

ENTER YOSSARIAN: HOW TO RESOLVE THE PROCEDURAL CATCH-22 THAT THE PRIVATE SECURITIES LITIGATION REFORM ACT CREATES

ELLIOTT J. WEISS*
JANET E. MOSER**

There was, of course a catch.

"Catch-22?" inquired Yossarian.

"Of course," Colonel Korn answered pleasantly. . . . ***

I. INTRODUCTION

The most striking aspect of the Private Securities Litigation Reform Act of 1995¹ is its rejection of the system of notice pleading that has governed all civil actions in federal courts since 1938. "[P]rompted by significant evidence of abuse in private securities lawsuits,"² Congress decided that a new set of procedural rules should govern such actions.³ It was evidence that the liberal pleading and discovery provisions of the Federal Rules of Civil Procedure routinely had been exploited by attorneys specializing in prosecuting securities class actions that led Congress to act. Congress found that plaintiffs' attorneys frequently filed class action complaints alleging securities fraud within hours or days after some unexpected news precipitated a significant decline in the price of a public corporation's stock.⁴

* Charles E. Ares Professor of Law, University of Arizona College of Law.

** Certified Public Accountant; J.D. 1998, University of Arizona College of Law. The authors wish to thank the participants in the University of Arizona College of Law faculty workshop and in the 1998 F. Hodge O'Neal Corporate & Securities Law Symposium, as well as Charles Ares, Adam Pritchard, Henry Ruth, Tom Mauet and Joel Seligman, for helpful comments and Ryan Breeden for valuable research assistance.

*** JOSEPH HELLER, *CATCH-22: A CRITICAL EDITION* 411 (Robert M. Scotto, ed.) (1973).

1. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.) [hereinafter referred to as the "PSLRA," the "Reform Act" or the "Act."].

2. H.R. REP. NO. 104-369 (1995), *reprinted in* 1996 U.S.C.C.A.N. 730, *Private Securities Litigation Reform Act of 1995*, at 59 (Jan. 10, 1996) [hereinafter Conf. Rep.].

3. Although Congress expressed concern primarily about class action alleging violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, *see* Conf. Rep., *supra* note 2, many of the procedural rules set forth in the Reform Act apply to all private actions brought under the 1934 Act. *See* Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78u-4(b) (Supp. II 1996).

4. This "race to the courthouse" was exacerbated by courts' practice of naming as lead counsel

These complaints often cited no evidence of wrongdoing. The attorneys hoped that through discovery—which courts generally allowed to proceed immediately after a complaint was filed—they would be able to uncover sufficient evidence suggesting wrongdoing to allow them to file amended complaints that would survive motions to dismiss.⁵ Plaintiffs' attorneys then would be in a position to threaten defendants with further, more extensive discovery. Defendants, concerned about the substantial attorneys' fees and disruption of business that such discovery entailed, often were willing to settle plaintiffs' claims, even those that lacked merit, so long as the cost of settling was not much more than the litigation costs defendants otherwise would incur.⁶

The Reform Act contains four provisions designed (a) to make it more difficult for a plaintiff to set forth a claim of securities fraud that will survive a motion to dismiss and (b) to preclude a plaintiff from engaging in “fishing expedition” discovery to develop the information necessary to state such a claim.

- The “*All Facts Requirement*”—Plaintiff must specify in her complaint “each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint [also] shall state with particularity all facts on which that belief is formed.”⁷
- The “*Strong Inference Requirement*”—“[W]ith respect to each act or omission alleged to violate” section 10(b) and Rule 10(b)-5, plaintiff must “state with particularity facts giving rise to a strong inference that the defendant acted with [scienter].”⁸
- The “*Discovery Stay*”—A court must dismiss any complaint that does not meet both of the above

for the plaintiff class the attorney who filed the first complaint alleging securities fraud. See Conf. Rep., *supra* note 2, at 68.

5. In an action alleging securities fraud, a complaint would have to both set forth a claim for which relief could be granted, see FED. R. CIV. P. 12(b)(6), and meet the more stringent pleading requirements of FED. R. CIV. P. 9(b).

6. See Conf. Rep., *supra* note 2.

7. 15 U.S.C. § 78u-4(b)(1) (Supp. II 1996). The bracketed words remedy some grammatical flaws in the text of the statute.

8. *Id.* § 78u-4(b)(2).

requirements⁹ and, during the time a motion to dismiss is pending, the court also must stay all discovery unless it “finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.”¹⁰

- The “*Sanctions Provision*”—The court, upon final adjudication of the action, is directed to make specific findings concerning the compliance by each party with each requirement of Federal Rule of Civil Procedure 11(b), to impose sanctions against any party or attorney who it finds has violated Rule 11(b), and, if it finds plaintiff’s complaint failed to comply with Rule 11(b), to presume that the appropriate sanction is an amount equal to defendants’ “reasonable attorneys’ fees and other expenses incurred in the action.”¹¹

The Conference Committee report makes clear that Congress’ intent in enacting these provisions was not to make it impossible for a defrauded investor to initiate or maintain a securities class action. Indeed, the Conference Committee explicitly recognized that “[t]he overriding purpose of our Nation’s security laws is to protect investors and maintain confidence in the securities markets,” that “[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses,” and that “[s]uch private lawsuits [also] promote public and global confidence in our capital markets and help to deter wrongdoing.”¹² The Committee stated that the goal of the Act was “to return the securities litigation system to that high standard.”¹³

Nonetheless, many questioned whether the Reform Act’s procedural provisions would create a Catch-22 that would preclude the prosecution of potentially meritorious claims. President Clinton vetoed the Act in part because he felt it would create a “procedural hurdle . . . so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.”¹⁴ Others argued that the

9. *See id.* § 78u-4(b)(3)(A).

10. *Id.* § 78u-4(b)(3)(B).

11. *Id.* § 78u-4(c)(3)(A)(ii).

12. Conf. Rep., *supra* note 2, at 59.

13. *Id.*

14. Private Securities Litigation Reform Act of 1995—Veto Message From the President of the United States, H.R. DOC. NO. 104-150, *reprinted in* 141 CONG. REC. H15215 (daily ed. Dec. 20, 1995) [hereinafter Veto Message].

Act's pleading standards were too high and that the Discovery Stay would make it impossible for many plaintiffs to craft complaints that would satisfy those standards.¹⁵

Developments since Congress enacted the Reform Act over President Clinton's veto suggest that the most extreme claims about the Act's potentially Draconian impact were unfounded. Securities class actions continue to be filed in roughly the same volume as was the case before the Act was passed¹⁶ and many complaints alleging open market fraud have survived motions to dismiss.¹⁷ Analysis suggests, however, that many of the claims that have survived fall within one of three categories of open market fraud cases that are largely unaffected by the Reform Act's procedural requirements. These are (i) cases where the "bad news" statement that precipitated a claim also made it clear that some earlier statement made by defendants was false or misleading, such as when a corporation has restated its earnings for some earlier period;¹⁸ (ii) cases where, in connection with the "bad news" statement, some third party disclosed information that indicated that one or more of a corporation's earlier statements were false or misleading;¹⁹ and (iii) cases where the temporal proximity between the "bad news" statement and an "earlier, cheerier"²⁰ statement, combined with the magnitude of the changes between the two, is itself sufficient to create a strong inference that a corporation was aware of the bad news at the time it made the earlier statement.²¹

15. "It simply will be impossible for the plaintiff, without discovery, to meet the standard inserted in the conference committee at the last minute." Securities Litigation Reform Act-Veto, 141 CONG. REC. S19,038 (daily ed. Dec. 21, 1995) (Remarks of Sen. Sarbanes, quoting letter from John Sexton, Dean, New York University School of Law).

16. *See Class Action Lawsuits Stage '97 Rebound Despite Legal Curbs*, WALL ST. J., Feb. 19, 1998, at B2 (reporting that SEC found the number of companies sued in securities class actions in 1997 was at same level as in years prior to passage of the Reform Act).

17. The office of the general counsel of the SEC has tallied post-Reform Act cases in which courts have ruled on motions to dismiss. As of April 21, 1998, it had identified 78 such rulings. Courts had denied motions to dismiss in 32 cases, denied motions to dismiss in part and granted them in part in 8 cases, granted motions to dismiss with leave to amend in 27 cases, and granted motions to dismiss with prejudice in 11 cases. *See* Telephone conversation with David Levine, Special Assistant to the General Counsel (Apr. 29, 1998).

18. *See, e.g., Gross v. Medaphis Corp.*, 977 F. Supp. 1463 (N.D. Ga. 1997). A restatement generally indicates an error in previously issued financial statements "resulting from mathematical mistake, mistake in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared." ACCOUNTING CHANGES, ACCOUNTING PRINCIPLES BULLETIN OPINION NO. 20, para. 36 (July, 1971) (emphasis added).

19. Such as where, after a ValuJet plane crashed in Florida, the FAA disclosed that ValuJet had a history of significant safety and maintenance problems that the company had not previously disclosed. *See In re ValuJet, Inc. Sec. Litig.*, 984 F. Supp. 1427 (N.D. Ga. 1997).

20. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1549 (9th Cir. 1994) (*en banc*).

