v. White Co., 290 N.Y.S. 204, 216 (N.Y. App. Div. 1936); *see also* King v. Horizon Corp., 701 F.2d 1313, 1317–18 (10th Cir. 1983).

241. Meyerson, *Objective Theory*, *supra* note 110, at 1315 ("For sellers who wish to avoid incorporating statements by their sales agents into the contract, the remedy is the proper selection, training, and supervision of sales agents and the adequate informing of consumers.").

242. *See generally* Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of* Respondeat Superior *Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1386–92 (1997) (arguing that respondeat superior is the most efficient regime in a securities fraud setting); Steven I. Rubin, *The Vicarious Liability of Professional Sports Teams for On-*

c. Marginal Consumer Rationale

In light of the rational ignorance limitation on *homo economicus* discussed above, contractarians next argue that the mass of humanity that fails to read and individually negotiate contracts will be protected by the occasional consumer or investor who comes along and bargains hard for pro-consumer terms.[243] Unfortunately, this marginal consumer/investor argument is largely the product of wishful thinking. First, economists estimate that if as small a portion of the consuming/investing public as one-third are aggressive, marginal consumers/investors, they can protect the inframarginal consumers/investors.[244] This may or may not be true, but it assumes without any observable evidence, that one-third of consumers read, understand, and bargain over product warranties before they purchase products and one-third of investors read, understand, and bargain over the terms of contracts they sign with broker-dealers or issuers. As noted earlier in this article, most consumers do not read most of the content of most of the contracts they sign.[245] They are particularly unaware of the subordinate contract provisions where product disclaimers and warranty exclusions reside.[246] Similarly, investors tend not to read prospectuses[247] and other complicated investor information, and are particularly unaware of liability disclaimers.[248] Even if there are inframarginal consumers and investors, their focus usually will not be upon the subordinate contract terms affecting liability.[249]

the-Field Assaults Committed by Their Players, 1 VA. J. SPORTS & L. 266, 279 (1999) ("The predominant rationale behind respondeat superior law today, it is generally agreed, is to distribute justly and efficiently to employers the risks and costs that are considered *inherent* to employment."); J. Hoult Verkerke, *Notice Liability in Employment Discrimination Law*, 81 VA. L. REV. 273, 342 (1995) (noting efficiency of requiring employer to internalize its costs through respondeat superior).

243. For example, in his article arguing for the enforcement of mandatory arbitration clauses in employment contracts, Hylton references the "marginal employee" and claims that "employees who are actively seeking alternatives will have a disproportionate impact on the terms of the employment contract offered to all employees." KEITH N. HYLTON, THE LAW AND ECONOMICS OF AGREEMENTS TO ARBITRATE CLAIMS 35 (Boston Univ. School of Law, Law & Econ. Working Paper No. 00-04, June 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=239329.

244. This one-third figure derives from a study by Schwartz and Wilde that several others have drawn upon. Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 653 (1979).

245. *See* Croley & Hanson, *supra* note 14, at 776 (doubting that one-third of consumers read product warranties and warnings, given the high cost of information); R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 664 (1996) ("[T]he existence of any sizable informed minority is highly doubtful.").

246. Meyerson, *Efficient Consumer*, *supra* note 112, at 596 (noting "the inevitable consumer ignorance of subordinate contract provisions").

247. *See* Terzah Ewing, *IPOs More Boldly Disclose Risk Factors*, WALL ST. J., Apr. 3, 2000, at C1 (noting that companies are comfortable disclosing more risks in prospectuses "because investors still don't read the fine print as they should").

248. Because liability disclaimers will typically not be part of the negotiation between buyer and seller and because the seller has every incentive not to highlight the disclaimer, the disclaimer will usually fly beneath the buyer's radar screen.

249. Meyerson notes:

Second, the contractarians assume that manufacturers of products and issuers of securities cannot segregate the aggressive marginal consumers/investors from the inframarginal ones.[250] This also seems wrong.[251] A car dealer forced by a particularly aggressive consumer to pencil in some changes to a form contract in order to make a sale is not going to rewrite the form contract and put those pro-consumer changes in permanent form. Instead, the dealer will interlineate, leave the form contract just as it is, and pray, probably successfully, not to see another such consumer walk onto the showroom floor any time soon. A broker-dealer confronted by an aggressive investor who wishes to renegotiate the broker-dealer's form contract will likely react in the same manner as the car dealer. Cruz and Hinck point out multiple ways in which sellers differentiate between informed consumers and others, concluding that "[s]ellers, when faced with informed consumers, can simply change their terms to accommodate those consumers, while keeping the terms in for those unaware."[252]

Third, the contractarians' argument holds only if their further assumption—that the preferences of the marginal customers/investors are representative of those of the inframarginal customers/investors—also holds, and this too seems unlikely.[253] Investors who actually read, understand, and negotiate over the form contracts they are provided by broker-dealers and issuers are much less likely to need and want protection from seller fraud than the average investor.[254] If, as some have argued, a smaller percentage (less than thirty-three percent) of consumers need be marginal to affect the bargaining process, there is a concomitantly smaller chance that the small group of marginal consumers/investors will be representative of inframarginal consumers/investors.[255] Thus, Gold-

> This protection-by-proxy, however, is not applicable to subordinate contract terms. While adventurous consumers may research to find the best price, the far greater costs of searching for, reading, understanding and finally comparing the aggregate value of different sets of contract terms will overwhelm any benefit from doing so.

Meyerson, *Efficient Consumer*, *supra* note 112, at 601.

250. Some economically oriented commentators have argued that under certain circumstances it might take less than a third of informed consumers to protect uninformed consumers. *See* Cruz & Hinck, *supra* note 245, at 656. However, they also note that the smaller a percentage of informed consumers that are needed, the easier it is for sellers to segregate them from the uninformed consumers. *Id.*

251. *See* Croley & Hanson, *supra* note 14, at 776 (noting that it "seems likely" that product manufacturers can so segregate); Trebilcock, *External Critiques*, *supra* note 230, at 78 (noting that sellers can segregate in this manner, requiring court intervention).

252. Cruz & Hinck, *supra* note 245, at 674.

253. *See* Croley & Hanson, *supra* note 14, at 784 ("Unfortunately, the [marginal consumer] theory fails to reconcile the positions that marginal consumers are similar to inframarginal consumers in their demand for warranty coverage but different from inframarginal consumers in their willingness to acquire information regarding warranty content.").

254. *See* Cruz & Hinck, *supra* note 245, at 670 (noting that "there is no reason to assume that marginal consumers are average consumers"); A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 BELL J. ECON. 417, 418 (1975) (arguing that "in many cases, the marginal consumer is quite unlikely to be representative in his marginal valuation of quality").

255. Cruz & Hinck, *supra* note 245, at 671.

berg has concluded that the hypothetical "aggressive bargain-seeking customer" is usually just a minor figure in the equilibrating process."[256]

d. Competition Rationale

The final contractarian defense of adhesion contracts is the notion that even if consumers/investors do not read their contracts and even if there are insufficient marginal consumers/investors to create fair and efficient contracts, competition will force form givers to provide fair and efficient adhesion contracts.[257] This argument claims that competition forces a "race to the top" in which competing sellers offer buyers increasingly pro-buyer contract provisions.[258] The theory is that firms will compete on contract terms as vigorously as they compete on price.[259] In this view, the fine print of adhesion contracts is littered with diamonds and pearls. If only a consumer/investor would read the fine print she would find promises, warranties, pledges, and benefits galore. This, of course, is a fantasy.[260] Surely in certain industries at certain times, sellers compete for consumers on the basis of warranties or other nonprice contract provisions. However, the extent of this competition should not be exaggerated.[261]

256. Goldberg, *Institutional Changes*, *supra* note 104, at 485; *see also* Meyerson, *Objective Theory*, *supra* note 110, at 1270–71:

> Despite wishful commentary to the contrary, there is no evidence that a small cadre of type-A consumers ferrets out the most beneficial subordinate contract terms, permitting the market to protect the vast majority of consumers. Obvious terms, such as pricing and warranties, may be subject to such comparison shopping. It is hard, however, to imagine a sufficient number of prospective consumers refusing to rent a car because the contract contains an unfair forum selection clause.

257. Paul H. Rubin, *Courts and the Tort-Contract Boundary in Product Liability*, *in* FALL AND RISE, *supra* note 230, at 119, 122 [hereinafter Rubin, *Tort-Contract Boundary*] (arguing that "the seller who offers the most valuable contractual terms will also succeed"); Schwartz & Wilde, *supra* note 244, at 660 (claiming that "if enough consumers comparison shop to make it profitable for firms to compete on price and quality, firms also are likely to compete on [contract] terms").

258. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 85 (2d ed. 1977).

259. *See id.* at 85–86.

260. Meyerson doubts there will be competitive advertising over subordinate contract terms in consumer contracts:

> Most of these clauses allocate risks to the consumer, such as the consequences of defaulting on payment and the possibility of a subsequent collection suit. Since consumers are, at best, only dimly aware of these risks, sellers will not want to call attention to the risks for fear of creating a disincentive for any purchase at all. It is ludicrous to imagine a bank advertising, "We have the only loan contract in town that doesn't require you to pay our attorney's fees if we successfully sue you for default," or a manufacturer proclaiming on television, "We will sell your note to a collection agency, but, don't worry, you don't have to pay them if our product doesn't live up to its warranty."

Meyerson, *Efficient Consumer*, *supra* note 112, at 602.

261. The franchise industry presents an example of relatively sophisticated contracting parties on both sides that contractarian theory hypothesizes should produce a rich texture of contractual terms adapting to a variety of market circumstances. Unfortunately for the theory, in real life franchise contracts are remarkably uniform and are generally presented to and accepted by franchisees on a take-it-or-leave-it basis. R. Preston McAfee & Marius Schwartz, *Opportunism in Multilateral Vertical Contracting: Nondiscrimination, Exclusivity, and Uniformity*, 84 AM. ECON. REV. 210, 224–25 (1994).

Adhesion contracts are not, nor have they ever been, pro-consumer/investor. As Slawson has noted, "[f]or the very reason that these [form contract] terms are imposed rather than agreed upon, they are almost universally unfair."[262] If sellers decide to compete on contract terms, those terms will not be hidden in take-it-or-leave-it form contracts. They will be trumpeted in advertising and highlighted in sales pitches.[263] But because consumers and investors are generally price conscious but not "term conscious,"[264] sellers and promoters usually will not advertise better contract terms because such terms will not increase demand.[265] Provisions that make up the boilerplate of the form contracts will be almost universally pro-seller and anticonsumer/investor and, of course, seldom advertised.[266]

Many factors that are not at all efficiency-related help account for the prevalence of form contracts. Rakoff points to strong organizational and institutional forces (such as the need to maintain internal hierarchical integrity) that lead firms to provide form contracts to their customers,[267] even in the absence of efficiency.[268] Kahan and Klausner note the

262. W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 529 (1971) [hereinafter Slawson, *Standard Form Contracts*].

263. Slawson has noted one such competition:

> Prior to 1963, warranties on all automobiles manufactured by major domestic manufacturers were uniform and meager. A buyer's sole remedy for defects was free repair or replacement of defective parts if they were found defective within the first twelve months or fourteen thousand miles, whichever was less. But, in 1963 [after *Henningsen*] Chrysler adopted a warranty covering parts in the "power train" for five years or fifty thousand miles *and advertised it*. General Motors, Ford, and American Motors responded with different, but also greatly improved, warranties, and competition continued until 1967, when the industry again reached uniformity with warranties covering most major parts for five years of 50,000 miles and all other parts for two years or 24,000 miles. Thereafter, however, apparently because consumer claims were costing more than had been anticipated, the advertising emphasis was dropped and warranties again restricted.

Id. at 548.

264. An empirical study of automobile warranties revealed that consumers simply were not particularly conscious of their existence and/or terms. William C. Whitford, *Law and the Consumer Transaction: A Case Study of the Automobile Warranty*, 1968 WIS. L. REV. 1006, 1097 [hereinafter Whitford, *Law and the Consumer*] ("[T]he details of warranty coverage and administration do not seem very important to most owners at the time of purchase when the most practical protective action can be taken.").

265. Meyerson, *Efficient Consumer*, *supra* note 112, at 605. Even after passage of the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301–2312 (2000), and widespread adoption of the Uniform Commercial Code (UCC) and various state consumers laws required sellers of consumer goods to offer warranties, there was precious little competition by sellers based on those provisions. For example, a comprehensive study by Gerner and Bryant found that "the provisions sections of the warranties were remarkably similar despite the diversity of technologies and failure rates exhibited by the appliances." Gerner & Bryant, *supra* note 112, at 84. They did find more variation in warranty exclusions, which they expected given consumers' rational ignorance about such provisions. *Id.* at 84–85.

266. *See* Cruz & Hinck, *supra* note 245, at 660 ("In fact, the majority of contractual terms are simply never advertised.").

267. Rakoff, *supra* note 54, at 1220–29. Rakoff notes, among other points, that organizations that wish to maintain internal hierarchical integrity will wish to have interchangeable sales representatives who "sell a standard product at a standard price on standard terms." *Id.* at 1223.

268. *Id.* at 1234–35.

role of herd behavior[269] by lawyers who draft the contracts on behalf of the sellers.[270] When the industry's standard form contains primarily pro-seller provisions, attorneys for the various firms will be extremely reluctant for a whole host of reasons, including herd behavior theory, to advise their clients to take the risk of adopting a pro-consumer variation.[271] Not surprisingly, Farnsworth, the reporter for the Restatement (Second) of Contracts, has noted that in his own experience in legal practice, "no one in any of the corporations or in the law firm ever suggested that the forms should be drafted other than as one-sidedly in the interests of the corporate client as possible."[272]

The fact is that most contractual terms are not given much thought by consumers and/or investors. They do not read the form contracts, do not know which seller's form might be better than another's, and therefore do not generate demand that might move sellers to alter their forms in a pro-consumer/investor direction. This situation creates one of Akerlof's "markets for lemons."[273] Therefore, it makes little sense for a form giver to frame contractual terms in a pro-consumer/investor fashion. And when a firm's competitors use their form contracts to nick the consumer/investor a little bit here and there in ways that the consumer/investor does not even notice, competitive pressure leads the firm to emulate its competitors in a "race-to-the-bottom."[274] This is why the small print in standardized contracts is so relentlessly anti-

269. For some prominent studies on herd behavior, see David Scharfstein & Jeremy Stein, *Herd Behavior and Investment*, 80 AMER. ECON. REV. 465, 466 (1990) (noting effect of herd behavior in investment field); Jeffrey Zwiebel, *Corporate Conservatism and Relative Compensation*, 103 J. POL. ECON. 1, 15 (1995) (modeling herd behavior in corporate compensation).

270. *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases*, 74 WASH. U. L.Q. 347, 353–59 (1996). Kahan and Klausner explore several explanations for why attorneys will tend to draft contracts with standardized rather than customized provisions. *Id.*

271. *Id.* Furthermore, attorneys have a self-serving reason for making legal risks seem greater to their clients. Lauren B. Edelman et al., *Professional Construction of Law: The Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47, 73–77 (1992) (finding that attorneys appear to exaggerate the threat of wrongful discharge liability in order to increase their importance to the client).

272. E. Allan Farnsworth, *On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law*, 46 U. PITT. L. REV. 1, 44 (1984).

273. *See* Hasen, *supra* note 102, at 427–29. Regarding the concept of a "market for lemons" generally, see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

274. Interestingly, this analysis parallels a debate in corporate law. Law-and-economics advocates have long argued that if unregulated, corporations would move to states with the most pro-shareholder rules of corporate governance and that states would compete for the right to be home to corporations in the "race to the top," a race to adopt the most pro-shareholder governance provisions. *See, e.g.*, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, J.L. ECON. & ORG. 225, 229–35 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 255–56 (1977). The most compelling recent evidence totally refutes this theory. *See* LUCIAN A. BEBCHUK ET AL., DOES THE EVIDENCE FAVOR STATE COMPETITION IN CORPORATE LAW? (Harv. L. & Econ. Discussion Paper No. 352, Oct. 2002), *available at* http://papers.ssrn.com/abstract303417.

consumer/investor[275] and would be even worse absent court intervention over the past forty years.

Thus, while Posner hypothesizes a race to the top,[276] Slawson explains why a race to the bottom is more likely:

> Even producers who might want to treat consumers fairly have difficulty doing so in a competitive economy when the law sets no limits on the elimination of a party's contractual rights. The money a producer can save by eliminating consumers' rights is pure profit. It costs no more to make an unfair contract than a fair one, and an unfair one will not noticeably reduce sales because so few consumers will read it. *Competitive pressure therefore works to compel every producer to make its contracts at least as unfair as the contracts of the other members of its industry.* It will make fewer profits than its competitors if it does not. The logical end result is for all the contracts in the industry to be the same and all to be as unfavorable to the consumer as a lawyer's skills can make them.[277]

Real life experience is not universally in either camp but generally is more consistent with Slawson's theory than with Posner's. Consider consumer contracts that existed in the age of unfettered contractual freedom. In the landmark *Henningsen* case,[278] for example, a typical pre–Uniform Commercial Code automobile warranty limited defendant Chrysler's liability to a simple duty to repair a broken steering mecha-

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275. As Slawson has noted:

> Forms standardized to achieve economies of mass production and mass merchandising will also, under the present system, almost certainly be unfair, because if they were not, their issuers would probably lose money. An unfair form will not deter sales because the seller can easily arrange his sales so that few if any buyers will read his forms, whatever their terms, and he risks nothing because the law will treat his forms as contracts anyway. The user of an unfair form does not even stand to lose any significant number of future sales because the contingencies against which his forms provide him protection are normally of a kind which only infrequently occur (although when they do, the buyer may lose a great deal). When such a contingency arises the buyer will not usually be in a position to compare the form he bought with others he might have bought instead. Most buyers probably believe (correctly) that the forms they could have bought from a competing seller would have been just as bad anyway. An unfair form thus normally constitutes a costless benefit which a seller refuses at his peril. If he fails to take advantage of it, his competitors will. Competitive pressures have worked so long and so thoroughly to make standard forms unfair that we no longer even notice the unfairness. Standard credit agreements commonly allow the lender to call the entire unpaid balance, plus costs of collection, should even a single payment be a moment late, or, not uncommonly, should the lender just wake up some morning feeling "insecure," but it is rare that either provision occasions even a judicial comment. A standard agreement signed recently by a colleague of the author who purchased a *new* automobile contained provisions disclaiming all representations and warranties of year, model, mileage, price or design-change prior to delivery (!), but he signed it without thought.