21. *See In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273, 1283 (D. Minn. 1997) (where

The cases that remain the most problematic are those where an investor suspects that a corporation has misrepresented material information but cannot demonstrate that her suspicions have merit without obtaining access to information that the corporation controls. Such cases have long brought into tension two competing interests: The public's interest in having private litigation, and the threat of such litigation, deter fraud in the securities markets and provide a remedy for defrauded investors, and the public's competing interest in deterring plaintiffs and their attorneys from employing the litigation process to extract undeserved settlements from innocent companies or to impose unnecessary costs on such companies.²²

Prior to passage of the Reform Act, courts were inclined to provide a plaintiff "some opportunity to conduct discovery of those [she] reasonably suspected of having perpetrated a fraud" unless it appeared beyond doubt, based on plaintiff's complaint, that she could "prove no set of facts in support of [her] claim that would entitle [her] to relief."²³ This approach reduced the risks that fraud would go unremedied, but increased the ability of plaintiffs and their attorneys to extract undeserved settlements from innocent defendants. Congress clearly intended to alter this balance when it passed the Reform Act.²⁴ However, Congress provided the courts with little guidance as to how heavy a thumb it intended to place on defendants' side of the scale.²⁵

We concluded that conducting a case study was a good way to assess the probable impact of the Reform Act's procedural provisions on this problematic class of cases. Before the Reform Act went into effect, plaintiffs tended to rely on documents obtained through discovery to support their claims, both because relying on discovery allowed plaintiffs to minimize their investigatory costs²⁶ and because documents obtained from defendants

corporation disclosed multi-million dollar cost overruns and major delays seven months after public offering, court stated that "[c]ommon sense dictates that, unless there is some type of catastrophic intervening event, construction and financing problems of this type and magnitude develop over time," and found it reasonable to infer that corporation was aware of these problems at time allegedly false or misleading statements were made).

22. See *In re Time Warner Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993), cert. denied., 511 U.S. 1017 (1994).

23. *Id.* (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).

24. See *supra* text accompanying notes 1-11.

25. In *Time Warner*, the court noted that no matter how the balance is drawn, it will not be possible to "avoid the risks of adverse consequences. . . ." *Time Warner*, 9 F.3d at 264. Reading the committee reports and the congressional debate on the Reform Act, one gets the impression that the proponents of the Act believed the Act would eliminate all "strike suits" but would not result in the dismissal (or non-prosecution) of a single meritorious claim. See generally, Conf. Rep., *supra* note 2, at 59-66; S. REP. NO. 104-98 (1995), reprinted in 1996 U.S.C.C.A.N. 679, at 71-79; H.R. REP. NO. 104-50 (1995), reprinted in 1995 WL 78795, at 143-46.

26. See Hillary A. Sale, *Still "Pleading" for the Reform of Securities Litigation*, 76 WASH. U. L.Q. 537, 561-79 (1998) (discussing pre-Reform Act cases in which plaintiffs were able to satisfy Rule

often constituted the most telling indicators of what defendants knew at the time they made allegedly false or misleading statements.²⁷ In the absence of appellate decisions interpreting the Reform Act's pleading provisions,²⁸ we believe, many plaintiffs have been testing whether courts will uphold complaints comprised primarily of generic allegations concerning information that defendants allegedly "knew" or reports that defendants allegedly "possessed."²⁹ While we do not think courts should uphold such complaints,³⁰ we also thought it would be worthwhile to examine whether, in a typical open market fraud case, a plaintiff would find it feasible to develop information, from sources other than defendants' files, that would allow plaintiff to set forth a valid claim of securities fraud.

We chose as the basis for our case study a claim that had been asserted against Green Tree Financial Corp. ("GTF"), the leading lender to purchasers of manufactured housing in the United States, Lawrence Coss, GTF's chief executive officer, and others. This securities fraud claim was precipitated by GTF's November 13, 1997 announcement that in the fourth quarter of 1997 it planned to add \$125 million to \$150 million (on a pre-tax basis) to reserves to reflect unexpectedly high prepayments that GTF had received with respect to outstanding loans.³¹ The addition to reserves was necessary because such prepayments reduced the value to GTF of interests it had retained in manufactured housing loans that it had made and then securitized.³²

The timing of GTF's announcement aroused suspicion because 1997 was the first year after a unique incentive compensation contract between Mr.

9(b) with information they found in defendants' files); Elliott J. Weiss, *The New Securities Fraud Pleading Requirements: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675, 706, n.187 (1996) (listing cases in which securities fraud complaints were dismissed and plaintiffs then filed amended complaints, all of which included additional information gleaned from defendants' files, that courts held satisfied Rule 9(b)).

27. See *In re GlenFed Inc. Sec. Litig.*, 42 F.3d 1541, 1544 (9th Cir. 1994) (en banc) (noting that a plaintiff can set forth the circumstances constituting fraud "most directly by pointing to inconsistent contemporaneous statements (such as internal reports) which were made by or available to the defendants.").

28. The only appellate decision interpreting the Reform Act's procedural provisions is *Medhekar v. District Court*, 99 F.3d 325 (9th Cir. 1996) (holding that initial disclosure constitutes "discovery or other proceedings" under the Reform Act). At the time this Article was written, appeals of three district court decisions interpreting the Act's pleading requirements were pending in Circuit Courts of Appeals. See *Hoffman v. Comshare* (E.D. Mich. 1997), *appeal docketed*, No. 97-2098 (7th Cir. Oct., 9, 1997); *In re Silicon Graphics Inc. Sec. Lit.*, 970 F. Supp. 746 (N.D. Cal. 1997), *appeal docketed*, No. 97-16204 (9th Cir. July 9, 1997); *Zeid v. Kimberley*, 973 F. Supp. 910 (N.D. Cal. 1997), *appeal docketed*, No. 97-16070 (9th Cir. June 18, 1997).

29. The validity of such complaints is a central issue in both *Silicon Graphics*, and *Zeid*.

30. See *infra* text accompanying notes 55-64.

31. See *Green Tree Issued Revised Fourth Quarter Earnings Expectations*, GREEN TREE FIN. CORP., Press Release, Nov. 13, 1997.

32. See *infra* text accompanying notes 82-85.

Coss and GTF had expired. That contract obligated GTF to pay Mr. Coss an annual bonus equal to 2.5% of GTF's pre-tax profits and resulted in GTF paying Mr. Coss \$65 million in 1995 and \$102 million in 1996.³³

Following GTF's November 13 announcement, the price of GTF stock declined by 19%. About three weeks later, the first of three class action complaints was filed alleging that GTF, Coss, and others had misrepresented GTF's earnings for 1996 and the first three quarters of 1997.

Had the allegations in the first complaints filed against GTF remained the basis of an ongoing securities fraud litigation, concern about the effect our research might have on that litigation would have made us reluctant to publish a case study of those claims. However, subsequent developments mooted that concern. On January 27, 1998, GTF issued a press release stating that, as a consequence of further review, it would restate (reduce) its reported income for 1996—and would also add an even larger amount to reserves in the fourth quarter of 1997—to account for increased prepayments of outstanding loans.³⁴ As a result of the January 27 announcement, it became clear that plaintiffs (a) would amend their complaints to reflect the information in GTF's January 27 press release³⁵ and (b) would find it far easier to craft claims against GTF that would survive a motion to dismiss. This was evident because the January 27 release strongly suggested that, as of the date GTF issued its 1996 annual report, GTF had access to and should have taken account of information about prepayments that would have led it to report substantially less income for 1996.³⁶

With these concerns aside, the allegations that had been made or that could have been made against GTF following its November 13, 1997 press release seemed to provide an ideal basis for a case study. We would proceed on the assumption that GTF, instead of issuing its January 27 press release, tried to keep secret the information that led it to restate its earnings for 1996. We then had a situation (a) in which a plaintiffs' attorney reasonably could have suspected a fraud had occurred, (b) in which—as GTF's subsequent restatement indicated—there was evidence indicating GTF's 1996 financial

33. For further description of this contract, *see infra* text accompanying notes 195-200.

34. *See* GREEN TREE FIN. CORP., Press Release, Jan. 27, 1998.

35. Indeed, within eight days after the January 27 announcement, notices of five new or amended complaints filed against GTF were posted on wire services. (Based on search of Westlaw WIRESPPLUS database, using search terms "Green Tree," "Class Action" and "Lead Plaintiff".)

36. *See supra* note 18. On April 7, 1998, as we were completing our study, GTF and Conseco, Inc. announced that Conseco had agreed to acquire GTF in a stock swap valued at \$6.44 billion. *See Conseco Agrees to Acquire Green Tree*, WALL ST. J., Apr. 8, 1998, at A2. That announcement also seemed likely to affect the value, if not the merits, of the securities fraud claims pending against GTF. *See* 15 U.S.C. § 78u-4(c) (Supp. II 1996) (providing that damages shall not exceed the mean trading price of a corporation's stock during the 90 day period following corrective disclosure).

statements were false or misleading, but (c) in which at least some of the information indicating those statements were false or misleading was under GTF's exclusive control. To study this type of problematic case, we decided to investigate whether it would have been possible for a plaintiffs' attorney, without discovery, to develop sufficient evidence to flesh out a claim that GTF had violated section 10(b) and Rule 10b-5 that would satisfy the Reform Act's pleading requirements.

Section II of this Article sets forth our understanding of what the Reform Act requires a plaintiff to set forth in a complaint to state a valid claim that a corporation has made false or misleading public statements in violation of section 10(b) and Rule 10b-5. Section III describes our case study of GTF. Section IV analyzes the options a court would face in a case similar to the "quasi-hypothetical" we studied and suggests the option we believe a court should choose.

II. WHAT THE REFORM ACT REQUIRES A PLAINTIFF TO PLEAD

To conduct a case study of the problems that would confront a plaintiff attempting to set forth a valid claim of securities fraud against GTF,³⁷ we first had to make some assumptions concerning what the Reform Act requires a plaintiff to include in her complaint. We had no personal knowledge of any facts relating to GTF and consequently assumed that any allegations we (or any plaintiff) made would be based on information and belief.³⁸ We also knew that we would have to do more than simply assert that, at the time GTF issued its financial statements for 1996,³⁹ it knew (and failed to disclose) the information concerning prepayments that it disclosed in its November 13, 1997 press release. Courts have made clear that, where disclosure of some fact precipitates a sharp drop in the price of a company's stock, a plaintiff cannot satisfy Rule 9(b) with such a plea of "fraud by

37. We assumed that claims of securities fraud, if viable, would be made against both GTF and Mr. Coss. However, for purposes of brevity, we refer either to claims "against GTF" or "against defendants."

38. See *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 763 (N.D. Cal. 1997), *appeal docketed*, No. 97-16204 (9th Cir. July 9, 1997) (where sources cited in complaint "do not provide plaintiffs with personal knowledge, the complaint must be based on information and belief—that is the only alternative.") *But cf.* *Zeid v. Kimberley*, 973 F. Supp. 910, 915 (N.D. Cal. 1997), *appeal docketed*, No. 97-16070 (9th Cir. June 18, 1997) (holding that where plaintiff based allegations on "investigation of counsel," plaintiff "cannot rely on conclusory allegations or tenuous inferences but instead, must allege with particularity: (1) each statement, (2) why each statement is false, and (3) as to each statement, facts giving rise to a strong inference that Defendants acted with scienter.")

39. As explained above, see *supra* text accompanying notes 31-36, we focused our case study on GTF's financial statements for 1996. See Complaint, *Chill v. Green Tree Fin. Corp.*, No. 97-CV-2666 (D. Minn., filed Dec. 2, 1997).

hindsight.”⁴⁰

At the same time, courts have not developed any consensus concerning how the pleading provisions of the Reform Act should be interpreted. The language of the All Facts and Strong Inference Requirements is somewhat ambiguous, as is their legislative history.⁴¹ District courts have adopted sharply different interpretations of those requirements,⁴² and, as of the time we completed this Article, no appellate decisions interpreting them had been handed down.⁴³ Moreover, circuit courts of appeals have developed different, arguably relevant, views concerning how Rule 9(b) applies to plaintiffs who assert claims of disclosure fraud.⁴⁴

Our approach to this uncertainty was to develop our own assumptions as to how the All Facts and Strong Inference Requirements should be interpreted. We started by focusing on the language and legislative history of those two provisions. We viewed all the Reform Act’s procedural provisions as parts of an integrated whole and attempted to develop an interpretation of the Act’s two pleading provisions that was consistent with the Discovery Stay and the Sanctions Provision. Finally, we tried to keep in mind what we understand to be Congress’ overarching goal—deterring claims of disclosure fraud by plaintiffs who lack evidence that a public corporation or its officials has misrepresented material facts, and preventing plaintiffs from engaging in “fishing expedition” discovery to ascertain if such facts exist. Also we kept in mind Congress’ desire to preserve investors’ ability to maintain private actions against those who have injured them by making materially false or misleading statements that affect the price of publicly traded securities.⁴⁵

Our principal task was to develop an understanding of what the Reform

40. See *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1549 (9th Cir. 1994) (en banc); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25-26 (1st Cir. 1992); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.), cert. denied, 498 U.S. 941 (1990); *Denny v. Barber*, 576 F.2d 465, 469-70 (2d Cir.1978) (Friendly, J.).

41. See, e.g., *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 n.2 (S.D.N.Y. 1997).

The district courts that have considered this issue [the Reform Act’s pleading requirements] in terms of legislative history are again divided as to the result. . . . This is hardly surprising, since the Congressional byplay that accompanies the enactment of a controversial law like the Reform Act inevitably yields a rich cornucopia of legislative history on which courts of every appetite can feed. But when it comes to interpreting such byplay, courts are poorly equipped to separate the husks from the kernels.

Id.

42. See Steven B. Rosenfeld, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, ___ REV. SEC. & COMMOD. REG. ___ (forthcoming 1998) (surveying cases).

43. Three cases were on appeal. See *supra* note 28.

44. See *infra* text accompanying notes 50-64.

45. See *supra* text accompanying notes 12-13. Congress, as is typical, failed to acknowledge the tension between these goals.

Act requires a plaintiff to include in a complaint to state a valid claim that a defendant has (i) misrepresented one or more material facts (ii) with an intent to deceive or defraud.⁴⁶ We recognized that, in many cases, facts that suggest that a statement was materially false or misleading will also suggest that a defendant acted knowingly or recklessly⁴⁷ when she issued that statement.⁴⁸ We also concluded that even where facts in a complaint strongly suggest a defendant had motive to misrepresent material facts—as would be the case with GTF and Mr. Coss' incentive compensation contract⁴⁹—the plaintiff

46. Plaintiff also must be able to plead (and then prove) reliance, but if plaintiff purchased the securities in question in an active public market, reliance will be presumed. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988). Plaintiff also must plead and prove causation, but if the price of the securities in question fell after defendant's deception was disclosed, this element is easily satisfied.

47. Some courts have concluded that facts suggesting a defendant acted recklessly cannot satisfy the Reform Act's pleading requirements. *See e.g., Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 49 n.2 (D. Mass. 1997) ("In light of the fact that the PSLRA has eliminated recklessness, this Court is of the opinion that conscious behavior can now only take the form of circumstantial evidence indicating intent to defraud or knowledge of the falsity.") However, we find more persuasive the cases that hold nothing in the text of the Act or its legislative history suggests that Congress intended to reject the view, subscribed to by eleven courts of appeal, *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568 n.6 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991), that proof of recklessness is sufficient to establish scienter. *See Queen Uno, Ltd. v. Coeur D'Alene Mines Corp.*, No. Civ. A. 97-WY-1431-C8, 1998 WL 195299, *10 (D. Colo. Apr. 13, 1998) ("There is little indication that Congress intended via the Reform Act to alter securities fraud liability for this type of recklessness conduct."); *In re Stratosphere Corp. Sec. Litig.*, No. CV-S-96-0708-PMP (RLH), 1998 WL 167259, *6 (D. Nev. Apr. 2, 1998) ("This court does not believe that Congress would abolish the well established use of recklessness as permissible scienter under the securities laws without expressly stating so in the language of the statute."); *In re Glenayre Tech., Inc. Sec. Litig.*, 982 F. Supp. 294, 298 (S.D.N.Y. 1997)

[T]he statute did not change the substantive law but merely the pleading requirement necessary to survive a motion to dismiss, i.e., that the complaint state facts raising a strong inference of scienter. The required scienter, however, remains the same, and has long been held in this Circuit (and others) to include conscious recklessness.

Id.; *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997) ("[R]ecklessness is sufficient to plead a strong inference of fraudulent intent under the PSLRA."); *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 241 (S.D.N.Y. 1997)

In the securities fraud context, then, "recklessness" is a state of mind—one that may be particularly applicable to cases involving corporate entities, whose "intent" is necessarily a legal construct—and one that most Circuits have held is sufficient to meet the *Hochfelder* definition of scienter. While the Supreme Court remains free to overrule that determination, nothing in the Reform Act purports to do so, and the few cases that might be read to suggest otherwise have simply, in this Court's view, substituted a selective reading of the convoluted legislative history for the clear and unambiguous language of the statute.

Id.

48. *See In re GlenFed Inc. Sec. Litig.*, 42 F.3d 1541, 1549 (9th Cir. 1994) (en banc) ("Setting forth contemporaneous statements or conditions [indicating that a statement was false or misleading when made] may well have the incidental effect of causing plaintiff to allege circumstances from which scienter can be inferred.")

49. *I.e.*, that Mr. Coss' bonus in 1996 would increase by an amount equal to 2½% of each dollar in pre-tax earnings that GTF reported, that this arrangement expired at the end of 1996, and that Mr. Coss therefore had a strong incentive to defer recognition of any losses GTF incurred as a result of

still must plead particularized facts indicating that a defendant knowingly or recklessly misrepresented material information.

Both common sense and the language of the Strong Inference Requirement support this conclusion. Every person that has a motive to defraud surely does not act on that motive. Moreover, the Reform Act provides that a plaintiff must plead facts that give rise to “a strong inference that the defendant *acted with*” an intent to deceive or defraud, not simply that she had a motive to deceive or defraud. In addition, even if one assumes, as did we, that a court can use the two-part test first set forth in *Beck v. Manufacturers Hanover Trust Co.*,⁵⁰ to determine whether a plaintiff has met the Strong Inference Requirement, it is important to remember that *Beck* held both (i) that a plaintiff could establish a “strong inference of scienter” by alleging either that defendant had “a motive for committing fraud and a clear opportunity for doing so” or “circumstances indicating conscious behavior by the defendant”⁵¹ and (ii) that “[w]here motive is not apparent, . . . the strength of the [plaintiff’s] circumstantial allegations *must be correspondingly greater.*”⁵² The clear implication of the emphasized phrase is that, even where motive *is apparent*, some factual allegations indicating that a defendant consciously or recklessly⁵³ misrepresented a material fact also are required.⁵⁴

unanticipatedly high prepayments until 1997. See *supra* text accompanying notes 195-202. See also *Professional Management Assoc., Inc. v. Coss*, 574 N.W.2d 107 (Minn. Ct. App. 1998) (holding that shareholders were excused from pre-suit demand in derivative action alleging corporate waste involving Coss’ compensation package).