Slawson, *Standard Form Contracts*, *supra* note 262, at 531–32.

276. Posner suggests that the "sinister explanation" for adhesion contracts that "the seller refuses to negotiate terms with each purchaser because the purchaser has no choice but to accept his terms" is "in general implausible because it implicitly assumes the absence of competition." POSNER, *supra* note 258, at 85. He concludes that "competition forces sellers to incorporate in their standard contracts terms that maximize the purchaser's benefits from transacting." *Id.*

277. SLAWSON, BINDING PROMISES, *supra* note 108, at 34–35 (emphasis added); *see also* Rakoff, *supra* note 54, at 1227 (also noting that "[s]trong competition, far from ameliorating the [anticonsumer] situation, will only exacerbate it").

278. 161 A.2d 69 (N.J. 1960).

nism that had caused a serious accident inflicting severe personal injuries.[279] Even the duty to repair that part arose only if plaintiff extracted it from the pile of rubble that was his car and shipped it to Chrysler (apparently in Detroit), *return shipping prepaid!*[280] This stingy warranty was furthermore available to the purchaser only within the first ninety days or 4,000 miles (whichever came first) and was located in tiny print in a sea of form provisions.[281]

If the competition rationale is to be credited, only morons bought Chryslers, because other car companies would have offered more consumer-friendly warranties. However, in fact other major car companies had virtually the same nearly illusory warranty.[282]

As long ago as 1931, Llewellyn noted that "even in such highly competitive spheres as installment sales, residence leases, investments, and commercial banking [there is an] accumulation of seller-protective instead of customer-protective clauses."[283]

> Confident in markets, [scholars in the products liability field] Huber and Epstein both call for a regime of free contracting. But, in light of the contracts that existed prior to the *Henningsen* decision in 1960, Huber's and Epstein's proposals are tantamount to proposals for absolute consumer liability. Put differently, given that there seem to be *no* examples (and the contractarians offer none) of firms that expressly contracted to accept liability for damages to consumers from product-caused injuries, no reason exists to believe that any manufacturers would, given the choice, contract to anything but absolute consumer liability.[284]

279. *Id.* at 74.

280. *Id.*

281. *Id.*

282. Whitford, *Law and the Consumer*, *supra* note 264, at 1013 (reporting empirical study revealing that: "in their essential features the 1967 model year warranties of the three major manufacturers are identical").

283. Karl N. Llewellyn, *What Price Contract? An Essay in Perspective*, 40 YALE L.J. 704, 734 (1931); *see also* SLAWSON, BINDING PROMISES, *supra* note 108, at 32 ("[T]he chief and most evident consequence of these systematic inequalities of bargaining power was to make contracts very unfavorable to consumers.").

284. Croley & Hanson, *supra* note 14, at 761.

The auto industry's practices depicted in *Henningsen* may well be a worst-case scenario, but a detailed examination of warranty practices in 1930 found that although competition sparked many manufacturers of various types of machines and appliances to make warranties, many form contracts were "entirely silent" as to any remedy for breach of warranty that customers might have. George G. Bogert & Eli E. Fink, *Business Practice Regarding Warranties in the Sale of Goods*, 25 ILL. L. REV. 400, 406 (1930). Those form contracts that had clauses addressing remedies tended not to mention actions for damages "since no seller would care to picture litigation to a prospective buyer." *Id.* at 407. The study also found widespread use of exclusions of warranties. *Id.* at 405–06. Sharp practices had already been constrained by some earlier cases that had declared as void against public policy various pro-seller provisions in standard form contracts. *Id.* at 413.

Posner himself notes:

> A manufacturer will reap little consumer ill will from fooling consumers with a disclaimer that they fail to read, because product accidents are so rare anyway; and for the same reason competing manufacturers will not find it profitable to try to compete by offering to disclaim disclaimers.

Investors, at least all lay investors and probably many others, are typically as vulnerable as product consumers.[285] Before passage of the federal securities laws, most investors accepted similarly one-sided form contracts. As I noted in an earlier article, a typical pre–1933 Act broker-customer contract was extremely one-sided:

> A standard contract spoke at length about the *rights of the broker*—to hold securities as collateral, to make transfers among the customer's accounts without notice, to segregate collateral in excess of margin requirements, to demand additional security at any time, to receive payment of commissions on demand, to employ sub-brokers, to sell, assign or deliver the customers' securities without advertisement or notice of sale whenever necessary to protect the brokers' interests, to hold the customer liable for any deficiencies, and to be held harmless and indemnified by the investor from any loss, damage or liability arising out of securities transactions. The contract provided that customers could not rely on the oral statements of their brokers agreeing to liquidate their accounts; "all such agreements must be in writing."
>
> The only *duties* of the broker mentioned in a standard agreement were to execute orders in compliance with exchange rules and to use reasonable care in selecting sub-agents.[286]

As another example, note the circumstances that prompted passage of the Trust Indenture Act (TIA) of 1939.[287] Corporate debt securities were issued under indentures that "resulted in injury to thousands of investors" because they were drafted to virtually eliminate trustee liability for defalcations.[288] The SEC noted, consistent with adhesion contracts generally, with pre–1933 Act broker-dealer form contracts, and with pre-*Henningsen* product contracts: (a) that investors seldom read the terms

> High information costs relative to the benefits of the information may defeat voluntary contracting.

LANDES & POSNER, *supra* note 111, at 281–82.

285. *See* Douglas M. Branson, *The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law*, *in* PROGRESSIVE CORPORATE LAW 93, 94 (Lawrence E. Mitchell ed., 1995) [hereinafter PROGRESSIVE CORPORATE LAW] (noting that it is typically neither feasible nor cost effective for individual investors to negotiate special contractual protections); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW, *supra,* at 1, 6 (noting that investors in corporate bonds must typically "accept the terms already negotiated by an investment bank"); Welle, *supra* note 61, at 578 (noting that investors usually do not read and cannot fully understand subscription agreements and, even if they do, "attempts to change provisions typically will be met with resistance, including responses such as the terms are dictated by counsel, the clause is an industry standard, we cannot make an exception for one investor, or we do not have the authority to change the terms").

For these reasons, even today customer agreements that investors sign with their stockbrokers "are one of the more one-sided agreements you'll ever sign." STONEMAN & SCHULZ, *supra* note 141, at 145.

286. Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1452 (footnotes omitted).

287. 15 U.S.C. §§ 77aaa–77bbbb (2000) (as amended).

288. 6 SEC. & EXC. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES: TRUSTEES UNDER INDENTURES 2–3 (1936).

of the trust indentures; (b) that even if they had done so, only the specialists among them would have understood the terms; and (c) that often indentures were drafted so that even highly trained investment agents would not notice vital liability-escaping provisions.[289] Thus, while pre-TIA debt securities were issued upon the strength of the reputation of the trustees, the reliance was unfounded.[290] Only when enactment of the TIA authorized the federal government to dictate the terms of the indentures and thereby eliminate liability disclaimers were investors adequately protected.

Thus, analysis by Rakoff, Kahan, Klausner, Slawson, and others helps to explain why companies and issuers *offer* form contracts; the behavioral analysis earlier in this article helps to explain why customers and investors *accept* them. Adhesion contracts cause no particular problem if the law constrains form givers from unconscionable actions, as general contract law has evolved over the past forty years to do.[291] As Slawson has noted:

> The principal purpose of contract law is to make certain kinds of promises binding. Before the recent [contract law] reforms, producers could use their superior bargaining powers to defeat this purpose. They could make contracts that did not include the promises they had made, and they could breach their contracts with impunity. These results were unjust because they systematically favored producers over consumers, and they were socially harmful because they weakened the incentives for producers to produce safe products and products of good quality.
>
> The reforms make producers' promises binding again.[292]

Unfortunately, securities cases such as *Carr* and *Rissman* roll back forty years of contract law reforms and again allow fraudsters to make promises, breach them, and do so with impunity.[293] Surely adhesion con-

289. *Id.*

290. *Id.* at 4 ("[A]n examination of the provisions of [1930s] trust indentures and their administration by trustees will show . . . that typically the trustees do not exercise the elaborate powers which are the bondholders' only protection; that they have taken virtually all of the powers designed to protect the bondholders, but have rejected any duty to exercise them; and that they have shorn themselves of all responsibilities which normally trusteeship imports."); *see also* Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 425 (1972) (noting that before the Trust Indenture Act was passed, "[e]ven in cases where misconduct by the indenture trustee was the proximate cause of injury to debenture holders, they found themselves impotent under the terms of most indentures to take action against the trustee"); Robert G. Miller, *The Trust Indenture Act of 1939*, 25 CORNELL L. REV. 105, 106 (1940) (noting that after trustees in an attempt to reduce their risk to a minimum wrote into indentures exculpatory clauses relieving them of many duties, responsibilities, and liabilities, "[t]he resulting position of the security holders is not hard to imagine, especially in cases of default").

291. SLAWSON, BINDING PROMISES, *supra* note 108, at 173–74 (noting that legislative and judicial reforms since 1960 have made form givers' promises binding again by disallowing one-sided adhesion contract terms that vitiated any true obligation by the form-givers).

292. *Id.* at 173.

293. Not that these cases stand alone. The law in the area is remarkably contradictory. *See* Rakoff, *supra* note 54, at 1197 ("The law currently governing contracts of adhesion is a jumble of different lines of analysis, contradictory outcomes, and convoluted expressions.").

tracts are necessary in today's economy. Efficiency interests are served by contracts that need not be negotiated (or even read) in excruciating detail by the parties *if* the law protects those form takers from unfair treatment. The doctrine of unconscionability[294] and the rule that surprising and unfair provisions in adhesion contracts are generally not enforceable[295] usually serve to protect consumers and thereby encourage parties to engage in transactions.[296] A provision in a contract that functionally provides: "I didn't say what I said to you" is inherently surprising and, if sufficiently central to the agreement, substantively unfair,[297] yet is explicitly approved by the *Carr/Rissman* line of cases.

B. Merger Clauses Generally

Rissman tells sellers that if their form contracts contain an integration clause only, buyers may be allowed to prove fraud; but if sellers add a simple sentence of boilerplate ("Buyer relies on no oral statements made by seller"), buyers will not be allowed to introduce evidence of fraud. In so doing, *Rissman* allows a simple formality to gut the fraud exception to the parol evidence that most courts recognize.

1. The Parol Evidence Rule

Contemplate for a moment the parol evidence rule without a fraud exception. The general argument in favor of applying the merger doctrine, that it is an efficient contractual mechanism,[298] must be weighed against its pernicious impact on the investor protection purposes Congress had in mind in enacting the securities laws. The argument that treating an integration clause as immune from parol evidence "honors the parties' decision to include such a clause in their written agree-

294. *See generally* JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS 316–28 (2d ed. 1977) (discussing theory and applications of the doctrine).

295. *See, e.g.*, Budget Rent-A-Car Sys., Inc. v. Crawford, C.A. No. 97-17131, 1999 U.S. App. LEXIS 10987, at *9 (9th Cir. May 25, 1999) (adhesion contracts are enforceable unless they are oppressive or unfairly surprising); Lewis v. Lewis, 748 P.2d 1362, 1366 (Haw. 1988) (same); Hartland Computer Leasing Corp. v. The Ins. Man, Inc., 770 S.W.2d 525, 527 (Mo. Ct. App. 1989) (same). The Restatement provides that "a party who adheres to the other party's standard terms does not assent to a term if the other party has reason to believe that the adhering party would not have accepted the agreement if he had known that the agreement contained the particular term." RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. f (1981).

296. There are a wide range of UCC, Restatement, and specific substantive provisions in remedial legislation that work to minimize the abuses that can arise from standardized contracts. Robert Dugan, *Good Faith and the Enforceability of Standardized Terms*, 22 WM. & MARY L. REV. 1, 5–7 (1980).

297. *See* Meyerson, *Objective Theory*, *supra* note 110, at 1315 ("Not only is this [allowing a seller to make oral representations and then place a clause in a form contract stating that no representations were made] unfair, but it also permits sellers to prevail despite their own knowledge of the consumer's reliance on their statements in entering the contract.").

298. *See, e.g.*, Layman v. Combs, 981 F.2d 1093, 1107 (9th Cir. 1992) (Kozinski, J., dissenting); One-O-One Enters., Inc. v. Caruso, 848 F.2d 1283, 1287 (D.C. Cir. 1988).

ment,"[299] is simply not persuasive where the defendant handed to the plaintiff a form contract that contained provisions inconsistent with their oral agreement. "[T]he essential incomprehensibility of standardized terms, which are neither read nor intended to be read by the nondrafter, absolutely contradicts the integration assumption that underlies the parol evidence rule."[300]

Most disclaimers and merger clauses are not dickered. They are simply contained in the form provided by one of the parties and passively accepted by the other. Most portions of adhesion contracts are not a product of any meeting of the minds of the parties[301] as traditional contract law requires. Even the most specifically drafted merger clause should be ineffective when the form taker was not given a meaningful opportunity to read and understand the contract.[302] And, for reasons explained above, even when given the opportunity to read and understand such terms, consumers and investors will often sign them even though they are inconsistent with the parties' true agreement.

2. *The Fraud Exception*

The parol evidence rule is riddled with exceptions and for our purposes the most important is the fraud exception.[303] Behavioral considerations probably did not underlie the origins of the fraud exception to the parol evidence rule, but they certainly justify its continued recognition. Although there is substantial inconsistency among jurisdictions,[304] "[i]t is generally agreed that the parol evidence rule does not bar extrinsic evidence to show fraud as a ground for rescission, a tort action for damages,

299. UAW-GM Human Res. Ctr. v. KSL Recreation Corp., 579 N.W.2d 411, 416 (Mich. Ct. App. 1998).

300. Dugan, *supra* note 296, at 5.

301. *See* Donald B. King, *Standard Form Contracts: A Call for Reality*, 44 ST. LOUIS U. L.J. 909, 911 (2000) ("[I]n the standard form contract setting, one party drafts and prints the contract and imposes it on the other. There is no negotiation or assertion to these printed terms and often the party on whom they are imposed never reads them.").

Several courts agree. *See* A & M Produce Co. v. FMC Corp., 186 Cal. Rptr. 114, 125 (Cal. Ct. App. 1982) ("[O]ne suspects that the length, complexity and obtuseness of most form contracts may be due at least in part to the seller's preference that the buyer will be dissuaded from reading that to which he is supposedly agreeing."); Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69, 87 (N.J. 1960) ("'Extreme inequality of bargaining between buyer and seller [regarding adhesion contracts] . . . is now often conspicuous. Many buyers no longer have any real choice in the matter.'" (quoting LAWRENCE VOLD, HANDBOOK OF THE LAW OF SALES 447 (2d ed. 1959)).

302. Joyner v. Albert Merrill Sch., 411 N.Y.S.2d 988, 993 (N.Y. Misc. 1978) (noting that defendant was twice called out of class and asked to sign the contracts without being given an opportunity to read them nor any explanation as to what they contained).

303. One court notes that "[i]t is arguably incorrect to say that fraud is an exception to the parol evidence rule. Rather, the rule does not apply because the fraud establishes that there is no contract—no contract, no parol evidence rule." Betz Labs., Inc. v. Hines, 647 F.2d 402, 406 (3d Cir. 1981) (Pennsylvania law).