We assumed that any court would consider it relevant that Mr. Coss’ incentive compensation contract gave him a strong motive to maximize GTF’s reported earnings in 1996. Some pre-Reform Act decisions can be read to suggest that a plaintiff should never be allowed to claim that a corporate manager was motivated to misrepresent material facts by a desire to enhance his incentive compensation, see *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061 (5th Cir. 1994), but those cases involved generalized claims that could be made with respect to almost any corporation. It seemed nonsensical to believe that the particularized facts suggesting motive that a plaintiff could allege with respect to Mr. Coss were not pertinent. See *Weiss, supra* note 26, at 700-02.

50. 820 F.2d 46 (2d Cir.1987), *cert. denied*, 484 U.S. 1005 (1988). For a summary of the legislative history of the Strong Inference Requirement, see *Weiss, supra* note 26, at 681-83.

51. *Beck*, 820 F.2d at 50.

52. *Id.* (emphasis added).

53. Subsequent to *Beck*, the Second Circuit made clear that circumstantial evidence that a defendant had acted recklessly also would suffice. See *In re Time Warner Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993).

54. A few Second Circuit decisions can be read to suggest that a plaintiff could satisfy Rule 9(b) simply by pleading facts giving rise to a strong inference that a corporation or its managers had a motive and the opportunity to misrepresent material facts. See *Weiss, supra* note 26, at 689-90, discussing *Time Warner*, 9 F.3d at 263. However, the very structure of the Second Circuit’s test suggests this was not (or should not have been) the case. After all, if no showing of falsity was

We also concluded that the All Facts Requirement places a significant interpretive gloss on the Strong Inference Requirement. The key issue raised by most motions to dismiss will be whether plaintiff has stated with particularity facts “giving rise to a strong inference” that the defendant acted with the requisite intent. The more specifics a plaintiff provides about her basis for allegations made on information and belief, the easier a court should find it to decide that her allegations give rise to the requisite strong inference. The less information a plaintiff provides about her sources, the greater the likelihood that the court will dismiss her complaint.

At the extreme, we assumed that a court always should dismiss a complaint comprised largely of unsubstantiated allegations that a defendant “knew” or “possessed” some later disclosed information at the time she made some allegedly false or misleading statement. We saw no real functional difference between such a complaint and one that alleges “fraud by hindsight.” After all, in virtually every situation in which a corporation announces some unexpected development, a plaintiff could find it easy to assert that the corporation had knowledge of that development, or of information foreshadowing that development, at the time some earlier statement was made.

To allow a plaintiff to proceed on the basis of such allegations, in our view, would undermine Congress’ goal of protecting defendants from having to incur substantial costs to respond to speculative and unsubstantiated claims of securities fraud.⁵⁵ Courts have recognized this danger for many years. *Decker v. Massey-Ferguson, Ltd.*⁵⁶ pointed out that a central purpose of Rule

required, it would make no sense to require “correspondingly stronger” evidence of reckless or conscious wrongdoing in the absence of motive and opportunity.

55. See *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 767 (N.D. Cal. 1977), *appeal docketed*, No. 97-16204 (9th Cir. July 9, 1997) (“If the Court allowed plaintiffs to go forward [on the basis of “generic” allegations concerning defendant corporation’s internal reports], the strengthened standard of the [Reform Act] would lose its meaning.”) See also *Novak v. Kasaks*, No. 96 Civ. 3073 (AGS), 1998 WL 107033, *6 (S.D.N.Y. Mar. 10, 1998) (dismissing complaint where key “paragraph provides none of the required facts underlying the complaint’s allegations as to the information that was available to the individual defendants, nor does it direct the Court to where those facts might be found.”); *Molinari v. Symantec Corp.*, No. C-97-20021-JN, 1998 WL 78120, *6-*7 (N.D. Cal. Feb. 17, 1998) (Court found that plaintiffs’ allegations concerning why defendant’s statements concerning “early sales” are false or misleading “are too conclusory and lack the necessary factual specificity” where “[p]laintiffs allege[d], without any factual support, that Defendants knew that (1) retailers’ sales of Symantec’s products were not meeting expectations; (2) the ‘attach’ rate was overstated; and (3) Windows 95 products were not selling well at retail and products were being returned to Symantec.” Court also held that “most of the [plaintiffs’] allegations regarding Enterprise products are too vague and conclusory to satisfy the pleading requirements.” For example, plaintiff pled “no facts . . . to support [their] allegation that Defendants already knew sales of Symantec’s Enterprise products were not meeting with success, were not ‘well-received,’ or were failing to gain market share.”).

56. 681 F.2d 111 (2d Cir. 1982).

9(b) was to prevent a plaintiff from relying on “conclusory allegations . . . to set off on a long and expensive discovery process in the hope of uncovering some sort of wrongdoing or of obtaining a substantial settlement.”⁵⁷ In *Greenstone v. Cambex, Inc.*,⁵⁸ Judge (now Justice) Stephen Breyer held that Rule 9(b) requires a plaintiff alleging securities fraud to “set[] forth *specific facts that make it reasonable to believe* that defendant knew that a statement was materially false or misleading.”⁵⁹ More recently, *Parnes v. Gateway 2000, Inc.*⁶⁰ held a complaint was “entirely lacking in the particularity required by Rule 9(b)”⁶¹ because it did not (i) “identify the goods and services allegedly purchased and sold by Gateway at deflated and inflated prices[,]” (ii) “allege the amount of fraudulent profit allegedly obtained by Gateway[,]” or (iii) “provide the source for” plaintiffs’ allegation “that a total of \$10,000,000 in goods and services were [fraudulently] bought and sold.”⁶²

Two recent Ninth Circuit decisions reflect a different point of view. Both appear to treat unsubstantiated allegations, which a plaintiff could have made by relating a corporation’s disclosure of unexpected adverse developments to publicly available information about that corporation’s business, as sufficiently particularized to satisfy Rule 9(b).⁶³ Those decisions conflict with the decisions of other circuit courts of appeal noted above and, if applied to post-Reform Act cases, would undermine Congress’ goals. They also, in our view, misinterpret *In re GlenFed, Inc. Securities Litigation*, in which an *en banc* panel of the Ninth Circuit observed:

Securities fraud cases often involve some more or less catastrophic event occurring between the time the complained-of statement was

57. *Id.* at 116.

58. 975 F.2d 22 (1st Cir. 1992) (Breyer, J.).

59. *Id.* at 25 (emphasis added).

60. 122 F.3d 539 (8th Cir. 1997).

61. *Id.* at 550.

62. *Id.* See also *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 365 (1st Cir. 1994) (upholding complaint in which “plaintiffs specifically identify the internal reports and the public statements underlying their claims, providing names and dates.”); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991) (holding that where “allegations of fraud are explicitly or, as in this case, implicitly, based only on information and belief, the complaint must set forth the source of the information and the reasons for the belief.”)

63. See *Fecht v. Price Co.*, 70 F.3d 1078, 1083 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996) (holding to be sufficiently particularized allegations of evidentiary fact plaintiffs’ uncorroborated assertions that “initial sales volumes of Price Company’s stores newly opened during Class Period were below levels usually experienced upon new store openings and levels necessary for the stores to achieve profitable operations” and that “recent store openings in [various locations] were proceeding poorly and most of these units were losing money.”); *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1998) (“declin[ing] to require that a complaint must allege specific shipments to specific customers at specific times with a specific dollar amount of improperly recognized revenue”).

made and the time a more sobering truth is revealed (precipitating a drop in stock price). . . . When such an event has occurred, it is clearly insufficient for plaintiffs to say that the later, sobering revelations make the earlier, cheerier statement a falsehood. In the face of such intervening events, a plaintiff must set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading when made. This can be done most directly by pointing to inconsistent contemporaneous statements or information (such as internal reports) which were made by or available to the defendants.⁶⁴

The Discovery Stay and the Sanctions Provision buttress our conclusion. The Discovery Stay reflects Congress' judgment that before a plaintiff will be allowed to impose the costs of discovery on those she charges with securities fraud, she should be required to demonstrate that facts exist that make it reasonable to believe a fraud has occurred. If she cannot—if the only facts a plaintiff can point to are unexpected changes in a corporation's circumstances that she alleges defendants were aware of, or recklessly disregarded, at some earlier date—then plaintiff's complaint should be dismissed.

Congress enacted the Sanctions Provision to give Rule 11 some real bite.⁶⁵ Prior to the passage of the Reform Act, a plaintiff who made speculative allegations on information and belief, and then was unable to produce evidence that supported those allegations, could claim that she had a reasonable belief that discovery would produce such evidence.⁶⁶ What constitutes "a reasonable belief" in these circumstances is very nebulous; a plaintiff's informed guess that the defendants may have known certain facts probably is sufficient. Consequently, Rule 11 did almost nothing to deter plaintiffs (and their attorneys) from initiating class actions on the basis of speculative, but potentially lucrative, claims of securities fraud.⁶⁷

64. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1548-49 (9th Cir. 1994) (en banc). *See also id.* at 1552 (holding certain of plaintiffs' allegations insufficiently particularized because although defendant's "statements are identified, and their falseness is alleged, but 'the reasons for their falsity' are not set forth.") (citation omitted).

65. *See* Conf. Rep., *supra* note 2, at 84. ("The legislation gives teeth to Rule 11")

66. FED. R. CIV. P. 11(b)(3) allows a party to make factual allegations that do not have evidentiary support but that the party reasonably believes "are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery." The rule was designed to tolerate speculative allegations where a litigant has "good reason to believe that a fact is true or false but may need discovery, formal or informal, from opposing parties or third persons to gather and confirm the evidentiary basis for the allegation." *Excerpt From the Report of the Judicial Conference Committee on Rules of Practice and Procedure*, 146 F.R.D. 515, 585 (1992).

67. *See* Conf. Rep., *supra* note 2, at 84 ("Existing Rule 11 has not deterred abusive securities

If courts interpret the All Facts Requirement as we believe they should, Rule 11 should deter speculative claims.⁶⁸ Once courts make it clear that a complaint alleging disclosure fraud that relies on unsubstantiated allegations concerning what defendants knew will not suffice, a plaintiff (or her attorney) who files what she then should know is an inadequate complaint should be subject to sanctions equal to all attorneys' fees and expenses defendants have incurred.⁶⁹ On the other hand, if a plaintiff attempts to avoid dismissal by asserting that she possesses evidence that supports claims she has made on information and belief and a court subsequently determines that a plaintiff had no such evidence, a plaintiff (or her attorney) also should be subject to sanctions equal to all attorneys' fees and expenses defendants have incurred.⁷⁰

A potential plaintiff who suspects fraud, but who does not have sufficient evidence to support a strong inference that a defendant deliberately or recklessly made a materially false or misleading statement will have only one attractive alternative. Before filing a complaint alleging securities fraud, she will need to conduct an investigation to determine whether such evidence exists.⁷¹ That is the burden Congress decided a plaintiff should bear before

litigation.”).

68. This assumes that successful defendants will have some interest in pursuing claims that plaintiffs have not complied with Rule 11 or that courts will have some interest in reviewing plaintiffs' compliance with that rule. Practitioners have expressed doubt as to whether either will prove to be the case. See *Litigation Reform Panelists Dispute Reform Law's Impact on Private Securities Fraud Litigation*, 29 Sec. Reg. & L. Rep. (BNA) 1134, 1135 (Aug. 15, 1997).

69. See 15 U.S.C. § 78u-4(c) (Supp. II 1996).

70. For example, a court should have little difficulty finding that plaintiff (or her attorney) did not proceed in good faith if a complaint states that a certain allegations are based on information obtained from former employees of a corporation and plaintiff subsequently is not able to produce any former employee who can provide evidence to support those allegations.

71. If a plaintiff discovers such evidence exists, we believe she retains considerable discretion as to how much detail to include in her complaint concerning her sources. The point of the exercise, after all, is for a plaintiff to plead specific facts that make it reasonable to believe the statements at issue were false or misleading at the time they were made. The more specifics a plaintiff provides about the sources that support her allegations, the more likely it is that a court will find her allegations are sufficient to support such a belief. If a plaintiff concludes that she can support a reasonable belief that the defendants misrepresented material facts without disclosing all her sources or, in the case of a live witness, without disclosing the identity of that witness, she should be free to do so. As noted above, see *supra* text accompanying note 69, if a plaintiff subsequently is unable to produce such a witness, she faces the probability of being subjected to substantial sanctions.

Consequently, we disagree with the court's holding in *Silicon Graphics* that a plaintiff must disclose in her complaint the names of all persons on whose testimony she has relied. See *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 763 (N.D. Cal. 1997), *appeal docketed*, No. 97-16204 (9th Cir. July 9, 1997). Courts need not to interpret the term "all facts" to embody such a requirement, and we do not believe that statements made on the floor by two members of Congress who opposed the House version of the Reform Act (which is the legislative history on which the court relied) represents authoritative statements of what Congress intended.

being able to saddle a defendant with the costs associated with responding to a claim of securities fraud. Our case study was directed at trying to determine whether a plaintiff could bear that burden with respect to claims that GTF and Mr. Coss had violated section 10(b) and Rule 10b-5.

III. COULD A PLAINTIFF HAVE MADE A VALID CLAIM AGAINST GREEN TREE?

GTF's November 13, 1997 press release and remarks made by GTF officials to investors during a conference call the following day gave rise to a suspicion that GTF substantially overstated its income for 1996 and the first three quarters of 1997.⁷² Our case study focused on whether, using information that was publicly available prior to January 27, 1998, when GTF announced it would restate its income for 1996, a plaintiff would have been able to make out a claim of securities fraud against GTF and Mr. Coss that would have satisfied both the requirements of Rule 9(b) and the pleading requirements of the Reform Act. To address that issue, we first developed an understanding of GTF's business and operations.

A. *GTF's Business and Operations*

GTF, a publicly traded company listed on the New York Stock Exchange, had 136 million shares outstanding at September 30, 1997.⁷³ GTF describes itself as a "diversified financial services company that provides financing for manufactured homes, home equity, home improvements, consumer products and equipment and provides consumer and commercial revolving credit."⁷⁴ GTF is the largest manufactured housing lender in the United States, originating approximately 30% of the industry's volume during the past several years.⁷⁵ Manufactured housing loans accounted for 64% of the loans

72. The first class action complaint against GTF was filed on behalf of investors who purchased GTF stock between Jan. 30, 1996, and December 11, 1997. *See* Complaint, *Chill v. Green Tree Fin. Corp.*, No. 97-CV-2666 (D. Minn., filed Dec. 2, 1997). It thus suggested that GTF's financials for 1995 also were false or misleading. However, we limited our inquiries to facts relevant to GTF's 1996 financials.

73. *See* GREEN TREE FIN. CORP., QUARTERLY REPORT (Sept. 30, 1997) [hereinafter GTF SEPT. 30, 1997 QUARTERLY REPORT].

74. GREEN TREE FIN. CORP., 1996 ANNUAL REPORT 13 (1997) [hereinafter 1996 GTF ANNUAL REPORT].

75. *See* Thomas Facciola, *Green Tree: Initiating Coverage with a 2-Outperform Rating*, First Call Notes (Lehman Bros.), Mar. 21, 1997. *See also*, Paul A. Mackey, *DWR Initiates Coverage of Green Tree Financial With a Buy; Target \$36*, First Call Notes (Dean Witter), Jan. 24, 1996 (noting that GTF originated 28% of the \$10 billion 1995 volume of new manufactured housing loans).

originated by GTF's in 1996⁷⁶ and 51% for the first nine months of 1997.⁷⁷ GTF is also the largest servicer of manufactured housing loans. Its servicing portfolio, approximately \$26 billion as of September 30, 1997,⁷⁸ represented approximately thirty percent of the manufactured housing loans outstanding in the United States.⁷⁹

GTF practically invented the market for manufactured housing loans. Such loans had been classified as "sub-prime" for two reasons. First, manufactured housing (i.e., mobile homes) generally is less durable than conventional housing and therefore is more likely to deteriorate in value over the life of a mortgage. Second, purchasers of manufactured housing often have spotty credit records.⁸⁰

As a consequence, at least through the early 1990s GTF was able to charge considerably higher interest rates on loans to purchase manufactured housing—typically 200 to 400 basis points above the rates charged on residential mortgages.⁸¹ Furthermore, GTF's mortgagees, in addition to being less credit worthy than purchasers of conventional housing, generally also were less financially sophisticated. As a consequence, they were less likely to attempt to refinance their loans when interest rates declined. Moreover, because GTF dominated the market for manufactured housing loans in certain parts of the country, its borrowers were less likely to have access to other lenders prepared to refinance their mortgages.

GTF also was a major force in financial markets. It regularly sold debt instruments to institutional and other investors that were secured by bundles of loans GTF had originated. In a typical transaction, GTF would sell multiple classes of senior and subordinated pass-through certificates, each of which gave the holder defined rights to payments of principal and interest that mortgagees were obligated to make with respect to the underlying manufactured housing loans.⁸² These securitization transactions provided

76. See 1996 GTF ANNUAL REPORT, *supra* note 74 (\$4.482 billion of the \$7.565 billion originated in 1996).

77. See GTF SEPT. 30, 1997 QUARTERLY REPORT, *supra* note 73 (\$4.111 billion of the \$8.086 billion originated).

78. See *id.*

79. See Jennifer O. Martin, *Green Tree Financial: Reiterating Strong Buy After Surprise Write Down*, First Call Notes (Morgan Stanley), Nov. 17, 1997. As a loan servicer, GTF collected mortgagees' monthly payments, maintained escrow accounts, monitored delinquencies, and remitted payments of principal and interest to the holders of pass-through certificates.

80. See Steven Davidson, *Financing Manufactured Housing*, AM. COMMUNITY BANKER, Nov. 1, 1997, at 38.

81. See *id.* GTF's average annual spreads were 3.6%, 3.8% and 3.1% in 1994, 1995, and 1996, respectively. See 1996 GTF ANNUAL REPORT, *supra* note 74, at 15.