304. Eric A. Posner, *The Parol Evidence Rule, Plain Meaning, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 540 (1998) ("In virtually every jurisdiction, one finds irreconcilable cases, frequent changes in doctrine, confusion, and cries of despair.").

or reformation."[305] This refers to promissory fraud as well as to fraud in the inducement.[306]

Because no-reliance clauses have the same effect as integration clauses, many courts believe that they should also be subject to the fraud exception. As Farnsworth has observed, "[e]ven a clause specifically reciting that there have been no representations of a particular kind should be ineffective as against extrinsic evidence of fraud."[307] Thus, most courts have held that "a person cannot free himself from fraud by incorporating a clause . . . in a contract."[308]

305. FARNSWORTH, *supra* note 107, at 465.

306. *Id.; see, e.g.*, Blackledge v. Allison, 431 U.S. 63, 75 n.6 (1977) (holding that integration clauses carry "great weight, . . . but . . can be set aside by a court on the grounds of fraud"); New Shows, S.A. de C.V. v. Don King Prods., Inc., Nos. 99-9019, 99-9069, 2000 U.S. App. LEXIS 6319, at *10 n.5 (2d Cir. Apr. 6, 2000) ("[U]nder New York law, fraud claims may be predicated on oral fraudulent representations, even where a contract between the parties contains a standard integration clause."); Audiotext Communs. Network v. U.S. Telecom, Nos. 97-3050, 97-3053, 1998 U.S. App. LEXIS 18212, at *9 (10th Cir. Aug. 6, 1998) ("It is well settled in Florida that such clauses will not bar evidence of fraud in the inducement of the contract."); Olympia Hotels Corp. v. Johnson Wax Dev. Corp., 908 F.2d 1363, 1373 (7th Cir. 1990) (Posner, J.) (Wisconsin law) ("Of course if the contract was procured by fraud, the integration clause would not prevent inquiry into the parties' discussions before the contract was signed; the integration clause would go down the drain with the contract of which it was a part."); Tusch Enters. v. Coffin, 740 P.2d 1022, 1030 n.5 (Idaho 1987); Abbott v. Abbott, 195 N.W.2d 204, 208 (Neb. 1972) (holding that in a tort claim the "parol evidence rule does not prevent reception or consideration of evidence to prove promissory fraud"); Goodwin R.R., Inc. v. State, 517 A.2d 823, 831 (N.H. 1986); Sabo v. Delman, 143 N.E.2d 906, 908–09 (N.Y. 1957) (holding that in a fraud suit the parol evidence rule does not bar evidence that one party made a promise "with the preconceived and undisclosed intention not to perform it"); Neihaus v. Haven Park W., Inc., 440 N.E.2d 584, 586 (Ohio App. 1981) (holding that an integration clause did not prevent plaintiff from proving fraud in oral representations not contained in the written contract). *But see* Blue Circle Atl., Inc. v. Wood, No. 90-16389, 1992 U.S. App. LEXIS 9527, at *7–8 (9th Cir. Apr. 24, 1992) (Arizona law) (holding that the fraud exception does not apply when the alleged fraud directly contradicts a statement in the written contract); Lewelling v. Farmers Ins. of Columbus, Inc., 879 F.2d 212, 217 (6th Cir. 1989) (holding that under Ohio law an integration clause cannot be defeated by a prior oral misrepresentation); Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282, 288 (9th Cir. 1988) (giving effect to an integration clause even though plaintiffs alleged that they had been fraudulently told that the writing would not compromise any of their rights); Fisher v. Pa. Life Co., 138 Cal. Rptr. 181, 184 (Cal. Ct. App. 1977) (giving force to a no-reliance clause in the face of a claim of fraud in the inducement).

307. FARNSWORTH, *supra* note 107, at 466; *see, e.g.*, Dunbar Med. Sys., Inc. v. Gammex, Inc., 216 F.3d 441, 449 (5th Cir. 2000) (holding under Texas law even an "as is" clause supported by a full integration clause did not prevent plaintiff from proving fraud in oral promises leading to the writing); Webster v. Palm Beach Ocean Realty Co., 139 A. 457, 460 (Del. Ch. 1927) (finding that a contract clause disclaiming fraudulent representations is ineffective in defending fraud); Bryant v. Troutman, 287 S.W.2d 918, 920–21 (Ky. 1956) (finding that mere silence does not constitute fraud where it relates to facts open to common observation); Ganley Bros., Inc. v. Butler Bros. Bldg. Co., 212 N.W. 602, 603 (Minn. 1927) (finding that "no one can escape liability for his own fraudulent statements by inserting in a contract that the other party shall not rely upon them"); Carty v. McMenamin, 216 P. 228, 230–31 (Or. 1923) (same); Dieterich v. Rice, 197 P. 1, 13 (Wash. 1921) (same).

308. Arnold v. Nat'l Aniline & Chem. Co., 20 F.2d 364, 370 (2d Cir. 1927) (noting Professor Wigmore's point that because the victim of fraud supposedly did not know of it, he or she cannot have intended that the merger clause encompass fraudulent statements); Lusk Corp. v. Burgess, 332 P.2d 493, 495 (Ariz. 1958) (finding that parties cannot contractually absolve themselves from fraud); Formento v. Encanto Bus. Park, 744 P.2d 22, 26 (Ariz. Ct. App. 1987) (same); Alphagraphics Franchising, Inc. v. Whaler Graphics, Inc., 840 F. Supp. 708, 711 (D. Ariz. 1993); *see also* Cummings v. HPG Int'l, Inc., 244 F.3d 16, 21 (1st Cir. 2001) (Massachusetts law); J. C. Whitney & Co. v. Renaissance Software Corp., No. 99-C3714, 2000 U.S. Dist. LEXIS 6180, at *38 (N.D. Ill. Apr. 19, 2000) (Illinois law) (same); Bates v. Southgate, 31 N.E.2d 551, 558 (Mass. 1941) (same); Joyner v. Albert Merrill Sch., 411 N.Y.S.2d 988,

A garden-variety example is *City Dodge, Inc. v. Gardner*,[309] wherein the seller's form contract provided that "no other agreement, promise or understanding of any kind pertaining to this purchase will be recognized."[310] Despite having signed the contract (which also provided that the car was being sold "as is"), the plaintiff buyer claimed that the salesman had told him that the car had never been wrecked, although after the purchase the buyer learned that it had been.[311] The defendant car dealer claimed that the language of the contract prevented the plaintiff from adducing evidence of the fraud, but the court disagreed:

> We believe the better view is that the question of reliance on the alleged fraudulent misrepresentation in tort cases cannot be determined by the provisions of the contract sought to be rescinded but must be determined as a question of fact by the jury. It is inconsistent to apply a disclaimer provision of a contract in a tort action brought to determine whether the entire contract is invalid because of alleged prior fraud which induced the execution of the contract. If the contract is invalid because of the antecedent fraud, then the disclaimer provision therein is ineffectual since, in legal contemplation, there is no contract between the parties.[312]

Most cases are in accord with *Gardner*, even in the presence of a complete integration clause.[313] Still, Eric Posner points out that many courts tend to strictly honor merger causes, resisting what they see as the fraud exception's swallowing of the parol evidence rule by either (a) limiting its application to fraud in the execution (and excluding fraud in the inducement), or (b) restricting its application to cases where the allegedly fraudulent promise does not directly contradict a statement in the

993–94 (N.Y. Misc. 1978) (holding that "sellers cannot, by careful drafting, immunize themselves against claims of fraud"); Crowell-Collier Publ'g Co. v. Josefowitz, 170 N.Y.S.2d 373, 375 (N.Y. Misc. 1957) (same); Angerosa v. White Co. 290 N.Y.S. 204 (N.Y. App. Div. 1936) (same); Dallas Farm Mach. Co. v. Reaves, 307 S.W.2d 233, 239 (Tex. 1957) (same); Coson v. Roehl, 387 P.2d 541, 545 (Wash. 1963) (holding that "fraud vitiates the contract, and [victims] are not foreclosed by the merger clause").

309. 208 S.E.2d 794 (Ga. 1974).

310. *Id.* at 796.

311. *Id.*

312. *Id.* at 797–98.

313. *See, e.g.*, Hall v. Coram Healthcare Corp., 157 F.3d 1286, 1289 (11th Cir. 1998) (Georgia law); Betz Labs., Inc. v. Hines, 647 F.2d 402, 408 (3d Cir. 1981) (Pennsylvania law) ("To give effect to an integration clause permits language to shield a party from the consequences of his fraud, contrary to public policy."); Marwell, La., Inc. v. Harris, 1996 U.S. Dist. LEXIS 8512, at *26 (W.D. Va. May 29, 1996) (Virginia law); Cone Mills Corp. v. A.G. Estes, Inc., 377 F. Supp. 222, 226 (N.D. Ga. 1974) (Georgia law); Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp., 38 Cal. Rptr. 2d 783, 787–88 (Cal. App. 1995), *petition for review denied*, No. S045867, 1995 Cal. LEXIS 3383 (Cal. May 18, 1995); Franklin v. Lovitt Equip. Co., 420 So. 2d 1370, 1372 (Miss. 1982); Lipsit v. Leonard, 315 A.2d 25, 28–29 (N.J. Sup. Ct. 1974) (New York law); Sunseri v. RKO-Stanley Warner Theatres, Inc., 374 A.2d 1342, 1346 (Pa. Super. Ct. 1977); George Robberecht Seafood, Inc. v. Maitland Bros. Co., 255 S.E.2d 682, 683 (Va. 1979). *But see* Urschel Farms, Inc. v. Dekalb Swine Breeders, Inc., 858 F. Supp. 831, 838–40 (N.D. Ind. 1994) (Indiana law); Banco do Brasil, S.A. v. Latian, Inc., 285 Cal. Rptr. 870, 885–86 (Cal. Ct. App. 1991); Deerfield Commodities, Ltd. v. Nerco, Inc., 696 P.2d 1096, 1111 (Or. Ct. App. 1985) (Pennsylvania law).

written contract.[314] *Carr* and *Rissman* are obviously in this school of thought. Professor Posner terms this the "hard-PER" view.[315] A "soft-PER" view is preferable for reasons explicated in the behavioral analysis above. Again, any fraudster who can lie convincingly enough to persuade an investor that a shell corporation actually has productive assets can also lie convincingly enough to induce the investor to sign a contract stating that no representations have been made about the company. As Judge Hand noted, if fraudsters are allowed to escape liability for drafting a contract in a certain way, one may rest assured that they will manage to draft the contract in that way.[316]

In *Rissman*, Judge Easterbrook cited two cases as supporting the notion that "non-reliance clauses in written stock-purchase agreements preclude any possibility of damages under the federal securities laws for prior oral statements."[317] But the D.C. Circuit had already (properly) backpedaled from one of those cases, *One-O-One Enterprises, Inc. v. Caruso*,[318] when it held in *Whelan v. Abell*,[319] that to eliminate the fraud in the inducement exception to the parol evidence rule "would leave swindlers free to extinguish their victims' remedies simply by sticking in a bit of boilerplate."[320]

In a case representative of the hard-PER view (and consistent with *Carr* and *Rissman*), a California appellate court noted that it simply could not "permit clear and unambiguous integrated agreements . . . to be rendered meaningless by the oral revisionist claims of a party who, at the end of the game, does not care for the result."[321] But this holding simply assumes without evidence that the writing did represent the true agreement of the parties and that the "revisionist" party had not been lied to. Similarly, when Judge Easterbrook wrote in *Rissman* that he would not allow an investor to lie by signing a contract saying that no representations were being made to him and then suing on the basis of alleged misrepresentations,[322] he was simply assuming that none had been made. If representations had been made, then it is the defendant not the plaintiff who is the liar. I assert that it would be better to do what the courts have always done in parol evidence cases involving allegations of fraud—attempt to determine who is telling the truth.

314. Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 536 (1998).

315. *Id.* at 534, 537.

316. *See supra* note 98 and accompanying text.

317. Rissman v. Rissman, 213 F.3d 381, 383 (7th Cir. 2000) (citing Jackvony v. RIHT Fin. Corp., 873 F.2d 411 (1st Cir. 1989) (Breyer, J.); One-O-One Enters., Inc. v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988) (Ginsburg J.)).

318. 848 F.2d 1283 (D.C. Cir. 1988).

319. 48 F.3d 1247 (D.C. Cir. 1994).

320. *Id.* at 1258.

321. Banco do Brasil v. Latian, Inc., 285 Cal. Rptr. 870, 893 (Cal. Ct. App. 1991).

322. *Rissman*, 213 F.3d at 387.

3. *Valuing Certainty*

Posner, Easterbrook, and the contractarians value certainty in contractual dealings, as well they should. But by simply assuming that defendants are honest sellers without giving buyers who allege that they were defrauded the opportunity to prove otherwise, they purchase that certainty at too high a price. After all, in cases like *Carr*, what are we really certain of? We are certain that the plaintiffs signed the contract. But did they read it? Did they understand it? Did it represent their agreement with the sellers? We do not necessarily know the answer to any of those questions. We do know that if an adhesion contract was involved, the answer to all three questions is most probably "no."[323] Corbin was right when he stated that in the context of adhesion contracts, merger clauses and no-reliance clauses should be treated as assertions of fact rather than as conclusions of law.[324] The value of "certainty" can be overstated:

> As a matter of principle it is necessary to weigh the advantages of certainty in contractual relations against the harm and injustice that result from fraud. In obedience to the demands of a larger public policy the law long ago abandoned the position that a contract must be held sacred regardless of the fraud of one of the parties in procuring it. No one advocates a return to outworn conceptions. The same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices. In the realm of fact it is entirely possible for a party knowingly to agree that no representations have been made to him, while at the same time believing and relying upon representations which in fact have been made and in fact are false but for which he would not have made the agreement. To deny this possibility is to ignore the frequent instances in everyday experience where parties accept, often without critical examination, and act upon agreements containing somewhere within their four corners exculpatory clauses in one form or another, but where they do so, nevertheless, in reliance upon the honesty of supposed friends, the plausible and disarming statements of salesmen, or the customary course of business. To refuse relief would result in opening the door to a multitude of frauds and in thwarting the general policy of the law.[325]

323. *See* Thomas W. Joo, *Contract, Property and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779, 794 (2002) (criticizing the contractarian model of a corporation and noting that although economists such as Easterbrook view the essence of a contract as its voluntariness, the fact that a provision is in an adhesion contract does nothing to prove that it was voluntarily agreed to).

324. Corbin, *supra* note 1, at 620.

325. Bates v. Southgate, 31 N.E.2d 551, 558 (Mass. 1941).

VI. BEHAVIORAL COUNTERPOINTS

In *Carr*, Judge Posner articulated concerns of the contractarians: "Without such a principle [that written disclaimers must trump inconsistent oral misstatements], sellers would have no protection against plausible liars and gullible jurors."[326]

Carr and *Rissman* arguably demonstrate a "preternatural solicitousness"[327] for the welfare of securities fraud defendants at a time when: (a) the unfolding Enron scandal indicates that earnings management and blatant fraud are widespread in corporate America;[328] (b) an estimated $100 billion of fraud occurs annually in the financial services industry;[329] (c) courts[330] and Congress[331] have thrown overwhelming procedural ob-

326. Carr v. CIGNA Sec., Inc. 95 F.3d 544, 547 (7th Cir. 1996). Judge Posner's reasoning lends credence to Corbin's observation that the parol evidence rule has become over time "a device for the control of the jury." Corbin, *supra* note 1, at 608.

327. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

328. In addition to the familiar names now emblematic of egregious corporate fraud, Enron, WorldCom, Global Crossing, Tyco, Adelphia, and others, the GAO recently reported that ten percent of all listed companies had to restate their earnings between 1997 and June 2002, with the percentage rising dramatically in recent years. *See* Hui-Yong Yu, *Improper Accounting Appears to Be on the Rise*, REC. (Bergen County, N.J.), Oct. 24, 2002, at B3.

In the 1990s, corruption on Wall Street knew very few bounds. *See generally* Marcia Vickers & Mike France, *How Corrupt Is Wall Street?*, BUS. WK., May 13, 2002, at 36–37 (detailing many of the excesses that recently took place).

329. *See supra* note 6 and accompanying text.

330. Courts have made it more difficult to be a securities fraud plaintiff in many ways in recent years. The Supreme Court has led the way, deciding in one stretch thirty-two out of forty securities cases in a pro-defendant direction. *See* Branson, *supra* note 9, at 6; *see, e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (dramatically reducing the coverage of '33 Act antifraud provision 12(a)(2)); Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (eliminating aiding and abetting claims in 10b-5 actions by private plaintiffs); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (reducing the long-recognized statute of limitations in 10b-5 cases).

Noting the powerful sentiment running against plaintiffs and their attorneys in securities fraud litigation, *see infra* notes 332–34 and accompanying text, Langevoort notes:

> One cannot read the case law under Rule 10b-5 since 1975 without a palpable sense that law-making has been driven by a fear of speculative litigation that had to be deterred, even at the price of making good cases harder to bring. Sometimes the fear has been explicit, as in cases like *Blue Chip Stamps* and *Central Bank of Denver.* Sometimes it is more hidden, as in *Gustafson.* Most potently, perhaps, has been its influence in the development of entirely new (or reinvented) doctrines under the securities laws. I doubt that we would have the three developments that to me, constitute the most interesting substantive change in 10b-5 doctrine over the past fifteen years—the "bespeaks caution" doctrine, the reinvigoration of an extraordinarily powerful "mere puffery" defense or the stunning willingness of judges to decide difficult materiality issues "as a matter of law"—were it not for the intensity of this perception.

Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 479 (2001) [hereinafter Langevoort, *Seeking Sunlight*]; *see also* Roger Parloff, *Seeds of Scandal*, DAILY DEAL, Sept. 26, 2002 (arguing that pro-defendant judicial and legislative reforms in the 1990s helped spur the Enron and related frauds); Spector, *supra* note 6, at A17 (same).

331. In passing the PSLRA and the Securities Litigation Uniform Standards Act of 1998, Congress tilted the playing field in securities fraud litigation dramatically toward the defendants' side. By instituting all manner of procedural hurdles for securities plaintiffs, including most significantly a potent pleading requirement and a stay of discovery whenever defendants file motions to dismiss, Congress has made "significant (and probably excessive) reforms in both the process and substance of private securities litigation." Langevoort, *Seeking Sunlight*, *supra* note 330, at 479; *see also* Ramirez, *supra* note 6, at 1058 (referring to the "near-fatal restrictions" on private securities fraud litigation im-

stacles in the way of any securities fraud plaintiff;[332] and (d) most claims of the type brought in *Carr* and *Rissman* will be heard by arbitration panels, rather than by juries, in a setting where it is plaintiffs rather than defendants who will have the most reason to be concerned about fair treatment,[333] because of the use of adhesion contracts that typically contain enforceable arbitration clauses.[334]

Nonetheless, Judge Posner's articulated concerns have merit. Must the courts guard against plausible liars and gullible jurors (and arbitrators)? Of course. One defense attorney recently reported a string of an-

posed by the PSLRA). Some observers speculated that when Congress passed Sarbanes-Oxley, it would take the opportunity to reverse some of the more egregious pro-defendant provisions of the PSLRA of 1995; it did not. *See* Parloff, *supra* note 330.

332. Thus, Branson refers to the "gauntlet" that any securities law plaintiff must run. Branson, *supra* note 9.

333. Many commentators have expressed concern about the fairness of securities arbitration. *See* Sung J. Lim, *Mandatory Arbitration in the Securities Industry: Efficiency at the Cost of Justice for All?*, 26 J. CORP. L. 771, 801 (2001) (noting that in the securities industry arbitrations between employers and employees, employers win more and pay less than they do in litigation and calling for elimination of mandatory arbitration clauses); Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 15 OHIO ST. J. ON DISP. RESOL. 63, 64 (1999) (noting that "[b]oth investors and Congress have express concern about the fairness of securities [arbitration]" and arguing that these concerns are well founded); Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 346–47 (1996) (noting that "the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public"); Marc I. Steinberg, *Securities Arbitration: Better for Investors than the Courts?*, 62 BROOK. L. REV. 1503, 1531 (1996) ("[A]rbitration is not the catastrophe to investors that many believed [it would be]."); Lynn Cowan, *Deal & Deal Makers: Traders Chase Moving Target in Arbitration*, WALL ST. J., Aug. 29, 2001, at C14 (noting that many investors have huge difficulties collecting arbitration awards); Madelaine Eppenstein & Theodore G. Eppenstein, *An Arbitration Albatross*, N. Y. TIMES, June 8, 1997, at F12 ("Given the power of the securities industry to fashion its own [arbitration] rules, and the inability of investors to have a real say in the administration of arbitration justice, there will no doubt be further erosion of public confidence in the system if the system is not improved."); Walter Hamilton, *Lawyers Group Alleges NASD's Arbitrations Biased for Firms*, L.A. TIMES, July 21, 2000, at C1 (reporting that lawyers representing investors in NASD arbitrations claimed that the NASD had tilted the process for choosing arbitrators in favor of industry); Margaret A. Jacobs & Michael Siconolfi, *Losing Battles: Investors Fare Poorly Fighting Wall Street—and May Do Worse—in Challenging Brokers, They Must Use Arbitration, but Firms Set the Rules—Next: No Punitive Damages?*, WALL ST. J., Feb. 8, 1995, at A1 (noting that "mandatory arbitration has earned a reputation for being stacked squarely against brokerage-firm customers"); Michael Schroeder, *Wall Street Should Stop Playing the Bully*, BUS. WK., Dec. 20, 1993, at 92 (noting that the arbitration system "tilts toward brokers").

However, there is substantial evidence that such arbitrations are generally fair to investors. *See* Ramirez, *supra* note 6, at 1061, 1102 (arguing that securities arbitration is generally fair to investors); PR NEWSWIRE, Aug. 5, 1999 (reporting an NASD survey finding that ninety-three percent of survey participants thought their NASD arbitration was handled "fairly and without bias").

A bigger problem than unfairness seems to be the difficulty that investors have in collecting when they win their arbitrations. A recent GAO report indicated that of $161 million in damages that arbitrators had ordered paid to investors in 1998, 80% remain uncollected; 49% of investors had never received a dime and 12% got only partial payment. Hamilton, *supra*, at C1.

334. For the same laundry list of reasons that plaintiffs accept form contracts containing no-reliance and merger clauses, they also accept arbitration clauses. No true choice is involved. *See* Seligman, *supra* note 333, at 345 (noting that consent in securities arbitration borders on being a "legal fiction" because investors usually have no true choice); Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335, 1337 (1996) (noting that the lack of true consent by investors faced with form contracts containing arbitration clauses is the "dark side" of the "consent coin").

ecdotes involving plaintiffs willing to lie to win what he termed the litigation "lie-tery."[335] Of course, investors' counsel could easily respond with a litany of major securities frauds that have been perpetrated lately by securities sellers.[336] The point to remember is that neither side has a monopoly on the truth. *Rissman*, as one example, simply assumes that the plaintiff is lying and the defendant is telling the truth.

Potentially a bigger problem than deliberate attempts to lie is various behavioral influences on human decision making that arguably justify Posner's concerns. Although Posner does not reference them, at least three such influences should be addressed in this context: (a) the self-serving bias, (b) the attribution bias, and (c) the hindsight bias.

A. The Self-Serving Bias

As I have explained in some detail elsewhere,[337] for both cognitive and motivational reasons, all people (investors, promoters, stockbrokers, and everyone else) tend to be self-serving.[338] The self-serving bias affects how people judge the fairness of situations.[339] It affects how people perceive information,[340] process and encode information,[341] and recall infor-

335. Michael Jones, *Lie-tery Winners*, NAT'L L.J., Mar. 26, 2001, at A24.

336. *See, e.g.*, Michael R. Young, *The Origin of Financial Fraud*, *in* ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD: A CORPORATE GOVERNANCE GUIDE 1, 1–2 (Michael R. Young ed., 2000) (listing several recent securities fraud scandals).

337. Prentice, *SEC and MDP*, *supra* note 2, at 1604–53 (explaining the bias generally, but focusing on implications of the self-serving bias for the audit profession).

338. The self-serving bias is widely recognized, but its causes are a matter of debate. Schlenker and Miller found some aspects of perceptual biases (subjects tended to remember themselves as truly having more to do with successful outcomes) and motivational (self-presentational) effects (subjects sought to improve their image). *See* Barry R. Schlenker & Rowland S. Miller, *Egocentrism in Groups: Self-Serving Biases or Logical Information Processing?*, 35 J. PERSONALITY & SOC. PSYCHOL. 755, 762 (1977). The debate on causation continues, but it seems clear that both cognitive and motivational factors play a role. *See generally* Gifford Weary Bradley, *Self-Serving Biases in the Attribution Process: A Reexamination of the Fact or Fiction Question*, 36 J. PERSONALITY & SOC. PSYCHOL. 56, 68–69 (1978) (discovering evidence for at least a partially motivational explanation for people's tendency to accept responsibility for positive outcomes and to deny responsibility for negative outcomes); Dale T. Miller, *What Constitutes a Self-Serving Attributional Bias? A Reply to Bradley*, 36 J. PERSONALITY & SOC. PSYCHOL. 1221, 1222 (1978) (finding little evidence that people alter their *perceptions* of causality to protect their self-esteem, but admitting to evidence that people often alter their *description* of causality in order to do so); Tom Pyszczynski et al., *Maintaining Consistency Between Self-Serving Beliefs and Available Data: A Bias in Information Evaluation*, 11 PERSONALITY & SOC. PSYCHOL. BULL. 179, 185–87 (1985) (concluding that both cognitive and motivational forces accounted for fact that students who thought they had done well on a particular test found more persuasive articles favoring the validity of the test and students who thought they had done poorly found more persuasive articles arguing that the test had low validity).

339. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1501 (1998) ("[P]arties may tend to see things in the light most favorable to them; while people care about fairness, their assessments of fairness are distorted by their own self-interest.").

340. Thus, according to one famous study, fans of two teams at a football game are each likely to come away from the game perceiving that the referees favored the other team. Albert H. Hastorf & Hadley Cantril, *They Saw a Game: A Case Study*, 49 J. ABNORMAL PSYCHOL. 129, 131 (1954). Proponents of two political candidates who have just watched them debate are likely to perceive that their favored candidate won the debate. David O. Sears & Richard E. Whitney, *Political Persuasion*, *in* HANDBOOK OF COMMUNICATION 253, 255 (Ithiel de Sola Pool et al. eds., 1973).

mation.[342] The self-serving bias is pervasive. It affects the performance of lawyers,[343] physicians,[344] auditors,[345] investment bankers,[346] securities

341. Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2105 (1979) (finding that when opponents and proponents of an issue are given two opposing studies, they tend to find the one that favors their position to be more persuasive); Leigh Thompson & George Loewenstein, *Egocentric Interpretations of Fairness and Interpersonal Conflict*, 51 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 176, 180–81 (1992) (finding that people tend to perceive information that favors their position as more important than information that does not support their position).

342. Baruch Fischhoff & Ruth Beyth, *"I Knew It Would Happen." Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 1, 13 (1975) (finding that students remembered having made better predictions than they actually did); Thompson & Loewenstein, *supra* note 341, at 189–90 (finding that negotiators tend to remember facts that support their position better than facts that undermine it).

343. Based on the behavioral evidence, Langevoort and Rasmussen argue that the self-serving bias is likely to lead attorneys to skew advice to clients in such a way as to increase their seeming importance to the client. Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 437 (1997). Edelman and her colleagues performed an empirical study in the wrongful discharge field and found exactly this effect. Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47, 73–77 (1992).

344. As just one example of the self-serving bias, numerous studies show that physicians order more tests for patients when they have the opportunity to refer the patients to labs in which they own a financial interest than when they refer patients to labs in which they have no interest. The effect is particularly potent if the patients are well insured. *See* Thomas L. Carson, *Conflicts of Interest*, 13 J. BUS. ETHICS 387, 394 (1994) ("[W]hen physicians are paid according to how much work they do for their patients, many physicians succumb to the temptation to provide their patients with unnecessary, even dangerous treatments."); Thomas S. Crane, *The Problem of Physician Self-Referral Under the Medicare and Medicaid Antikickback Statute*, 268 JAMA 85, 86 (1992) (noting studies by the Office of the Inspector General and the State of Florida Health Care Cost Containment Board showing that physicians respond to financial incentives in their treatment practices); Bruce J. Hillman, et al., *Physicians' Utilization and Charges for Outpatient Diagnostic Imaging in a Medicare Population*, 268 JAMA 2050, 2050 (1992) (finding self-referral resulting in "1.7 to 7.7 times more frequent performing of imaging examinations than radiologist-referral"); Jean M. Mitchell & Elton Scott, *Physician Ownership of Physical Therapy Services*, 268 JAMA 2055, 2055 (1992) (finding that visits per patient were thirty-nine to forty-five percent higher in facilities where referring physicians were joint venturers and that more revenues were generated from patients with well-paying insurance).

345. Auditors are much more likely to give their clients slack to make questionable accounting moves when the client is solvent and an important source of revenue. *See* David B. Citron & Richard J. Taffler, *The Audit Report Under Going Concern Uncertainties: An Empirical Analysis*, 22 ACCT. & BUS. RES. 337, 344 (1992) (finding that auditors tended to issue going concern qualifications only to clients that were both in a very weak financial condition and in imminent danger of failing); Jagan Krishnan & Jayanthi Krishnan, *The Role of Economic Trade-Offs in the Audit Opinion Decision: An Empirical Analysis*, 11 J. ACCT., AUDITING & FIN. 565, 583 (1996) (finding that an auditor is more likely to issue a qualified opinion if the client carries a higher litigation risk and pays lesser fees to the auditor); Michael K. Shaub & Janice E. Lawrence, *Ethics, Experience and Professional Skepticism: A Situational Analysis*, 8 BEHAV. RES. IN ACCT. 124, 155 (Supp. 1996) (finding that "auditors' professional skepticism was . . . counteracted when the client was important to the audit firm's practice development"); Arnold Wright & Sally Wright, *An Examination of Factors Affecting the Decision to Waive Audit Adjustments*, 12 J. ACCT., AUDITING & FIN. 15, 33 (1997) (finding a "strong positive association . . . between the likelihood [that an accounting] adjustment was waived [by the auditor] and client size, a surrogate for audit fees").

346. Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense:" May Target Boards "Just Say No"? Should They Be Allowed to?*, 15 DEL. J. CORP. L. 377, 468–69 (1990) (citing several sources indicating that self-interest in the form of potential fees from clients sway investment bankers' fairness opinions).

analysts,[347] scientists,[348] and even judges.[349] It affects expert witnesses,[350] so it will likely affect lay witnesses as well.

At a minimum, the self-serving bias means that even a witness who is attempting to be honest will almost inevitably slant his or her testimony in a self-serving way. Judge Easterbrook correctly noted this point in *Rissman*:

> Memory plays tricks. Acting in the best of faith, people may "remember" things that never occurred but now serve their interests. Or they may remember events with a change of emphasis or nuance that makes a substantial difference to meaning. Express or implied qualifications may be lost in the folds of time. A statement such as "I won't sell at current prices" may be recalled years later as "I won't sell."[351]

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347. Mathew L.A. Hayward & Warren Boeker, *Power and Conflicts of Interest in Professional Firms: Evidence from Investment Banking*, 43 ADMIN. SCI. Q. 1, 14–15 (1998) (reporting an empirical study finding substantial evidence that an investment banking firm's self-interest in the form of potential fees causes its stock analysts to rate more highly the securities of its clients than do other stock analysts).

348. One study showed that 96% of a controversial drug's defenders in the scientific community had financial ties to the drug's maker, 60% of neutral authors had such ties, and only 37% of critical authors had such ties. Henry Thomas Stelfox et al., *Conflict of Interest in the Debate Over Calcium-channel Antagonists*, 338 NEW ENG. J. MED. 101, 101 (1998). Other studies indicate that the self-serving bias causes scientists to rate more highly research that agrees with their position than research that disagrees with their position. Jonathan J. Koehler, *The Influence of Prior Beliefs on Scientific Judgments of Evidence Quality*, 56 ORG. BEHAV. & HUM. DECISION PROCESSES 28, 47 (1993); Michael J. Mahoney, *Publication Prejudices: An Experimental Study of Confirmation Bias in the Peer Review System*, 1 COGNITIVE THERAPY & RES. 161, 161–62 (1977).

349. *See* Frank B. Cross & Emerson H. Tiller, *Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 YALE L.J. 2155, 2175 (1998) (reporting an empirical study finding that D.C. Circuit Court three-judge panels controlled by Republican-appointed judges were more likely to defer to conservative administrative agency decisions than were panels controlled by Democrat-appointed judges); David B. Spence & Paula Murray, *The Law, Economics, and Politics of Federal Preemption Jurisprudence: A Quantitative Analysis*, 87 CAL. L. REV. 1125, 1195 (1999) (finding in empirical study that decisions about federal preemption in environmental cases are the result of "actions of (partly) ideologically-motivated federal judges"); Emerson H. Tiller & Frank B. Cross, *A Modest Proposal for Improving American Justice*, 99 COLUM. L. REV. 215, 224 (1999) (noting that there is now substantial "evidence that partisan ideology often influences judicial case decisions on a variety of issues . . . [and] that judges exercise these partisan preferences through judicial decision-making instruments").

350. *See* Paul S. Applebaum, *In the Wake of* Ake: *The Ethics of Expert Testimony in an Advocate's World*, 15 BULL. AM. ACAD. PSYCHIATRY & L. 15, 21 (#1) (1987) (commenting on the "frequency with which highly respected [psychiatric] experts arrive at conclusions favorable to the side for which they are working or to which they have been assigned"); Eric H. Marcus, *Unbiased Medical Testimony: Reality or Myth?*, 6 AM. J. FORENSIC PSYCHIATRY 3, 4 (#4) (1985) (commenting on the inevitable bias that infects the judgments of medical expert witnesses); Randy K. Otto, *Bias and Expert Testimony of Mental Health Professionals in Adversarial Proceedings: A Preliminary Investigation*, 7 BEHAV. SCI. & L. 267, 271 (1989) (reporting empirical results finding evidence in criminal case setting, but not in civil case setting, that mental health professionals' testimony often varies according to the side by which they are retained).

351. Rissman v. Rissman, 213 F.3d 381, 384 (7th Cir. 2000); *see also* Trident Ctr. v. Conn. Gen. Life Ins. Co., 847 F.2d 564, 569 (9th Cir. 1988) (noting that we must be wary of "self-serving testimony offered by partisan witnesses whose recollection is hazy from passage of time and colored by their conflicting interests").

Conversely, a statement such as "I won't sell" may be recalled years later as "I won't sell at current prices." *Rissman*, 213 F.3d at 384.

Thus, plaintiff investors will tend to recall that they were not given oral warnings about the risks of their investment (even if they were). However, the same self-serving bias leads defendant sellers to tend to recall that they did not make any promises about the investment's potential to the buyers (even if they did).