82. See *id.* at 4. GTF sometimes provided credit enhancements, such as corporate guarantees, bank letters of credit, surety bonds, cash deposits or other collateral to enhance the marketability of

GTF with cash that it needed to finance its operations. In 1995, GTF packaged and sold manufactured housing loans totaling \$5.3 billion; in 1996, it packaged and sold manufactured housing loans totaling \$8.4 billion.⁸³

In these securitization transactions, GTF did not sell its entire interest in the underlying loans. Rather, GTF agreed to pay fixed rates of interest with respect to the pass-through certificates and retained the right to keep all payments of principal, interest and fees that it collected in excess of the amounts it was obliged to turn over to the holders of the pass-through certificates.⁸⁴ These retained rights had substantial value for two reasons. First, the manufactured housing mortgages that secured the pass-through certificates bore rates of interest substantially higher than the interest GTF was required to pay on the pass-through certificates. Second, the principal due with respect to those mortgages exceeded the principal of the pass-through certificates they secured.⁸⁵

As explained in the following section, generally accepted accounting principles required GTF to treat these securitization transactions as "sales" of the underlying mortgages on which GTF recognized gain equal to the present value of the excess cash flows it expected to receive. Such "sales" were the source of most of GTF's reported income. GTF's reported income from the securitization of loans was \$671 million in 1995 and \$941 million in 1996,⁸⁶

these certificates. GTF had bank letter of credit and surety bonds outstanding of \$140,972,000 and \$156,617,000 at December 31, 1996 and 1995, respectively. *Id.*

83. *See id.* GTF issued 77.6% of all manufactured housing securities in 1995 and 85% in 1994. *See* Michael Millman, *Green Tree: Good Start for 1996; Stock Strong Buy*, First Call Notes (Lehman Bros.), Jan. 25, 1996. For the period 1986 through June 30, 1996, GTF had completed in excess of 100 deals. *See* Paul A. Mackey, *DWR Raises Green Tree 1997 EPS Estimate & Target Price: Reiterates Buy*, First Call Notes (Dean Witter), Sept. 27, 1996. GTF's investors include banks, insurance companies, bond funds and pension funds. *See id.*

84. GTF also remained obligated to service the loans, for which it received a servicing fee.

85. The fact that GTF's borrowers were less likely to refinance than borrowers with conventional mortgages greatly increased the value of the rights GTF retained. *See* Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1022 (4th Cir. 1997):

Historically, investments in fixed-rate home mortgages have not been attractive to institutional investors. Investors in most fixed-rate securities benefit when interest rates fall. The fixed-rate security then earns interest at a rate higher than decreased prevailing rates. However, unlike other fixed-rate investments such as U.S. treasuries, fixed-rate home mortgages do not benefit from declines in interest rates. Because home mortgages may be freely prepaid, home owners frequently refinance their homes to take advantage of a drop in interest rates. When the mortgage is prepaid, the investor's funds are returned. If the investor seeks to reinvest those funds, as would be the case with most institutional investors, they must be reinvested at the low prevailing rate, rather than earning interest at the higher rate of the original mortgage. This is called the "prepayment risk." If interest rates rise, home mortgages are generally not refinanced, and they lose value just like any other fixed-rate security. Thus, investments in home mortgages perform poorly both when interest rates rise and when they fall.

Id.

86. *See* 1996 GTF ANNUAL REPORT, *supra* note 74, at 16 (before provision for losses which

amounts equal to more than 63% of GTF's net income in each of those years.⁸⁷

GTF also raised additional cash (but did not generate additional income) from another kind of securitization transaction. GTF sold \$600 million in "Securitized Net Interest Margin Certificates" ("NIMs") in 1994 and \$308 million in NIMs in 1995.⁸⁸ The NIMs were secured by GTF's pledge of its rights to the excess cash flows that would be generated by the mortgages securing pass-through certificates that GTF previously had sold.⁸⁹ In each of these NIMs offerings, GTF itself purchased a subordinated tranche with a face value equal to about 25% of the value of the entire offering. GTF was not entitled to receive any payments with respect to these subordinated NIMs until all payments of principal and interest had been made with respect to the NIMs purchased by others. As of December 31, 1996, GTF held subordinated NIMs with a book value of \$322 million.⁹⁰

B. GTF's Accounting Conventions

In accordance with generally accepted accounting principles, GTF used what is referred to as "gain on sale accounting."⁹¹ When GTF sold a pool of loans in a securitization, it recorded its "net gain on contract sales" as income

were \$351.7 million and \$223.0 million in 1996 and 1995, respectively).

87. Net of provisions for losses. In contrast, servicing fee income, net of related expenses, represented less than 8% of GTF's income in 1995 and 1996. *See id.* at 11.

88. *See id.* at 13.

89. These deals were collateralized by "excess cash flow on [GTF] deals, which is essentially the difference between the interest rate on the manufactured housing loans and the coupon rate on the [NIMs], ranging from a low of 2.86% on deals issued prior to 1986 to a high of 5.78% on a deal issued in 1992. This money, less servicing fees on the deals, would normally revert to [GTF] periodically." Am. Banker, Inc., *GreenTree to Securitize Excess Spread from Manufactured Housing ABS*, 8 ASSET SALES REP. 4 (Jan. 31, 1994), available in 1994 WL 3765799. *See infra* notes 91-96 and accompanying text for a discussion of excess servicing rights receivable.

90. *See* 1996 GTF ANNUAL REPORT, *supra* note 74, at 21. GTF disclosed that the \$322 million "is analyzed quarterly to determine the impact, if any, of adverse prepayment or loss experience [but] will continue to reflect the discount rates utilized at the time of sale." *Id.* at 22.

91. *See generally*, ACCOUNTING FOR CERTAIN MORTGAGE BANKING ACTIVITIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 65 (Financial Accounting Standards Bd. 1982) [hereinafter ACCOUNTING FOR CERTAIN MORTGAGE BANKING ACTIVITIES]. In June, 1996, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 125 (SFAS No. 125), effective for transactions occurring subsequent to December 31, 1996, which amended SFAS No. 65. While gain on sale accounting continues to be the proper accounting method, SFAS No. 125 requires that the interest only portion of excess servicing rights receivable (the amount "that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment") be classified as "available for sale or trading" and thereafter measured at fair value, with adjustments through equity. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 125 (Financial Accounting Standards Bd. 1996).

and an "excess servicing rights receivable" as an asset. GTF described the "net gain on contract sales" as an "amount equal to the present value of the expected excess servicing rights receivable to be collected during the term of the [loans], plus or minus any premiums or discounts realized on the sale of the [loans] and less any selling expenses."⁹² It described the "excess servicing rights receivable" as "the cash expected to be received . . . over the life of the [loans] discounted to present value."⁹³

To calculate "net gain on contract sales," first GTF would total up the amounts due to be paid by the borrowers whose mortgages it had "sold."⁹⁴ Then it would deduct from this total (i) the amounts it was required to pay to the holders of the pass-through certificates secured by those mortgages; (ii) estimated amounts that borrowers would not remit as a result of prepayments, delinquencies and defaults; (iii) FHA and other fees it was required to remit on behalf of the mortgagees; and (iv) the servicing fees it was entitled to receive.⁹⁵ Finally, GTF would calculate and record as income the present value of the remaining balance. As noted above, such gains on sales comprised more than 63% of GTF's reported income in both 1995 and 1996.⁹⁶

Gain on sale accounting has its critics.⁹⁷ By its very nature, gain on sale is an estimate, a best guess of what will occur.⁹⁸ GTF could not value its excess cash flows with precision. They would fluctuate as a result of prepayments

92. 1996 GTF ANNUAL REPORT, *supra* note 74, at 10.

93. *Id.*

94. These payments include principal and interest, FHA insurance and other credit enhancement fees.

95. See 1996 GTF ANNUAL REPORT, *supra* note 74. Statement of Accounting Standard No. 65 provides that where a loan is sold and servicing retained, a portion of the sales price represents deferred income to the extent the stated servicing fee rate differs from the current (normal) servicing fee rate. The deferred amounts are amortized into income over future periods, as they are earned. See ACCOUNTING FOR CERTAIN MORTGAGE BANKING ACTIVITIES, *supra* note 91, at para. 11 (Financial Accounting Standards Bd. 1982).

96. This total included gains on sales of other kinds of loans as well, such as home improvement loans. However, originating, servicing and selling manufactured housing mortgages comprised by far the largest portion of GTF's business.

97. Gain on sale accounting also allows a company to "manage" its earnings to some degree, especially since a company can exercise considerable control over how many loans it "sells" in any given period and how many it retains. As one analyst noted: "Through innovative loan syndications, [GTF] front-ends profits by recognizing the present value difference between the interest rate it charges customers and the interest rate it pays investors, less provisions for losses and prepayments." Mackey, *supra* note 75.

98. However, this estimate does not fall within the safe harbor the Reform Act created for "forward looking statements" because it is "included in a financial statement prepared in accordance with generally accepted accounting principles." See Securities Exchange Act of 1934, *as amended*, 15 U.S.C. § 78u-5(b)(2)(A) (Supp. II 1996).

and defaults, both of which would reduce gain on sale.⁹⁹ Consequently, GTF's reported gains on sales were only as reliable as the assumptions it used to calculate those gains.

GTF disclosed in its financial statements that it used discount rates of 9.4% in 1995 and 9.2% in 1996 to calculate the present value of the excess payments it expected to receive.¹⁰⁰ However, GTF did not disclose, in its financials or elsewhere, the assumptions concerning prepayments and defaults that it used to calculate gains on sales.

GTF did make the following public statements concerning its assumptions:

- That in calculating gain on sale, it used assumptions concerning prepayments, defaults, and interest rates which it "believes market participants would use."¹⁰¹
- That "[t]he Company believes that the excess servicing rights receivable recognized at the time of sale does not exceed the amount that would be received if it were sold in the marketplace."¹⁰²
- That it "analyzed [the value of its excess servicing rights receivables] quarterly to determine the impact of prepayments, if any."¹⁰³
- That it had "developed its assumptions based on experience with its own portfolio, available market data (including market estimates utilized in the sales of the NIM Certificates) and ongoing consultation with its investment bankers" and that these assumptions "are similar to those which would be used by an outside investor."¹⁰⁴

99. A default obviously would reduce the cash received by GTF if the property securing a mortgage was worth less than the principal outstanding. Prepayments, whether due to defaults, refinancings or other causes, also would reduce GTF's gain on sale by reducing the period during which GTF would receive payments of interest at rates higher than the interest GTF was obliged to pay on the pass-through certificates. *See supra* note 172.