Judge Posner's "plausible liars" are more likely just honest witnesses whose recollections are influenced by the self-serving bias. What Judge Posner's holding ignores is that "plausible liars" may also sit at the defense table in trials. No side has a monopoly on intentional lying or inadvertently mistaken testimony. While the self-serving bias clearly affects the actions of litigants, there is no reason to believe that it affects plaintiffs more severely than defendants.[352] Both Professor Langevoort[353] and I[354] have built substantial cases describing the strong incentives for misrepresentation that affect sellers of securities, especially because their incentive structure typically compensates them the most for selling the riskiest securities.[355]

B. The Attribution Bias

The self-serving bias is complicated by a related phenomenon often termed fundamental attribution error. Attribution theory addresses how people assess causality.[356] The fundamental attribution error refers to the fundamental human tendency to "attribute others' behavior largely to personality factors and our own behavior largely to situational factors to which we respond."[357] In other words, people tend to overestimate dispositional causes of behavior and to underestimate situational constraints.[358] Attribution theory has many facets,[359] but of immediate con-

352. Indeed, because behavioral research shows clearly that people do not anticipate gains as much as they fear losses, *see* PLOUS, *supra* note 141, at 96–98, an argument could be made that a defendant has a greater motivation to lie than a plaintiff. Therefore, if a plaintiff sues for a million dollars, the evidence is clear that the defendant will fear loss of the million dollars more than the plaintiff will anticipate the gain of a million dollars. The effect is heightened if one considers that the plaintiff is actually anticipating the gain of only $666,667 (or less) given his or her attorney's share of the recovery. On the other hand, if the defendant has insurance, the scale tips back the other way.

353. Langevoort, *Selling Hope*, *supra* note 54, at 664–66.

354. Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1426–34; *see also supra* text accompanying note 2.

355. *Id.* at 1429–30.

356. PLOUS, *supra* note 141, at 174.

357. HASTIE & DAWES, *supra* note 165, at 29. *See generally* FRITZ HEIDER, THE PSYCHOLOGY OF INTERPERSONAL RELATIONS 96 (1958) (arguing that one flaw in people's causal attribution is that "under certain conditions there is a tendency to attribute the outcome of an action to the person even though its source may reside in the environment"); Lee Ross, *The Intuitive Psychologist and His Shortcomings: Distortions in the Attribution Process*, 10 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 173, 183 (1977) (same).

358. Neal R. Feigenson, *Merciful Damages: Some Remarks on Forgiveness, Mercy and Tort Law*, 27 FORDHAM URB. L.J. 1633, 1641 (2000) (noting that because of the fundamental attribution error [FAE], jurors "tend to think (among other things) that bad outcomes must be due to bad people, and that the worse the outcome, the worse the cause"); Philip E. Tetlock, *An Alternative Metaphor in the Study of Judgment and Choice: People as Politicians*, *in* RESEARCH ON JUDGMENT AND DECISION

cern to us are jurors' tendencies (a) to assume that bad results are caused by people's actions, and (b) to attribute causation on the basis of the parties' perceived personal dispositions.[360]

One possible consequence of fundamental attribution error is that investors will believe that when they lose money in an investment it must be someone's fault and that the self-serving bias will lead them to conclude that the fault does not lie with them. This could, of course, trigger unjustified lawsuits against sellers.

However, there are many behavioral factors discouraging the filing of lawsuits that counteract the fundamental attribution error. As noted earlier, factors such as overoptimism, the false consensus effect, the personal positivity bias, and cognitive dissonance all work to convince an investor that their sellers would not cheat them.[361] Hence, many lawsuits that should be filed will go unfiled.[362]

Still, if investors lose money in the stock market and do file suit, attribution theory indicates that jurors or other fact finders may believe that causation does not lie with situational factors (the overall market was weak, the company had unforeseeable business complications, etc.), but may tend to believe that the loss was someone's fault. Rather than conclude that the loss "just happened," jurors may choose to blame the sellers, whether or not that is just.[363]

Related to this phenomenon (and to the hindsight bias discussed below) is the outcome bias,[364] the tendency when knowing that things

MAKING: CURRENTS, CONNECTIONS, AND CONTROVERSIES 657, 669 (William M. Goldstein & Robin M. Hogarth eds., 1997) [hereinafter RESEARCH ON JUDGMENT]; David Watson, *The Actor and the Observer: How Are Their Perceptions of Causality Divergent?*, 92 PSYCHOL. BULL. 682, 698 (1982) (finding evidence to support this aspect of attribution theory); ALAN DURELL, ATTRIBUTION IN PERFORMANCE EVALUATION 30–33 (Dartmouth Dep't of Econ. Working Paper No. 01-07, Mar. 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265210 (reporting results of a study strongly supporting the existence of fundamental attribution error).

359. Feigenson notes:

> The fundamental attribution error reflects both the availability and representativeness heuristics. It derives from the availability heuristic because, in social settings, actors tend to appear more salient, and hence are more available, than situational elements, and are thus more likely to be seen as causal agents. It also derives from overreliance on the representativeness heuristic because it treats behavior as representative of a dispositional state it resembles.

Neal R. Feigenson, *The Rhetoric of Torts: How Advocates Help Jurors Think About Causation, Reasonableness, and Responsibility*, 47 HASTINGS L.J. 61, 128 (1995) [hereinafter Feigenson, *Rhetoric of Torts*] (citations omitted).

360. Edward E. Jones & Richard E. Nisbett, *The Actor and the Observer: Divergent Perceptions of the Causes of Behavior*, *in* ATTRIBUTION: PERCEIVING THE CAUSES OF BEHAVIOR 79, 93 (Edward E. Jones et al. eds., 1971); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1444 (1983).

361. *See supra* notes 121–69 and accompanying text.

362. *See* Langevoort, *Selling Hope*, *supra* note 54, at 660 (noting that the natural tendency for investors is to seek nonthreatening explanations for their losses).

363. *See generally* Feigenson, *Rhetoric of Torts*, *supra* note 359, at 129–35 (discussing fundamental attribution error in negligence cases).

364. *See, e.g.*, Jonathan Baron & John C. Hershey, *Outcome Bias in Decision Evaluation*, 54 J. PERSONALITY & SOC. PSYCHOL. 569 (1988) (finding, in a study where subjects were told that eight percent of the patients who have a certain heart bypass operation die from the operation itself, that

turned out badly to believe that someone was at fault. Thus, supervisors of an employee who know of a bad outcome are more likely to rate that employee's conduct negatively than supervisors who do not know of the bad outcome.[365] Jurors called upon to find facts in such a dispute may be subject to these biases. Instead of finding that "stuff happens" occasionally, jurors may be on the lookout to blame some person.[366] Personal factors tend to drift to the fore, whereas situational factors tend to fade into the background.[367]

However, this tendency does not necessarily punish defendants unduly. Having taught securities regulation for twenty years, I know that my students often react to egregious frauds with a grudging admiration for the creative fraudster and a "How could they be so stupid?" reaction toward the defrauded investors. For several reasons, jurors might tend to blame the investors for their own losses.

As Feigenson points out, jurors

> may believe that the plaintiff, because he started the suit, is more aggressive and demanding, and that this aggressive stance is due to negative traits (hostility toward the defendant or greed) rather than to the demands of role (suing is how you get things done in the legal system); consequently, jurors may be biased against plaintiffs.[368]

Relatedly, jurors (like everyone else) wish to believe that they would not be victimized as plaintiffs have been. Therefore, they look to find ways to blame plaintiffs for their own losses. The tendency is a natural one. If we read about someone in our town dying in a car wreck on streets that we drive, our security is threatened. We want to believe that it cannot happen to us, so we begin looking for ways to blame the victim. Was the victim drinking? Did the victim run a red light? Was the victim wearing a seatbelt? If the victim was following the rules of the road and was simply smashed into by a drunk driver, this process is harder. But we may then find ourselves saying: "Well, I never drive on that particular street." Or, "I am never on the roads at that time of night." This is often called "defensive attribution," in that people at-

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those told a particular surgery was successful rated the decision to do the surgery significantly more favorably than those who were told it failed); Dan Zakay, *The Evaluation of Managerial Decisions' Quality by Managers*, 56 ACTA PSYCHOLOGICA 49 (1984) (finding that midlevel managers thought that outcome was the most important factor in evaluating the quality of a previously made decision even though good outcomes are not always traceable to good decision making and vice versa).

365. Terence R. Mitchell & Laura S. Kalb, *Effects of Outcome Knowledge and Outcome Valence on Supervisors' Evaluations*, 66 J. APPLIED PSYCHOL. 604, 609–10 (1981).

366. Jerry M. Burger, *Motivational Biases in the Attribution of Responsibility for an Accident: A Meta-Analysis of the Defensive-Attribution Hypothesis*, 90 PSYCHOL. BULL. 496, 496 (1981) ("Several investigators have observed strong attributional distortion by persons attempting to make sense of seemingly random catastrophes.").

367. Because of the fundamental attribution error, "[s]ituational information is apparently ignored or poorly judged." Serge Moscovici & Miles Hewstone, *Social Representations and Social Explanations: From the 'Naïve' to the 'Amateur' Scientist*, *in* ATTRIBUTION THEORY: SOCIAL AND FUNCTIONAL EXTENSIONS 98, 120 (Miles Hewstone ed., 1983) [hereinafter ATTRIBUTION THEORY].

368. Feigenson, *Rhetoric of Torts*, *supra* note 359, at 136.

tempt to distance themselves from victims to convince themselves that they are not vulnerable to a similar fate.[369] Some studies show that as the severity of a plaintiff's injuries increases, people assign more and more blame to that plaintiff.[370]

Think about the hostile reactions that most people had to the plaintiff in the famous McDonald's hot coffee case, even though every single one of them has spilled a drink on himself or herself at some time. Most people initially wished to blame the victim for her own "stupidity" in doing something they all have done rather than blame McDonald's for selling coffee that was twenty degrees hotter than that sold by competitors, for ignoring 700 coffee burn complaints in the previous year, or for refusing an opportunity to settle the case by paying plaintiff's modest medical expenses.[371] One of the jurors in that case admitted that *before* she heard the evidence, she thought "it was a ridiculous lawsuit."[372] Thus, there is significant evidence that "people frequently blame victims for their fate because they do not want to accept that such things can happen to them by chance and out of the blue."[373]

Another factor leading to this "blame the victim" tendency is the psychological need to believe in a just world, which causes many people

369. Neal Feigenson et al., *Effect of Blameworthiness and Outcome Severity on Attributions of Responsibility and Damage Awards in Comparative Negligence Cases*, 21 LAW & HUM. BEHAV. 597, 612 (1997) [hereinafter Feigenson, *Blameworthiness*] ("By blaming the victim, observers distance themselves from him or her, preserving their belief that they will not find themselves in the same position." (citations omitted)); *see also* Simo Salminen, *Defensive Attribution Hypothesis and Serious Occupational Accidents*, 70 PSYCHOL. REP. 1195, 1198 (1992) (finding that accident victims tended to attribute causation to external factors, but coworkers and foremen tended to attribute causation to the victim's own actions).

370. Feigenson, *Blameworthiness*, *supra* note 369, at 608 (finding that mock jurors' "judgments on fault and damages show a fairly consistent antiplaintiff effect" and that "[t]he percentage of fault attributed to the victim, which ought to be affected only by legal blameworthiness, is significantly greater when the victim's injuries are more severe").

371. *See* Andrea Gerlin, *A Matter of Degree: How a Jury Decided That a Coffee Spill Is Worth $2.9 Million*, WALL ST. J., Sept. 1, 1994, at A1 (detailing facts of the case).

372. Mark Curriden, *'Runaway' No More: Despite Reputation, Juries Getting Less Likely to Give Big Awards or Buy Novel Defenses*, DALLAS MORNING NEWS, May 8, 2000, at 1A (quoting juror Betty Farnham).

373. Gurnek Bains, *Explanations and the Need for Control*, *in* ATTRIBUTION THEORY, *supra* note 367, at 126, 131, 134 (noting that many studies support these motivational factors, but that others finding the same effect attribute it to cognitive factors such as a belief that serious crimes are rare so more responsibility must lie with the victims of such crime); Tom R. Tyler & Victor Devinitz, *Self-Serving Bias in the Attribution of Responsibility: Cognitive Versus Motivational Explanations*, 17 J. EXPERIMENTAL SOC. PSYCHOL. 408, 413 (1981) (finding more evidence for cognitive explanations); Elaine Walster, *Assignment of Responsibility for an Accident*, 3 J. PERSONALITY & SOC. PSYCHOL. 73, 77 (1966) (presenting the classic study showing that the worse the consequences of an accidental occurrence, the greater the tendency of others to assign responsibility to the accident victim and explicating the defensive attribution theory). *But see* Kelly G. Shaver, *Defensive Attribution: Effects of Severity and Relevance on the Responsibility Assigned for an Accident*, 14 J. PERSONALITY & SOC. PSYCHOL. 101, 111 (1970) (finding that "increasing severity of outcome does not reliably produce correspondent increments in attributed responsibility").

to derogate rather than sympathize with plaintiffs.[374] Because most of us wish to believe that we live in a just world where good things happen to good people and bad things happen to bad people, we have an innate inclination to blame the victim.[375]

This desire to make themselves feel comfortable in their environment, coupled with the illusion of control discussed earlier, the desire to feel free from potential victimhood, and to believe that they live in a just world all factor together to make it easy for jurors and others to tend to blame investors for their own losses, stupidity, and gullibility. These factors are so strong that not only do others tend to blame victims, victims tend to blame themselves for things that clearly are not their fault.[376] Thus, cancer victims often attribute their illness to their own misconduct.[377] Parents often blame themselves for their children's serious illnesses.[378] Even rape victims often blame themselves,[379] as they are often blamed by others,[380] for their own misfortune.[381] Of accidents believed to be caused by human agency, "victims blame themselves nearly two-thirds

374. MELVIN J. LERNER, THE BELIEF IN A JUST WORLD: A FUNDAMENTAL DELUSION 39–41 (1990) ("Normal people *will* reject, or at least devalue, an innocent victim, if they are not able to intervene effectively to correct the injustice.").

375. A belief that bad things happen only to "bad" people is obviously related to the fundamental attribution error. Feigenson, *Rhetoric of Torts*, *supra* note 359, at 137.

376. *See* Bains, *supra* note 373, at 128 ("[A] number of studies suggest that individuals frequently blame themselves for accidents and illnesses to which they fall victim."); Ronnie J. Bulman & Camille B. Wortman, *Attributions of Blame and Coping in the "Real World": Severe Accident Victims React to Their Lot*, 35 J. PERSONALITY & SOC. PSYCHOL. 351, 360 (1977) (finding that victims of serious accidents who blame themselves are better at coping with their misfortune).

377. Ruth D. Abrams & Jacob E. Finesinger, *Guilt Reactions in Patients with Cancer*, 6 CANCER 474, 475–76 (1953).

378. Paul Chodoff et al., *Stress, Defenses and Coping Behavior: Observations in Parents of Children with Malignant Disease*, 120 AM. J. PSYCHIATRY 743, 747 (1964) (noting that self-blame "can serve the defensive purpose of denying the intolerable conclusion that no one is responsible, and therefore that neither expiation nor propitiation can undo a malign event which has come about impersonally and meaninglessly").

379. Andrea Parrot, *Medical Community's Response to Acquaintance Rape—Recommendations*, *in* ACQUAINTANCE RAPE: THE HIDDEN CRIME 304, 306 (Andrea Parrot & Laurie Bechhofer eds., 1991).

380. *See* Linda Olsen-Fulero & Solomon M. Fulero, *Commonsense Rape Judgments: An Empathy—Complexity Theory of Rape Jury Story Making*, 3 PSYCHOL. PUB. POL. & L. 402, 406–07 (1997) (noting several studies finding substantial blaming of the victim in rape cases).

381. Again, part of the reason is the need to control one's environment in order to feel secure:

> Wortman argues that tendencies towards self-blame are also to be found among victims of rape, natural disasters and those who are made redundant. She suggests that one way of explaining such counter-intuitive findings may lie in the fact that, by blaming themselves for these unfortunate events, the victims reject the notion that they could occur by chance and, more importantly, preserve the view that in the future such calamities can be avoided by taking appropriate actions.

Bains, *supra* note 373, at 129 (citing Camille B. Wortman, *Causal Attributions and Personal Control*, *in* I NEW DIRECTIONS IN ATTRIBUTION RESEARCH 23–48 (John H. Harvey et al. eds., 1976)); *see also* Andrew E. Taslitz, *Patriarchal Stories I: Cultural Rape Narratives in the Courtroom*, 5 S. CAL. REV. L. & WOMEN'S STUD. 302, 387, 427–28 (1996) (noting impact of fundamental attribution error on juror thinking in rape cases).

of the time."[382] Of personal frauds that are committed, only a small percentage are ever reported.[383]

So, putting all this together, it is likely that juries will be looking for human causes for investment losses; they may underestimate situational causes.[384] Their initial tendency to blame the victim means that human nature places the burden of proof on plaintiffs, just as the law does. The anchor and adjustment phenomenon means that plaintiffs will have to produce evidence to move jurors off this initial disposition to blame the victims of securities fraud.[385] There is certainly nothing in the statistics regarding plaintiff win rates that would indicate a juror bias in favor of plaintiffs.[386] Indeed, one of the most deep-seated prejudices extant in

382. Neal R. Feigenson, *Accidents as Melodrama*, N.Y.L. SCH. L. REV. 741, 784 (1999–2000) [hereinafter Feigenson, *Melodrama*].

383. Heith Copes et al., *Reporting Behavior of Fraud Victims and Black's Theory of Law: An Empirical Assessment*, 18 JUST. Q. 343, 352 (2001).

384. Fortunately, recent research in attribution theory indicates that it is not as large a stumbling block to human decision making as earlier research had indicated. *See, e.g.*, Susan M. Davies, *Evidence of Character to Prove Conduct: A Reassessment of Relevancy*, 27 CRIM. L. BULL. 504, 524 (1991) ("[T]he studies of interpersonal perception relied upon to demonstrate that lay persons, including jurors and character witnesses, make erroneous predictions about behavior because they are unable to perceive and assess accurately the character traits of others, have been cast into doubt by criticisms of the experimental methodology employed, and by recent studies indicating significant accuracy in assessments of personality by lay observers." (footnotes omitted)); David C. Funder, *Errors and Mistakes: Evaluating the Accuracy of Social Judgment*, 101 PSYCHOL. BULL. 75, 76 (1987) (arguing that research on attribution error is almost completely irrelevant to the accuracy of social judgment in daily life); Fiona Lee & Mark Hallahan, *Do Situational Expectations Produce Situational Inferences? The Role of Future Expectations in Directing Inferential Goals*, 80 J. PERSONALITY & SOC. PSYCHOL. 545, 554 (2001) (finding that "situational expectations led observers to make more situational inferences than dispositional inferences"); Roger C. Park, *Character at the Crossroads*, 49 HASTINGS L.J. 717, 738 (1998) (noting that "recent [FAE] studies seem to be more favorable to lay reasoning than those studies relied upon by legal scholars in the 1970s and 80s" (footnote omitted)); Jack C. Wright & Walter Mischel, *Conditional Hedges and the Intuitive Psychology of Traits*, 55 J. PERSONALITY & SOC. PSYCHOL. 454, 456 (1988) (claiming that subjects who make assessments of a trait like aggressiveness actually qualify opinions in ways that show sensitivity to situational influences).

385. The general notion behind the anchor and adjustment bias is that "[i]ndividuals make estimates for values based upon an initial value (derived from past events, random assignment, or whatever information is available) and typically make insufficient adjustments from that anchor when establishing a final value." BAZERMAN, *supra* note 122, at 39. Thus, assume that a wheel is spun and the arrow lands on 65 and a subject is asked whether the percentage of African nations in the United Nations is more or less than 65% and then asked the *exact* percentage. The wheel is spun again and lands on 10 and a different subject is asked whether the percentage of membership is more or less than 10% and then asked the *exact* percentage. Persons in the first condition tend to guess a much higher percentage (45%) than persons in the second condition (25%), even though the totally random spin of the wheel is the only difference. Kahneman & Tversky, *supra* note 129, at 14.

386. Feigenson, *Melodrama*, *supra* note 382, at 778 (noting that plaintiffs win only about half the tort cases that go to trial); Neil Vidmar, *The Performance of the American Civil Jury: An Empirical Perspective*, 40 ARIZ. L. REV. 849, 851–54 (1998) (noting that plaintiffs win less than half the time in state court jury trials, less than half the time in federal court jury trials, and win in front of juries about the same percentage of times as they do in front of judges); Rocco Cammarere, *That Juror Looks Biased; Here's What You Can Do*, N.J. LAW., Apr. 12, 1999, at A5 ("Nationally, the likelihood of a plaintiff recovering damages has dropped in the past 10 years from a 61 percent chance of winning in 1987 to 51 percent in 1997, according to figures from Jury Verdict Research. The odds for plaintiffs are even slimmer in medical malpractice—37 percent—and products liability cases.").

Interestingly, corporate plaintiffs win litigation more often than do individual plaintiffs, and corporations win more often as both plaintiffs and defendants when opposing individuals than when oppos-

American society is that against plaintiffs' lawyers.[387] Securities plaintiffs' attorneys have been particularly demonized,[388] making it implausible to conclude that securities plaintiffs do not face serious uphill battles in almost every case. In short, it seems wildly unrealistic to presume that the attribution bias will cause juries to be eager to hand out verdicts to plaintiffs in securities fraud suits in the absence of concrete evidence supporting their positions.

C. The Hindsight Bias

Judge Posner's obvious concern with jury performance may arise from a familiarity with the research regarding the hindsight bias, which, of course, encompasses the notion that "people who know the nature of events *falsely* overestimate the probability with which they *would have* predicted them."[389] Thus, in negligence cases defendants may have their actions examined with 20-20 hindsight by both jurors[390] and judges.[391]

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ing other corporations. Marc Galanter, *Contract in Court; Or Almost Everything You May or May Not Want to Know About Contract Litigation*, 2001 WIS. L. REV. 577, 600 (studying a sample of cases omitting personal injury suits).

387. Daniels and Martin have pointed out that due to the aggressive public relations campaigns of insurance companies and other tort reformers, the vision of a civil justice system that has gone terribly wrong "has become a part of contemporary American mass culture." Stephen Daniels & Joanne Martin, *"The Impact That It Has Had Is Between People's Ears:" Tort Reform, Mass Culture, and Plaintiffs' Lawyers*, 50 DEPAUL L. REV. 453, 491 (2000); *see also* Feigenson, *Melodrama*, *supra* note 382, at 781–82 (noting that contemporary images of greedy, undeserving plaintiffs give corporate defense attorneys a ready, plausible story to tell juries); Michael Friedman, *Judgment Day*, FORBES, May 14, 2001, at 132 (noting that "Plaintiff lawyers: They are the folks everyone loves to hate"); Evan P. Schultz, *It's the Lawyers, Stupid: Presidential Wannabes Miss the Mark When They Take Aim at Attorneys*, N.J. L.J., Aug. 28, 2000, at 891 (noting that political candidates try to make hay by lawyer-bashing).

388. *See* Langevoort, *Seeking Sunlight*, *supra* note 330, at 478 ("[T]his 'tarring' of the plaintiffs' bar has been immensely successful."); Ramirez, *supra* note 6, at 1069 ("[I]n an era of pervasive demonization of attorneys, the private securities lawyer became the caricature of the greedy, self-serving destroying of upstanding captains of industry.").

389. HASTIE & DAWES, *supra* note 165, at 147. Fischhoff, one of the foremost students of the hindsight bias, describes it in this way:

> In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also view it as having appeared "relatively inevitable" before it happened. People believe that others should have been able to anticipate events much better than was actually the case.

Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 124, at 335, 341; *see also* Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXP. PSYCHOL. 288 (1975); Fischhoff & Beyth, *supra* note 342, at 1; Scott A. Hawkins & Reid Hastie, *Hindsight: Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311, 323 (1990).

The hindsight bias has been detected in many contexts. *See, e.g.*, Hal R. Arkes et al., *Hindsight Bias Among Physicians Weighing the Likelihood of Diagnoses*, 66 J. APPLIED PSYCHOL. 252 (1981) (diagnoses by physicians); Susan J. LaBine & Gary LaBine, *Determinations of Negligence and the Hindsight Bias*, 20 LAW & HUM. BEHAV. 501 (1996) (diagnoses by psychotherapists); Nicolaos E. Synodinos, *Hindsight Distortion: "I Knew-it-All-Along and I Was Sure About It,"* 16 J. APPLIED SOC. PSYCHOL. 107, 109–14 (1986) (elections).

390. *See, e.g.*, Jonathan D. Casper et al., *Juror Decision Making, Attitudes, and the Hindsight Bias*, 13 LAW & HUM. BEHAV. 291, 308 (1989) (finding that jurors are affected by the hindsight bias); Lee J. Gilbertson et al., *A Study of Hindsight Bias: The Rodney King Case in Retrospect*, 74 PSYCHOL. REP. 383, 384 (1994) (studying verdict in initial Rodney King case); Reid Hastie & W. Kip Viscusi, *What*

Where a critical element of a negligence cause of action is whether defendants should have foreseen that their actions might cause injury to plaintiffs, decision makers who know that the actions did in fact cause injury tend to conclude that this was foreseeable beforehand. Studies show that human decision makers find it difficult to disregard information that they know even when they are specifically instructed to do so.[392]

Rachlinski counters by arguing that "[t]he legal system has a good understanding of the hindsight bias and its effects on judging liability after the fact."[393] He notes that the law has developed several mechanisms for minimizing the impact of the hindsight bias, such as the business judgment rule to minimize review of corporate directors' decisions, exclusion of evidence of subsequent remedial measures to minimize second-guessing of product liability defendants' actions, and special review procedures for determining "nonobviousness" in the patent context.[394] Peters notes additionally that "[r]esearch studies are not jury trials. The differences may be material. Jury trials have greater gravity, more robust facts, greater accountability, and group deliberations. Each of these has the potential to minimize the presence of the hindsight bias[]."[395] At

Juries Can't Do Well: The Jury's Performance as a Risk Manager, 40 ARIZ. L. REV. 901, 917 (1998) (noting that in "decisions involving evaluations of risk, especially where the judgment requires the decision maker to infer ex ante risk estimates from an ex post perspective, the typical juror appears to be subject to a massive hindsight bias"); Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 LAW & HUM. BEHAV. 89, 99 (1995) (finding evidence of hindsight bias in study asking subjects to review decision of municipality as to whether to take precautions against flooding); Norman G. Poythress et al., *Reframing the Medical Malpractice Tort Reform Debate: Social Science Research Implications for Non-Economic Reforms*, 16 LAW & PSYCHOL. REV. 65, 99–103 (1992) (discussing hindsight and outcome bias).

391. *See, e.g.*, John C. Anderson et al., *Evaluation of Auditor Decisions: Hindsight Bias Effects and the Expectation Gap*, 14 J. ECON. PSYCHOL. 711, 722 (1993) (finding evidence of hindsight bias in study asking state and federal judges to review auditor decisions); Marianne Jennings et al., *Causality as an Influence on Hindsight Bias: An Empirical Examination of Judges' Evaluation of Professional Audit Judgment*, 21 J. ACCT. & PUB. POL'Y. 143, 161 (1998) (finding in study of judges' review of auditors' actions that hindsight bias is stronger in some situations than in others).

392. *See* Thomas A. Buchman, *An Effect of Hindsight on Predicting Bankruptcy with Accounting Information*, 10 ACCT., ORGS. & SOC'Y 267, 267 (1985) (finding this to be so in the context of accounting professionals).

Some studies indicate that if subjects are forced to consider reasons why things might have turned out differently, the hindsight bias can be moderated. *See* Paul Slovic & Baruch Fischhoff, *On the Psychology of Experimental Surprises*, 3 J. EXP. PSYCHOL. 544 (1977). However, studies show that it is difficult to eliminate the hindsight bias, although numerous methods have been tried. *See* Jolls et al., *supra* note 339, at 1527; Rudiger F. Pohl & Wolfgang Hell, *No Reduction in Hindsight Bias After Complete Information and Repeated Testing*, 67 ORG. BEHAV. & HUM. DECISION PROCESSES 49, 56 (1996).

393. *See* Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, *in* BEHAVIORAL LAW & ECONOMICS 95, 111 (Cass R. Sunstein ed., 2000).

394. *Id.* at 106–11.

395. Philip G. Peters, Jr., *Hindsight Bias and Tort Liability: Avoiding Premature Conclusions*, 31 ARIZ. ST. L.J. 1277, 1300 (1999) (citing studies indicating that each of these factors can, in fact, help minimize the hindsight bias's effects).

least one study indicates that use of debiasing techniques by defense counsel in closing arguments can effectively reduce the hindsight bias.[396]

I am not as sanguine as Rachlinski and Peters regarding the effectiveness of these countermeasures, but would point out that to the extent that jurors second-guess the parties, this tendency may injure plaintiffs in 10b-5 cases more than defendants. After all, to recover under 10b-5, plaintiffs must not only convince jurors that defendants acted intentionally (or at least recklessly) to mislead, they must also establish materiality, reliance, transaction causation, loss causation, the "in connection with" requirement, and damages.[397] But simple carelessness by plaintiffs (as seen with 20-20 hindsight by jurors) may eliminate the "reasonable reliance" element of their claim and thereby bar recovery.[398]

D. *Inability to Detect Deception*

Judge Posner in *Carr* referred to "gullible" juries.[399] This is a legitimate concern, for there is no reason to believe that jurors are particularly good at determining who is lying (if anyone) when plaintiffs and defendants present conflicting testimony. However, there is also no reason to believe that jurors will be fooled more often by plaintiff liars than by defendant liars.

The traditional criticism of juror gullibility is that they persistently fall victim to the testimony of bogus plaintiffs' experts. However, research shows that juries are skeptical of the motives and testimony of plaintiffs' (and other) experts,[400] and "[e]xperimental studies also lend little support to the claim of juror gullibility."[401] Furthermore, as noted above, nothing in the empirical studies of trial results indicate any such bias either.[402]

396. Merrie Jo Stallard & Debra L. Worthington, *Reducing the Hindsight Bias Utilizing Attorney Closing Arguments*, 22 LAW & HUM. BEHAV. 671, 680–81 (1998).

397. *See generally* Robert A. Prentice & John H. Langmore, *Beware of Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies*, 8 HARV. J.L. & TECH. 1, 20–62 (1994) (discussing and applying elements of a 10b-5 claim).

398. *See* HAZEN, *supra* note 69, at 876 (noting that "the federal courts developed a requirement that the plaintiff in a Rule 10b-5 action must have acted with due diligence with regard to the transaction in question").

399. Carr v. CIGNA Sec., Inc., 95 F.3d 544, 547 (7th Cir. 1996).

400. Valerie P. Hans & Sanja Kutnjak Ivkovich, *Jurors and Experts*, 16 ADVOC. MAG. DEL. TRIAL LAW. 17 (1994); *see also* Dennis J. Devine et al., *Jury Decision Making: 45 Years of Empirical Research on Deliberating Groups*, 7 PSYCHOL., PUB. POL'Y & L. 622, 689 (2001) (reporting that forty-five years of jury studies show that "[i]t is clear that expert testimony is not accepted in a mindless fashion by gullible jurors awed by flashy credentials").

401. Neil Vidmar & Shari S. Diamond, *Juries and Expert Evidence*, 66 BROOK. L. REV. 1121, 1174 (2001) (reporting results of studies finding that juries are "motivated to critically assess the content of the expert's testimony and weigh it in the context of other trial evidence, as they are instructed to do"); Vidmar, *supra* note 386, at 863 (but noting that jurors, like others (including judges) are not skilled at handling statistical evidence).

402. *See supra* note 386.

Posner seems to assume that jurors' limitations in detecting when they are being lied to will always work for plaintiffs because jurors are antibusiness when, in fact, there is little or no evidence supporting this conclusion.[403] Indeed, a noted expert in the field recently concluded that "[a] variety of studies using different methodologies do not support the claim" of a jury bias for plaintiffs.[404] Some research indicates that anti-plaintiffs' attorney bias generally swamps any antibusiness bias in jurors.[405] Recent studies show that there is almost universal agreement among Americans of all races that the current system is abused by plaintiffs who are too quick to file frivolous lawsuits.[406] Jurors, like other people in society, have a tendency (noted above) to blame the victim.[407] The most comprehensive study of potential jury bias that has been done reported in 2000 that (a) there is no evidence to support the claim "that juries are pro-plaintiff,"[408] and (b) there is little support for the claim "that civil jurors are hostile to business."[409]

403. *See, e.g.*, Valerie P. Hans, *The Illusions and Realities of Jurors' Treatment of Corporate Defendants*, 48 DEPAUL L. REV. 327, 342 (1998) (reporting findings from a field experiment showing "no evidence that juries were more pro-plaintiff in cases with business defendants" and from numerous other empirical studies finding little evidence of juror hostility to corporations); Valerie P. Hans & William Lofquist, *Jurors' Judgments of Business Liability in Tort Cases: Implications for the Litigation Explosion Debate*, 26 LAW & SOC'Y REV. 85, 93 (1992) (finding that jurors tend to be generally favorable toward business defendants and inclined to hold down awards); Richard Lempert, *Why Do Juries Get a Bum Rap? Reflections on the Work of Valerie Hans?*, 48 DEPAUL L. REV. 453, 454 (1998) [hereinafter Lempert, *Bum Rap*] (accepting evidence from Hans's studies that the only apparent antibusiness result from jury holdings comes from juries' special faith in the capacity of corporations to avoid harm); Peters, *supra* note 395, at 1294 (noting that "most studies have found that juries are actually tougher on plaintiffs than judges are"); Vidmar, *supra* note 386, at 898 ("Nor does research support claims that juries are consistently moved by sympathy for plaintiffs or against deep pocket defendants.").

404. Vidmar, *supra* note 386, at 868.

405. Peters has noted:

> [A]n increasing body of evidence suggests that jurors begin their job favoring tort defendants and doubting the motives of personal injury plaintiffs, especially in medical malpractice cases. For example, Ellen L. Leggett has found that one-third of the potential jurors she has studied believe that malpractice plaintiffs are "looking for easy money." Potential jurors are even more distrustful of plaintiff lawyers than they are of plaintiffs; two-thirds believe that plaintiff lawyers are pressuring dissatisfied plaintiffs into filing suit. . . . Neil Vidmar has also found that potential jurors are concerned about plaintiff motives and about an excess of litigation.

Peters, *supra* note 395, at 1293 (footnotes omitted); *see also* Gloria Hayes, *Taking a Stand Against Lawyer Bashing*, LEGAL INTELLIGENCER, May 24, 2000, Suburban Ed., at 1 (noting that one lawyer called as a juror, after listening to other juror candidates discussing the legal system, concluded that plaintiff "lawyer bashing had been raised to the level of a spectator sport").

406. Stephen S. Meinhold & David W. Neubauer, *Exploring Attitudes About the Litigation Explosion*, 22 JUST. SYS. J. 105, 112 (2001) (reporting results of empirical study and noting "that the myth of the litigation explosion continues to be widely held and appears to be permanently entrenched"). A brand new study released by the *National Law Journal* found that fifty-three percent of jurors pooled believed that "most lawsuits these days are frivolous." Bob Van Voris, *Pollsters Find No Love for HMOs: But the Public Still Dislikes Some Suits*, NAT'L L.J., Feb. 11, 2002, at A1.