100. *See* 1996 GTF ANNUAL REPORT, *supra* note 74, at 20.

101. *Id.* at 9.

102. *Id.*

103. *Id.* at 22. This represents 44% and 32% of GTF's total assets at December 31, 1996 and 1995, respectively. *See id.* at September 30, 1997, excess servicing rights were reclassified, as a result of GTF's application of SFAS No. 125 (*see supra* note 91), into two components: servicing rights of \$42.8 million (1% of total assets) and interest only securities of \$1.208 billion (32% of total assets). *See* GTF SEPT. 30, 1997 QUARTERLY REPORT, *supra* note 73.

104. 1996 GTF ANNUAL REPORT, *supra* note 74, at 20.

GTF did not report any gain (or loss) on the NIMs transactions because, for accounting purposes, all they involved was GTF swapping excess servicing rights receivables for cash and NIMs of equal value. These transactions also removed from GTF's books the excess servicing rights receivables that served as collateral for the NIMs. However, the value of the subordinated interest in the NIMs that GTF retained depended on the value of those excess servicing rights receivables. As noted above, as of the end of 1996, GTF reported the value of the subordinated NIMs to be \$318 million, an amount that GTF stated it had "calculated using prepayment and default assumptions which the Company believes market participants would use currently."¹⁰⁵ GTF did not disclose any other information about those prepayment and default assumptions.

C. GTF's Statements Concerning its Income for 1996 and 1997

In its annual report for the year ending December 31, 1996, GTF reported net income of \$308.7 million (\$2.20 per share), up 22% from \$253.9 million (\$1.81 per share) in 1995.¹⁰⁶ In his letter to shareholders, Mr. Coss observed: "This represents our sixth consecutive year of record earnings, a notable achievement considering the volatile interest rate patterns and changing competitive forces that have prevailed during that period."¹⁰⁷ As concerned analysts' estimates that GTF would earn \$3.00 per share for 1997 (a 37% increase over 1996), Mr. Coss stated: "We think that's an achievable number. We're comfortable with that."¹⁰⁸

GTF did report increased earnings for the first three quarters of 1997. On April 17, 1997, it issued a press release announcing first quarter earnings of \$0.65 per share, an increase of 35% from the first quarter of 1996.¹⁰⁹ On July 17, 1997, it announced second quarter earnings of \$0.78 per share, a 44% increase from the second quarter of 1996.¹¹⁰ On October 15, 1997, it announced third quarter earnings of \$0.85 per share, a 39% increase from the

105. *Id.* at 28.

106. *See id.* at 16. In 1994, GTF reported net income of \$181.2 million (\$1.31 per share). *See id.*

107. *Id.* at President's Letter (emphasis added).

108. Reuters, Ltd., *Green Tree: Says \$3/EPS in 1997 Achievable*, REUTERS FIN. SERVS., May 16, 1997.

109. *See Green Tree Financial Announces 35 Percent Increase in First Quarter Earnings to a Record \$.65 Per Share*, Press Release, Apr. 17, 1997 (noting that the quarter's earnings exceeded expectations despite implementation of SAFS No. 125 which resulted in a \$0.03 per share charge to earnings and a \$9 million reduction in equity).

110. *See Green Tree Financial Announces Record Second Quarter Earnings Per Share of \$.78; Declares Increased Cash Dividend*, Press Release, July 17, 1997.

third quarter of 1996, a "third straight quarter of record earnings."¹¹¹

Not quite one month later, on November 13, 1997, GTF issued the press release in which it announced that it would make an addition to reserves in the fourth quarter of 1997 of \$125 to \$150 million. GTF stated that it would take this action "primarily to accommodate a reduction in the carrying value of certain interest only securities, specifically the subordinated interests in [the NIMs], in response to higher prepayment assumptions for certain pools of manufactured housing loans."¹¹² The addition to reserves would have reduced GTF's earnings by \$0.57 to \$0.68 per share.¹¹³ That day, GTF's stock closed at \$32.75, down 18.9% from the previous day's close of \$40.375.¹¹⁴

On November 14, 1997, GTF filed its Form 10-Q for the third quarter of 1997, which provided additional information about the proposed increase in reserves:

The Company, along with other financial services companies, has experienced higher prepayment activity in its portfolio, particularly with respect to manufactured housing loans made in the higher interest rate environment of 1994 and 1995. *Since the end of the third quarter of 1997, the company has undertaken a special review of prepayment rates for such loans and the assumptions utilized in its models to compute the value of its interest only securities.* Preliminarily, the Company has determined that a write down of the value of its interest only securities in an amount estimated to be in the range of \$125 to \$150 million will be made for the quarter ended December 31, 1997. Depending on the final results of the review, the actual valuation adjustment may be greater or less than his amount. The valuation adjustment will result in a fourth quarter pre-tax reduction to earnings equal to the amount of the adjustment. The Company has also instituted programs to reduce the number of prepayments and loss severity, and the Company's management will monitor the effect of these programs in connection with its quarterly review of the valuation of its interest only securities.¹¹⁵

The wording of GTF's press release and Form 10-Q implies that GTF

111. *Green Tree Financial Posts Record Third Quarter Earnings; Managed Receivables Reach \$26 Billion*, Press Release, Oct. 15, 1997.

112. Press Release, *supra* note 31.

113. Net of taxes, assuming GTF had 136 million shares outstanding. See GTF SEPT. 30, 1997 QUARTERLY REPORT, *supra* note 73.

114. See WALL ST. J., Nov. 14, 1997, at C4.

115. GTF SEPT. 30, 1997 QUARTERLY REPORT, *supra* note 73 (emphasis added).

based its proposed addition to reserves on newly available information. Had that been the case, it probably would have been appropriate for GTF to reflect that information in a "change of estimate" that reduced its earnings for the fourth quarter of 1997.

Accounting literature acknowledges that "preparing financial statements requires estimating the effects of future events [that] cannot be perceived with certainty."¹¹⁶ Estimates can change "as new events occur, as more experience is acquired, or as additional information is obtained."¹¹⁷ A change in estimate "results from new information or subsequent developments and accordingly from better insight or improved judgment."¹¹⁸ Generally accepted accounting principles require a company to account for the effect of a change in accounting estimate in the period the change is made and in future periods.¹¹⁹ Restatement of prior periods is not allowed.¹²⁰

Generally accepted accounting principles draw a sharp distinction between a change of estimate and an accounting error,¹²¹ which the literature defines as the "result [of] mathematical mistakes, mistakes in the application of accounting principles, or *oversight or misuse of facts that existed at the time the financial statements were prepared.*"¹²² A company is required to account for an error by restating its income for prior periods.¹²³

The key question posed by GTF's November 1997 statements was whether the information that led GTF to announce its proposed addition to reserves had just become available, or whether GTF had known or recklessly disregarded that (and, perhaps, additional similar information) when it issued its financial statements for 1996 and the first three quarters of 1997. If the latter was the case, a strong claim could be made that GTF had issued those financial statements in violation of section 10(b) and Rule 10b-5. The essence of such a claim would be that GTF had overestimated and then overstated its gain on sale. Additionally, the claim would specify that GTF did the same with respect to the value of its excess servicing rights receivables and its subordinated interest in the NIMs. A plaintiff would argue that GTF achieved this by using assumptions concerning prepayments and

116. ACCOUNTING CHANGES, ACCOUNTING PRINCIPLES BULLETIN OPINION NO. 20, para. 10 (July, 1971).

117. *Id.*

118. *Id.*, para. 13.

119. *See id.*, para. 31.

120. *See id.*

121. *See id.*, para. 36.

122. *Id.*, para. 13 (emphasis added).

123. *See id.*, para. 36 (as provided for in REPORTING THE RESULTS OF OPERATIONS, ACCOUNTING PRINCIPLES BULLETIN OPINION NO. 9, para. 18 (Dec. 1966)).

defaults that were considerably more aggressive than the assumptions a "market participant" would have used.¹²⁴

D. Facts that Suggest GTF's 1996 Annual and 1997 Quarterly Financial Statements Were Materially False or Misleading

There were two ways in which a plaintiff could attempt to show that GTF's assumptions concerning prepayments were unreasonable: by comparing them to GTF's actual experience with prepayments, or by pointing to information concerning the market for manufactured housing loans that indicated a strong likelihood prepayments would accelerate. During the period prior to January 28, 1998, GTF did not make public data concerning its actual prepayment experience and we did not find such data available through any other source.¹²⁵ Consequently, we focused our inquiry on the market for manufactured housing loans. We found a great deal of information that indicated (i) significant changes in competitive and economic conditions had occurred in that market prior to the end of 1996; (ii) GTF knew about those changes; and (iii) it would have been at least reckless for GTF not to alter its prepayment assumptions to reflect those changes.¹²⁶

1. Increased Competition

Mr. Coss founded GTF in 1975 to originate loans for mobile homes and

124. Much of our inquiry focused on GTF's assumptions concerning prepayments because GTF identified increased prepayments as the reason for its change of estimate. We also looked for information suggesting that GTF experienced a significant increase in losses due to defaults.