407. VALERIE P. HANS, BUSINESS ON TRIAL: THE CIVIL JURY AND CORPORATE RESPONSIBILITY 36 (2000) ("Findings from all three studies that I conducted, as well as the research of other investigators, confirms that jurors and, to a lesser extent, lay observers often blame the victim.").

408. *Id.* at 216; *see also* NEIL VIDMAR, MEDICAL MALPRACTICE AND THE AMERICAN JURY: CONFRONTING THE MYTHS ABOUT JURY INCOMPETENCE, DEEP POCKETS, AND OUTRAGEOUS DAMAGE AWARDS 161–73 (1995) (finding that juries do a good job in medical malpractice cases and are, if

The empirical research that supports the jury institution is impressive. "If there is any single finding that stands out in the thirty-two years of modern social science research on juries, beginning with *The American Jury* [by Kalven and Zeisel], it is that case facts are the most important determinant of jury verdicts. Ordinarily their influence dwarfs everything else."[410] While urban legends routinely denigrate jury performance,[411] "jury researchers generally find that juries perform most tasks entrusted to them well."[412] There have been exhaustive empirical studies of jury performance over the years and the large bulk of that work strongly supports the jury institution.[413]

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anything, slightly pro-defendant); Peter H. Schuck, *Mapping the Debate on Jury Reform*, *in* VERDICT: ASSESSING THE CIVIL JURY SYSTEM 306, 308–11 (Robert E. Litan ed., 1993) [hereinafter VERDICT] (finding no evidence of systematic jury bias).

409. HANS, *supra* note 407, at 217. Admittedly, with the Enron and related scandals, businesses have shot themselves in the foot and created a potential antibusiness backlash that could alter the situation that has existed for the past several years. *See* Tamara Loomis, *Business Scandals Rock Juror Attitudes*, N.Y. L.J., Oct. 16, 2002, at 1 (reporting the results of a recent survey).

410. Lempert, *Bum Rap*, *supra* note 403, at 462; *see also* JOHN BALDWIN & MICHAEL MCCONVILLE, JURY TRIALS 14 (1979) ("[T]he overwhelming weight of this body of evidence points strongly towards the jury being a reliable and competent fact-finding body."); VALERIE P. HANS & NEIL VIDMAR, JUDGING THE JURY 245 (1986) ("Jurors take their responsibilities seriously, and the prime determinant of verdicts is the weight of evidence."); Christy A. Visher, *Juror Decision Making: The Importance of Evidence*, 11 LAW & HUM. BEHAV. 1, 13–14 (1987) (reporting a study finding that jurors' decisions are dominated by evidential issues).

411. Vidmar, *supra* note 386, at 850 (noting that most of the criticisms of "juries are based on anecdotes that are unrepresentative or fabricated or on studies that are so badly flawed that they lack scientific validity"). Hans lists a number of these urban legends in her book, before summarizing the evidence of her extensive studies that debunks them completely. HANS, *supra* note 407, at 215.

412. Lempert, *Bum Rap*, *supra* note 403, at 460; *see also* HANS, *supra* note 407, at 221 (reporting that the best research regarding the fact-finding ability of juries "reaches largely positive conclusions about the jury's fact-finding abilities, although areas of vulnerability can be identified"); REID HASTIE ET AL., INSIDE THE JURY 230 (1983) ("In their task of fact-finding, juries perform efficiently and accurately."); Richard Lempert, *Civil Juries and Complex Cases: Taking Stock After Twelve Years*, *in* VERDICT, *supra* note 408, at 181, 235 (surveying the empirical evidence in complex cases and concluding that "the weight of the evidence indicates that juries can reach rationally defensible verdicts in complex cases [and] that we cannot assume that judges in complex cases will perform better than juries").

413. Devine et al., *supra* note 400, at 685 (reporting that most jury studies find a "strong positive association" between the strength of the evidence and jury verdicts); Valerie P. Hans, *Attitudes Toward the Civil Jury: A Crisis of Confidence?*, *in* VERDICT, *supra* note 408, at 248, 275 ("Judges report that, in general, they agree with jury verdicts and strongly support the civil jury's soundness as an institution."); Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—and Why Not?*, 140 U. PA. L. REV. 1147, 1236–39 (1992) (reviewing the research and concluding that "juries are one of our society's most reliable decision-making institutions").

Lempert notes:

> Generally speaking, the jury performs its task well, particularly the task of fairly finding facts. Bias does not seem to be a great problem in jury verdicts. Professors Harry Kalven and Hans Zeisel, in their seminal study, found that judges agreed with juror verdicts in more than three-quarters of the cases they heard, and where they disagreed, the cases were ordinarily close on the facts. In only a few cases did judges feel that juror attitudes were strongly determinative of their verdicts. Recent surveys convey a similar picture. In a poll carried out by Louis Harris and Associates, 99% of federal judges and 98% of state judges believed that jurors made a serious effort to apply the law and 80% of federal judges and 69% of state judges rejected the idea that "the feelings of the jurors about the parties often cause them to make inappropriate decisions." A survey of Georgia state judges reports that 87% of the time judges agreed with civil juries' ver-

That does not mean that juries are perfect. The numerous DNA-based reversals of criminal convictions that have occurred in recent years highlight the inevitable imprecision of the trial process.[414] Jurors inevitably labor under the same heuristics and biases as all human decision makers and they are not skilled at detecting when they are being lied to. What the empirical work does show pretty clearly is that jury performance is generally as good as judge performance in fact-finding tasks, and that jury decisions are not generally influenced in any important degree by the antibusiness bias that Posner apparently fears.[415]

> dicts in negligence cases, and when there was disagreement, only 19% of the judges indicated that it was their belief that the jury was pro-plaintiff.

Lempert, *Bum Rap*, *supra* note 403, at 454–55 (footnotes omitted); *see also* Curriden, *supra* note 372, at 1A (reporting that a recent survey of 1000 active Texas state and federal trial judges found that more than three-fourths said they have never seen a "runaway jury" and "[u]pward of 98 percent said that in general, juries do a good job of delivering just and fair verdicts").

414. *See DNA Evidence Helps Send Death Row Case to Retrial*, HOUS. CHRON., Apr. 20, 2001, at A28; *Death Penalty Moratoriums*, AMERICA, Mar. 18, 2000, at 3; Shirley E. Perlman, *Trials by Error: DNA Evidence a Powerful Forensic Tool That Has Helped Prosecutors Obtain Hundreds of Rape and Murder Convictions Is Being Used to Clear Suspects and Overturn Guilty Verdicts*, SUN SENTINEL (Ft. Lauderdale), Aug. 1, 1999, at 3A.

415. Paul Rubin has contended that behavioral evidence demonstrates that juries will be biased and that all eight biases that he identifies move jurors in a pro-plaintiff direction. Rubin, *Tort-Contract Boundary*, *supra* note 257, at 119, 135–38. His analysis deserves a response. Two quick overviews are needed. First, Rubin pays no attention to either (a) the impressive empirical evidence demonstrating that jurors are neither pro-plaintiff nor antibusiness or (b) the psychological evidence showing that jurors, like everyone else, tend initially toward being antiplaintiff. Second, Rubin is speaking in the context of strict products liability, and many of his arguments simply do not apply (and were not intended to apply) to the securities fraud setting.

Rubin's first argument is that the hindsight bias will lead jurors to find defendants liable based on 20-20 hindsight. *Id.* at 135–36. I have already suggested: (a) that some studies indicate that the hindsight bias is exaggerated; (b) the hindsight bias can be debiased to a small extent; and (c) most importantly, the bias does not necessarily aid plaintiffs more than defendants in securities fraud cases.

Second, Rubin cited the law of small numbers, which is the tendency of experimental subjects to overgeneralize from small samples. He theorizes that if jurors observe a mishap regarding a product, they "might well view the product as being more dangerous than it is, again giving rise to overestimates of the risk associated with the product." *Id.* at 136. This is a valid point, but it is unclear that this tendency outweighs the counterveiling "blame the victim" tendency.

Third, Rubin cites evidence that low-probability events (events with probabilities less than .2) are overweighed in decision making and reminds us that product injuries are low probability events. *Id.* at 136. Given that plaintiffs in 10b-5 actions must show falsity, materiality, scienter, reliance, transaction causation, loss causation, that the loss occurred "in connection with" a purchase or sale, *and* damages, *see* Prentice & Langmore, *supra* note 346, at 20–62 (setting forth and illustrating these elements), it seems unlikely that their merely demonstrating the last of these elements ("the stock price fell and we lost money") will lead a jury to automatically presume that all the other elements must be met.

Fourth, Rubin notes that people tend to be overconfident in their accuracy of their assessments of probabilities. Rubin, *supra* note 257, at 136. This is true, but could cut both ways. Jurors could be overconfident of their pro-defendant assessments just as readily as of their pro-plaintiff assessments. Rubin extends the argument by noting the confirmation bias, the tendency to interpret new evidence as consistent with an initial hypothesis. Because substantial evidence indicates that jurors usually begin in a "blame the victim" posture, this argument undermines Rubin's position.

Fifth, Rubin argues that some studies indicate that individuals undervalue actions that reduce but do not eliminate risk. *Id.* at 136. Thus, actions that defendant manufacturers took to reduce the risk of a product may be discounted by jurors if they did not eliminate the risk altogether. This information seems largely irrelevant to a securities fraud case.

Sixth, Rubin argues that the endowment effect will cause jurors to grant excessive damages. *Id.* at 137. His theory is that the endowment effect shows that losses are overvalued relative to gains and

Still, the imperfections in the judicial fact-finding process might justify Posner's fears if the signed adhesion contract meant anything other than that plaintiff signed it. But, for a host of behavioral reasons explained above, it generally means no more than that. Therefore, an effort to find the truth is warranted, even through an imperfect process.

The Supreme Court implicitly rejected Posner's views in the 2001 case *Wharf Holdings Ltd. v. United International Holdings, Inc.*[416] The plaintiff in *Wharf Holdings* argued that the defendant had orally promised the plaintiff an option to buy some securities, never intending to honor the promise.[417] Defendant claimed that such an oral promise was unenforceable, citing *Blue Chip Stamps v. Manor Drug Stores*,[418] which had held that a plaintiff who merely claimed that he *would have* bought stock had defendant not misrepresented the facts did not have standing to sue under 10b-5.[419] The Court in *Blue Chip* worried openly about proof problems—how could a jury ever determine whether plaintiff truly would have invested absent the misrepresentation? The Supreme Court could have followed Posner's reasoning in *Carr* by throwing up its collective hands and saying: "We'll never find out who told the truth." But

that once an accident occurs, the entire focus is on the losses. "Therefore, cognitive theory indicates that juries will systematically place more weight on the actual accident and award more in damages than consumers would desire ex ante." However, the empirical evidence that shows that jury assessments of damages strongly correlate to judge assessments indicates that Rubin worries needlessly. Vidmar, *supra* note 386, at 875–93, 898 ("Systematic studies of jury damage awards indicate that, on average, awards are rather modest [and that] awards tend to be consistent with actual losses.").

Seventh, Rubin argues a salient point—before an accident the risk of harm is to an unidentified, "statistical" person, but after the accident there is an identifiable plaintiff. Rubin argues that after the accident, the risk to the identifiable person is overweighed. Rubin, *supra* note 257, at 138. I suggest that before the accident, the risk to the statistical person is undervalued. In another context, I suggested that auditors may well fudge the numbers in favor of their known client with whom they interact daily when the damage, if any, that they inflict by their reckless auditing will be borne by some unknown number of unidentified investors at some point off in the future. Prentice, *Irrational Auditor*, *supra* note 2, at 179 (quoting George Loewenstein, *Behavioral Decision Theory and Business Ethics: Skewed Trade-Offs Between Self and Others*, *in* CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 214, 226 (David M. Messick & Ann E. Tenbrunsel eds., 1996)). Again, this factor cuts both ways.

Eighth and finally, Rubin suggests that the anchoring phenomenon inflates damage awards "since the jury begins with a loss and a claim for damages, rather than with a neutral expected value calculation." Rubin, *supra* note 257, at 138. This is a legitimate concern, for there is evidence that the anchor and adjustment phenomenon may affect jury decisions if they focus initially upon the plaintiff's requested damage amount. Dale W. Broeder, *The University of Chicago Jury Project*, 38 NEB. L. REV. 744, 756–60 (1959). However, there is also evidence that if plaintiffs make extreme requests, there is a "boomerang effect" that raises juror ire. John Malouff & Nicola S. Schutte, *Shaping Juror Attitudes: Effects of Requesting Different Damage Amounts in Personal Injury Trials*, 129 J. SOC. PSYCHOL. 491, 495 (1989). Also, many jurisdictions are eliminating the ad damnum clause, thus removing the anchor that worries Rubin. Brittain Shaw McInnis, Comment, *The $75,001.01 Question: What is the Value of Injunctive Relief?*, 6 GEO. MASON L. REV. 1013, 1047 n.91 (1998).

Most importantly, the bottom line is that juries do not produce excessive win rates for plaintiffs, *see* Vidmar, *supra* note 386, at 868–70; nor do they usually produce damage awards that are out of line with what judges would award in the same case.

416. 532 U.S. 588 (2001).

417. *Id.* at 590.

418. 421 U.S. 723 (1975).

419. *Id.* at 751.

the unanimous opinion clearly distinguished the situation in *Wharf Holdings* (and *Carr/Rissman*) from that in *Blue Chip*, noting that "[a]n actual sale, even if oral, would not create this problem, because both parties would be able to testify as to whether the relevant events had occurred."[420] In *Carr* and *Rissman*, both parties should have been allowed to testify regarding the alleged fraud.

E. Potential Compromises

I am not in favor of the following alternative compromises, but I offer them up to those judges who might not be persuaded by my objections to the *Carr-Rissman* line of cases. Those two cases totally foreclose plaintiffs from attempting to prove fraud when the defendants induce them to sign written contracts containing the proper talismanic phrases. Even given legitimate worries about the ability of jurors to detect who is lying and their other cognitive limitations, *irrebuttable* presumptions that written must trump oral and that plaintiffs who claim that they received oral representations inconsistent with writings they signed must necessarily be liars are harsh and unrealistic.

> Of course, an integration clause or a contractual provision specifically disavowing the assurances allegedly relied upon is strong evidence that these assurances were never made or that their incorporation in the written agreement was considered and rejected. . . . Such factors are matters for the trier of fact to weigh. Mechanistic formulations . . . can only frustrate the true goal of all contract law: ascertainment and enforcement of the parties' true intent.[421]

Compromise #1: At a minimum, courts should allow plaintiffs to utilize the fraud exception to the parol evidence rule to prove oral representations inconsistent with written agreements by clear and convincing evidence.[422] This is a familiar burden of proof, often used in common law fraud cases. It is a degree of proof higher than the preponderance of the evidence standard that is normally used for all issues in civil litigation.[423] According to some courts, this standard requires evidence that is clear, in that "it is certain, unambiguous, and plain to the understanding" and convincing, in that "it is reasonable and persuasive enough to cause the trier of facts to believe it."[424] For evidence to be clear and convincing:

> [T]he witnesses to a fact must be found to be credible; the facts to which the witnesses testify must be distinctly remembered; the

420. *Wharf Holdings*, 532 U.S. at 595.
421. Coal Res., Inc. v. Gulf & W. Indus., Inc., 756 F.2d 443, 452–53 (6th Cir. 1985) (Morton, J., dissenting).
422. This compromise may require congressional action, because the Supreme Court has clearly rejected the clear and convincing evidence standard in favor of the preponderance of the evidence standard in the basic 10b-5 case. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 (1983).
423. BALLENTINE'S LAW DICTIONARY 208 (3d ed. 1969).
424. Ortega v. IBP, Inc., 874 P.2d 1188, 1198 (Kan. 1994).

details in connection with the transaction must be narrated exactly and in order; the testimony must be clear, direct and weighty; and the witnesses must be lacking in confusion as to the facts at issue.[425]

Jolls, Sunstein, and Thaler have proposed adoption of a clear and convincing evidence standard as a potential solution to the problem of juror hindsight bias.[426] It could be applied to disclaimers, no-reliance, and merger clauses as well.[427]

Examples of clear and convincing evidence that plaintiffs might produce in such cases come easily to mind. Defendants, or some of their agents, might admit to having made the false oral representations.[428] Plaintiffs, through discovery or dumb luck, might come into possession of documents in which defendants instructed their agents to make such oral misrepresentations.[429] Defendants may have put their representations in the form of brochures or videotapes that are still in the possession of investors.[430] Multiple plaintiffs, and other witnesses who were given defendants' sales pitch but declined to buy and therefore have no self-interest in the outcome of the case, might testify in very similar terms as to the oral sales pitch they received from defendants.[431] Plaintiffs will not be

425. Modern Air Conditioning, Inc. v. Cinderella Homes, Inc., 596 P.2d 816, 824 (Kan. 1979); *see also In re* Medrano, 956 F.2d 101, 102 (5th Cir. 1992) (quoting Cruzan v. Dir., Mo. Dep't of Health, 497 U.S. 261, 285 n.11 (1990)) (defining clear and convincing evidence as "that weight of proof which 'produces in the mind of the trier of fact a firm belief or conviction as to the truth of the allegations sought to be established, evidence so clear, direct and weighty and convincing as to enable the fact finder to come to a clear conviction, without hesitancy, of the truth of the precise facts' of the case").

426. Jolls et al., *supra* note 339, at 1529–31.

427. Issacharoff has argued that changing the burden of proof has little impact on jury decision making. Samuel Issacharoff, *Can There Be a Behavioral Law and Economics?*, 51 VAND. L. REV. 1729, 1743–44 (1998). However, psychologists Hastie, Penrod, and Pennington's study found that "jury decision processes do not falter when confronted by abstract legal concepts, such as the beyond a reasonable doubt standard, reasonable inference, and the presumption of innocence." HASTIE ET AL., *supra* note 412, at 231. Furthermore, Farber notes that a change of burden of proof would have its greatest impact in judges' decisions regarding summary judgment motions and appellate review of verdicts. Daniel A. Farber, *Toward a New Legal Realism*, 68 U. CHI. L. REV. 279, 300 (2001). And, if jurors do have trouble with burdens of proof, some evidence indicates that it is because they place too high a burden on plaintiffs. *See* Dorothy K. Kagehiro, *Defining the Standard of Proof in Jury Instructions*, 1 PSYCHOL. SCI. 194, 195 (1990) (finding that jurors expressed the "preponderance of the evidence" standard in terms closer to those appropriate for the "beyond a reasonable doubt" standard).

428. In one products liability case, for example, defendant's testimony admitted to an express warranty that had been excluded from the written contract by a merger clause. Edgerton v. Johnson, 7 S.E.2d 535, 537 (N.C. 1940).

429. In boiler room cases, plaintiffs sometimes locate copies of transcripts of the phone calls that banks of operators made to unsuspecting investors. *See, e.g.*, Blinder, Robinson & Co., No. 3-6380, 1985 SEC LEXIS 2636, at *39–46 (SEC Aug. 30, 1985). In a recent Supreme Court case involving an oral contract, the plaintiff discovered internal documents belonging to the defendant indicating that the defendant never intended to carry out its oral promises. Wharf Holdings Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 591–92 (2001).

430. *See, e.g.*, Keller v. A.O. Smith Harvestore Prods., Inc., 819 P.2d 69, 71 (Colo. 1991) (a negligent misrepresentation case).

431. *See, e.g.*, *In re* Linder, Bilotti & Co., Inc., 42 S.E.C. 407, 409 n.6 (1994) (explaining that several witnesses, some investors/plaintiffs and some not, testified as to misrepresentations in sellers' sales pitch).

able to win simply by showing that defendants made general statements of optimism, for these will be held immaterial as a matter of law.[432]

Compromise #2: A recent trend in the never-ending debate regarding the parol evidence rule, and a trend sparked by Judge Posner himself,[433] focuses on the reliability of the parol evidence rather than on some more arbitrary decision to use a hard or a soft approach to parol evidence rule cases.[434] This alternative would require plaintiffs seeking to overturn no-reliance or merger clauses to support their position by objective evidence. In an analogous situation—where one party to a written contract alleged that the other had orally waived his rights under it—Judge Posner wrote in *Cole Taylor Bank v. Truck Insurance Exchange*:

> There is no more vexing question in contract law than when a written contract can be rewritten by oral testimony. "Always" is an unsatisfactory answer because it defeats one of the main purposes of written contracts, which is to protect a contracting party against the vagaries of juries. "Never" is equally unsatisfactory [although it is the alternative Judge Posner chose in *Carr*], because of the acute danger of misinterpretation by a reader ignorant of the contract's commercial setting. In *AM International* [, *Inc. v. Graphic Management Associates, Inc.*, 44 F.3d 572 (7th Cir. 1994),] . . . we concluded that the law draws a line between "objective" and "subjective" testimony. The former, illustrated by evidence of trade usage, is evidence that is capable of being given by disinterested witnesses. The latter is the self-serving testimony of one of the parties to the contract.[435]

Most of the potential examples of clear and convincing evidence of fraud—admissions by defendants, testimony by disinterested witnesses, documentary support, but not a plaintiff's testimony alone (no matter how compelling)—listed above would also constitute the objective evidence that Judge Posner has in related circumstances deemed sufficient to carry a party's burden of proof.

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432. *See, e.g.*, *In re* CDNOW Sec. Litig., 138 F. Supp. 2d 624, 637 n.15 (E.D. Pa. 2001) ("Vague and general statements of optimism constitute no more than puffery and are understood by reasonable investors as such.").

433. *See, e.g.*, Cole Taylor Bank v. Truck Ins. Exch., 51 F.3d 736 (7th Cir. 1995); AM Int'l, Inc. v. Graphic Mgmt. Assoc., Inc., 44 F.3d 572 (7th Cir. 1995); Bristow v. Drake St., Inc., 41 F.3d 345 (7th Cir. 1994) (applying Illinois law); Herzog Contracting Corp. v. McGowen Corp., 976 F.2d 1062 (7th Cir. 1992) (applying Indiana law); FDIC v. W.R. Grace, 877 F.2d 614 (7th Cir. 1989) (applying Illinois law); Patton v. Mid-Continent Sys., Inc., 841 F.2d 742 (7th Cir. 1988) (applying Indiana law).

434. *See generally* Lawrence A. Cunningham, *Toward a Prudential and Credibility-Centered Parol Evidence Rule*, 68 U. CIN. L. REV. 269 (2000).

> Wigmore was right when he said that "whatever virtue and strength lies in the argument for the antique [parol evidence] rule leads not to a fixed rule of law, but only to a general maxim of prudent discussion." Linking the parol evidence rule to credibility, and possibly to good faith, reflects this prudential sense of the rule far more coherently and realistically than doctrinal statements of courts adhering to a strong or a weak version of the rule.

Id. at 320.

435. Cole Taylor Bank v. Truck Ins. Exch., 51 F.3d 736, 737 (7th Cir. 1995) (citation omitted).

Because I see no reason to believe that jurors tend to favor plaintiffs unduly or that the "certainty" provided by adhesion contracts is of any real significance, I oppose both of these proffered compromises. Posner himself explained in *Cole Taylor Bank* why such special treatment is unneeded:

> The fact that the courts have not converged on a blanket general requirement of reliance, consideration, a writing, a heightened standard of proof, or other means of assuring the reliability of questionable evidence may reflect the inherent implausibility of offers to prove "bare" waiver in a contractual setting. Unless the right waived is a minor one . . . why would someone give it up in exchange for nothing? If something is given in return, then there is consideration. If purely "subjective" evidence of waiver is incredible in an arm's length contractual setting, the exclusion of such evidence may not be necessary in order to prevent the erosion of the subjective/objective decision that is an essential feature of a sensible law of contracts.[436]

However, if courts do not find my argument convincing, then I ask them to accept these intermediate compromises to give defrauded plaintiffs at least a glimmer of hope.

If the contract at issue happens not to be an adhesion contract, then a clear and convincing evidence standard or an objective evidence requirement then becomes more appealing.[437] However, even sophisticated investors can be trusting and vulnerable to deception.[438] As one court has noted, "[a] sophisticated investor is not barred by reliance upon the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce."[439]

436. *Id.* at 739–40.

437. In trying to make sense out of Texas law in the area, the Fifth Circuit recently explained that effectiveness should be granted to no-reliance clauses only in limited circumstances:

> We read *Schlumberger* as holding that particular contract clauses may, under certain limited circumstances, curtail the contracting parties' ability to challenge the contract's validity on fraudulent inducement grounds. *Schlumberger* gives us some indication of what those circumstances may include. That the negotiating parties in *Schlumberger* were represented by counsel, were experts in the subject matter of the negotiations, and were bargaining at arm's length were important to the court. . . . In addition, the court noted that at the center of the parties' dispute was the object of the alleged misrepresentations—the value of the mining project—and that the sole purpose of the unambiguous release was to end that dispute "once and for all."

Dunbar Med. Sys., Inc. v. Gammex, Inc., 216 F.3d 441, 449 (5th Cir. 2000); *see also* Megan R. Comport, Comment, *Enforcing Contractual Waivers of a Claim for Fraud in the Inducement*, 37 SANTA CLARA L. REV. 1031, 1031 (1997) (arguing that "a merger clause in a contract between business parties who are represented by counsel during the negotiation, drafting, and execution of the contact should preclude a claim for fraud in the inducement").

438. *See* Langevoort, *Selling Hope*, *supra* note 54, at 631 (making as the central point of his article the claim "that once a broker successfully cultivates trust, willing reliance by the sophisticated investor—imprudent though it may seem in hindsight—is quite likely and, for that reason alone, worthy of some protection").

439. EP Medsystems, Inc. v. Echocath, Inc., 235 F.3d 865, 883 (3d Cir. 2000); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976).

VII. CONCLUSION

In 1933 and 1934, Congress passed two major federal securities laws for the purpose of restoring confidence in the securities markets by, in part, protecting investors from fraud.[440] Those laws contained tort-based remedies that Congress expressly provided could not be contractually waived.[441] Yet, in the past two decades, many courts have given effect to disclaimers, no-reliance clauses, and/or merger clauses, effectively allowing sellers to induce investors to contractually waive 10b-5 tort remedies.[442] These cases encourage fraud[443] and are inconsistent with congressional intent under the '33 and '34 Acts. Behavioral analysis demonstrates that they are also unwise policy.

Most sales pitches in the securities field are made orally, yet most adhesion contracts disclaim oral representations in legal boilerplate.[444] Why? For competitive reasons, sellers have an incentive to make oral representations to buyers of securities[445] and then to present the buyers with written contracts that disclaim those same representations. For the behavioral reasons examined in this article, investors often sign those written contracts notwithstanding the fact that their provisions misrepresent the agreement of the parties. As Langevoort has noted, "[i]t is ironic that lawyers for brokerage defendants aggressively promote a defense based on the claim that reasonable customers should be skeptical of broker recommendations—and thus read their prospectuses in search of inconsistencies—given how much money and effort brokers and firms spend on sending the message to investors that trust is wise and profitable, and how much they charge investors for their advice."[446] The irony is magnified when judges hold that consumers and investors must read their adhesion contracts knowing that (a) they usually will not,[447] and (b)

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440. Those acts succeeded. They "were among the New Deal's most constructive and enduring achievements . . . [and] were a real rescue and repair of the financial system, with a few reforms." VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 352 (1970).

441. *See supra* note 93–100 and accompanying text.

442. *See supra* note 7.

443. Davis, *supra* note 91, at 519–20 (noting that to enforce disclaimers "sends the wrong message to brokers. For the broker, the lesson to be learned from this line of cases is not that fraud is reprehensible, but rather that fraud is an acceptable part of a sales pitch so long as at the end of the day one goes through the formality of sending the prospective customer a prospectus [containing a disclaimer].").

444. *Id.* at 528 (noting that disclaimers are "typical" in the securities field).

445. There is a logical disconnect here. On the one hand, sellers of securities induce buyers to disclaim reliance on any sellers' representations. Yet, if these representations were not extremely important to the selling process, one assumes that the job of stockbroker would be simply to hand out prospectuses. Sales agents *shape* demand with their oral representations, *see* Langevoort, *Selling Hope*, *supra* note 54, at 634, and it is only to disingenuously limit liability that sellers place no-reliance and similar clauses in contracts.

446. *Id.* at 685.

447. Leff noted long ago that attempts to induce consumers to read form contracts are bound to fail:

> The normal, nonpathological consumer sale, is one in which a form is proffered by a nonmonopolist selling non-life-essential goods pursuant to no huge quantum of lying, and in which

if they do, the short-cut efficiency that justifies the existence of those form contracts disappears.

Courts that allow sellers to prevent plaintiffs from even adducing evidence of fraud by the simple expedient of placing in the contract a no-reliance clause do so in order that parties may be certain that the written contract will be honored as their definitive agreement. This certainty is easily overvalued. At least where adhesion contracts are concerned, there is little reason to believe that the written contract is the parties' definitive agreement. It is more likely that one side drafted a form and the other side signed it without reading and/or understanding it. The only certainty is that the buyers had the opportunity to read the contract and object to the no-reliance clause and probably did neither.

In *Rissman*, Judge Easterbrook wrote that "promoting the primacy of the written word is a principal function of the federal securities laws."[448] Judge Easterbrook cites no authority for this notion, and I am aware of none.[449] If true, it is surpassingly odd that (a) the Supreme Court recently held that oral securities contracts are enforceable,[450] (b) Congress expressly made oral misrepresentations actionable under the '33 Act,[451] (c) Congress drafted section 10(b) extremely broadly with no hint that it did not apply to oral misrepresentations,[452] and (d) the courts

> that form is signed because no one is particularly interested in the sub-set of the whole package which is the contract. In such a context, how does one go about regulating the contract as a process. By facilitating more bargaining? That is absurd (1) because, as Llewellyn saw as early as anybody, the mass produced contract is complementary to, and has the same economic utility of, the mass-produced product; (2) most "objectionable" clauses of a consumer contract have only contingent, often highly contingent, importance, and no buyer not represented by a lawyer (whose job it is almost wholly to think about things which are not going to happen) is going to think much about them; and (3) even if the unrepresented consumer were interested, it is unlikely that he would have the necessary sophistication for such consideration.

Leff, *supra* note 113, at 148–49.

448. Rissman v. Rissman, 213 F.3d 381, 384 (7th Cir. 2000).

449. To the extent that the securities laws sought to require that certain disclosures be required to be in writings filed with the SEC and/or provided to investors, the purpose was to protect investors rather than to facilitate their defrauding. *See supra* note 62.

450. Wharf Holdings Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001). The Court noted:

> Neither is there any . . . convincing reason to interpret the [1934] Act to exclude oral contracts as a class. The Act itself says that it applies to "any contract" for the purchase or sale of a security. . . . Oral contracts for the sale of securities are sufficiently common that the Uniform Commercial Code and statutes of frauds in every State now consider them enforceable. . . . Any exception for oral sales of securities would significantly limit the Act's coverage, thereby undermining its basic purposes.

Id. at 595.

451. Section 12(a)(2) of the 1933 Securities Act expressly makes oral misrepresentations actionable; *see also* EP Medsystems, Inc. v. EchoCath, Inc., 235 F.3d 865, 871 (3d Cir. 2000); Mid-Am. Fed. Sav. & Loan v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1255 (10th Cir. 1989) (noting that section 12(a)(2) makes oral misrepresentations actionable).

452. Section 10(b) of the '34 Act broadly outlaws fraud by making it unlawful to use "any manipulative or deceptive device or contrivance," and does not in any way hint that oral fraud is unprotected.

unanimously agree that oral misrepresentations are actionable under Rule 10b-5.[453]

The true principal purpose of the '33 and '34 Acts was to save the securities markets by, in large part, blunting securities fraud. In the wake of the Enron scandal, the importance of that task stands in sharp relief.[454] By providing contractual cover to fraudsters, the rulings in *Carr* and *Rissman* frustrate this primary congressional goal in order to advance a goal (promoting the primacy of the written word) that Judge Easterbrook has imagined and a certainty that, at least in the context of adhesion contracts, is largely illusory. No lesser a scholar than Corbin once wrote: "I have read all the contract cases for the last twelve years; and I know that 'certainty' does not exist and that the illusion perpetrates injustice."[455]

453. *See, e.g.*, Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1325 (7th Cir. 1988); Northland Capital Corp. v. Silver, 735 F.2d 1421, 1427 n.8 (D.C. Cir. 1984); *In re* Gupta Corp. Sec. Litig., 900 F. Supp. 2d 1217, 1240 (N.D. Cal. 1994); Geeting v. Prizant, 664 F. Supp. 343, 346 (N.D. Ill. 1987); Hammond Group, Inc. v. Republic Nat'l Life Ins. Co., No. 75 Civ. 3713, 1976 U.S. Dist. LEXIS 16368, at *8 (S.D.N.Y. Mar. 2, 1976); Desser v. Ashton, 408 F. Supp. 1174, 1176–77 (S.D.N.Y. 1975).

454. The Enron scandal has caused a loss of investor trust that goes well beyond the Enron company itself. *See* Ralph Frammolino & Jeef Leeds, *Andersen's Reputation in Shreds*, L.A. TIMES, Jan. 30, 2002, at A1 (noting that the Enron disclosures are "reverberating widely, shaking investors' confidence in the profits and losses reported by corporate America").

455. Joseph M. Perillo, *Twelve Letters from Arthur L. Corbin to Robert Braucher Annotated*, 50 WASH. & LEE L. REV. 755, 758 (1993) (quoting letter from Corbin to Braucher).

If I were to rewrite Posner's key language in *Carr* to be consistent with my analysis, it would read as follows:

> This principle [that no-reliance clauses must be subject to a fraud exception] is necessary to provide buyers of goods and services, including investments, with a safe harbor against groundless oral misrepresentations by their sellers. Without such a principle, buyers would have no protection against plausible liars and gullible judges. The purchase of supposedly safe investments would itself be a very risky enterprise. Risky investments by definition are often difficult to sell, and stockbrokers are prime candidates to orally misrepresent their safety because brokers are compensated by commissions and receive the greatest commissions from selling the securities with the greatest risks. If documents they prepare and submit to the buyer, knowing that the buyer is unlikely to read them, contain boiler-plate disclaimers, they will have a nearly fool-proof method of committing fraud and escaping liability.

Compare this version to Judge Posner's original, *supra* note 46 and accompanying text.