Although GTF announced in November 1997 that it was increasing the discount rate it used to calculate the present value of excess servicing rights receivables, *see M. Huges, Green Tree: Lowering Rating Based on Charge*, First Call Notes (Merrill Lynch), Nov. 14, 1997, GTF had disclosed the discount rate it used to calculate that value in previous years. We did not believe that a plaintiff could reasonably claim that it was fraudulent for GTF to use a discount rate that was lower than the rate a market participant would have used, so long as GTF disclosed the rate it was using.

GTF's announcement on January 27, 1998 that information about prepayments would lead it to restate its 1996 financial statements to reduce by \$200 million the carrying value of its "interest only securities," *see* Press Release, *supra* note 31, amounted to an acknowledgment that GTF ignored or misused information about prepayments that was in existence at the time GTF prepared those financial statements. That announcement presumably shifted the focus of the plaintiffs' claims from whether such information existed but had been ignored by GTF to whether GTF's error was deliberate, reckless or merely negligent. We assume that plaintiffs' pursuing securities fraud claims against GTF also will question whether the amount of the restatement was correct, or whether it should have been larger it to take account of the information that led GTF to also add \$190 million (up from \$125 to \$150 million) to reserves in the fourth quarter of 1997. *See id.*

125. Such as government reports.

126. We limited our research to published materials. Attorneys for real plaintiffs, of course, also have the option of hiring investigators with a view to obtaining information from a potential defendant's employees, former employees, customers and competitors.

RVs, a sub-prime market that few established lenders sought to serve. Financing opportunities created by fallout from the savings and loan crisis helped GTF to experience rapid growth in the 1980s.¹²⁷ A more important factor that contributed to GTF's expansion was the steady growth of the manufactured housing industry. Mobile homes now represent approximately 7% of U.S. housing stock and account for about one quarter of new housing starts.¹²⁸ The quality of mobile homes also has improved.¹²⁹ This has attracted more buyers; approximately 45% of first-time home buyers purchase mobile homes.¹³⁰ As a result, traditional lenders who had previously steered clear of manufactured housing began entering the market, including such "banking giants" as NationsBank Corp., First Union Corp., and Barnett Banks, Inc.¹³¹

As more lenders began offering manufactured-housing loans, competition increased.¹³² A 1996 article in *American Banker* noted that manufactured housing was a "tough market" because "[t]here are so many new players. Even though the market is growing by 10%, the number of players is growing faster."¹³³ To attract new customers, lenders found it necessary to offer lower interest rates and to loosen underwriting guidelines by offering low down payment loans to borrowers with poor credit records.¹³⁴

This increase in competition had direct implications for GTF and for the assumptions it was making concerning prepayment of outstanding loans.

127. See HOOVER'S COMPANY PROFILE, GREEN TREE FIN. (1998).

128. See Steven Davidson, *Financing Manufactured Housing*, AM. COMMUNITY BANKER, Nov. 1, 1997, at 38. For the first seven months of 1997, manufactured housing was 24% of single family housing starts and 29% of all new single-family houses sold. See *id.* A decade ago, manufactured housing was less than 3% of all housing stock. See Mackey, *supra* note 75.

129. "Manufactured housing is beginning to take on more of the look and feel of permanent construction than that of a mobile home." Davidson, *supra* note 128, at 38.

130. See *id.*

131. Christina Binkley, *Mortgage Lenders Pursue Once-Shunned Borrowers*, WALL. ST. J., Sept. 11, 1996 (noting that some lenders are offering 30-year mortgages on mobile homes). Other new players during 1996 and 1997 included: CWM Mortgage Holdings, Cargill, Inc., Resource Mortgage Capital Corp., Alliance Funding, Chase Manhattan Corp., and KeyCorp. See John Bancroft, *In the News*, REAL ESTATE FIN. TODAY, Feb. 14, 1997, at 1; Edward Kulkowsky, *Pipeline: Resource Mortgage Capital Exemplifies 1996 Revival in the Mortgage Business*, AM. BANKER, Dec. 11, 1996, at 12; Heather Timmons, *Barnett Hiring May Signal Prefab-Home Effort*, AM. BANKER, May 22, 1997; *BankAmerica Puts a For-Sale Sign on Prefab-Home Lending Division*, AM. BANKER, Oct. 16, 1997, at 1.

132. See Becky Froass, *A Definition of Terms*, MORTGAGE BANKING, June 1, 1997, at 99 (noting that the market share of the top 25 sub-prime lenders fell to 42.1% from 59.1% in 1996 as mortgage banks, mortgage brokers, and commercial banks and thrifts competed for borrowers with "non-conforming" credit).

133. Heather Timmons, *Cargill Merges Subprime, Manufactured Housing Units*, AM. BANKER, Apr. 25, 1996, at 11.

134. See Davidson, *supra* note 128, at 38 (noting that increased delinquencies have accompanied the "greater credit availability").

First, the increased quality of manufactured housing was attracting more creditworthy purchasers. More financing institutions were competing for their business, reducing the spread between manufactured housing and conventional mortgage loans. Reduced spreads, more sophisticated borrowers, and a decline in interest rates from a secular peak in 1994 all made it more likely that borrowers would refinance their mortgages, which would increase prepayments.¹³⁵ In addition, because GTF also was responding to increased competition by making loans to less creditworthy borrowers and at higher loan-to-value ratios, prepayments as a result of defaults also were likely to increase, making historical loss experiences a less reliable indicator of future performance.¹³⁶

Outside observers clearly anticipated that GTF's prepayments and delinquencies would increase as a result of these developments. In early 1996, Lehman Brothers noted that GTF was "aggressively target[ing] better credit, including borrowers of more expensive homes with placement on private lots and homes with longer lives. In addition, it was also targeting those with higher LTVs (95%)."¹³⁷ Lehman Brothers suggested that prepayments appeared "faster than anticipated, perhaps because of better credit quality of borrowers with higher balances who are more sensitive to interest rate changes."¹³⁸

During the first quarter of 1997, Standard & Poor's decided to include manufactured housing securities in its "convexity stress test" applicable to bonds deemed to have "higher prepayment risk of negative convexity."¹³⁹ Moody's Investor Services predicted that manufacturing housing securitization would reach \$10 billion in new issuances in 1997, "a record total that brings with it new players and possibly higher loan default rates" since many of the pools previously issued were "hitting their peak loss

135. See *S&P Says Competition is Cause for Concern for Some Lenders*, NAT'L MORTGAGE NEWS, Dec. 22, 1997, at 20 (citing David Graifman, associate director of S&P's rating group: "To think that prepayment speeds are going to be consistent when you have so many new companies jumping in is not a good premise to base your assets on.").

136. See Am. Banker, Inc., *See Market Debates Manny Health*, 11 ASSET SALES REPORT (Oct. 27, 1997), available in 1997 WL 14227044 (noting that loans were being made to borrowers who "might not otherwise have gotten that credit had there only been a handful of lenders"; that there has been a "steady loan-to-value creep"; and that manufactured housing lenders are operating in a "high-default environment").

137. Millman, *supra* note 83 (noting that GTF was now targeting borrowers with loan to value (LTV) ratios of 95%).

138. *Id.*

139. Am. Banker, Inc., *DLJ Urges Some HEL Caution*, 11 ASSET SALES REP. (Jan. 20, 1997), available in 1997 WL 7897901 (noting that higher prepayments in 1996 for manufactured housing were "widely anticipated").

periods.”¹⁴⁰

GTF’s own actions and statements indicate that it also was aware of the changing competitive climate for manufactured housing loans. In 1993, when manufactured housing loans represented 92% of GTF’s loan originations, GTF began to diversify.¹⁴¹ By the first half of 1997, manufactured housing represented only 38% of GTF’s \$10.6 billion loan origination volume, while commercial financing accounted for 27%.¹⁴² In his 1996 letter to shareholders, Mr. Coss observed: “The diversification strategy that Green Tree implemented *many years ago* has been the single most important element in generating a stable operating profile for the Company.”¹⁴³

2. Prepayment Rates

The rate at which the mortgages underlying pass-through certificates are likely to be prepaid affects investors’ calculations of the period during which their principal will be outstanding and the rate of interest they should receive.¹⁴⁴ Until the early 1990s, GTF’s manufactured housing certificates reflected “stability of prepayment rates” because

[b]orrowers [were] not as sensitive to changes in interest rates and thus [did] not refinance as readily [since] their loan balance [was] typically small [and] depreciation of a manufactured home often exceed[ed] amortization in the early years of a loan, meaning that a borrower

140. *Manufactured Housing Market Should Hit Record in 1997*, 12 MORTGAGE-BACKED SEC. LETTER (Mar 3, 1997), available in 1997 WL 8651619 (noting that lenders will be tempted to offer promotions such as 5% down payment programs to increase market share).

141. See GREEN TREE FIN. CORP., 1993 ANNUAL REPORT 7 (1994).

142. See Alan R. Elliott, *Companies in the News: Green Tree is Financing More Than Manufactured Housing*, INV. BUS. DAILY, Aug. 21, 1997, at B14 (noting that increase in commercial lending was largely a result of GTF’s acquisition of the sales-finance division (equipment leasing services to manufacturers and dealers) of Finova Group, Inc., in 1996).

143. 1996 GTF ANNUAL REPORT, *supra* note 74, at President’s Letter (emphasis added).

144. The court for the Southern District of New York stated:

CMOs are derivative securities that represent distinct interests in the cash flow generated by an underlying collateral pool of residential mortgages. The cash flow generated by this pool is derived from two sources: (i) repayment of principal; and (ii) interest payments. Consequently, the value of a particular CMO depends upon the extent to which the instrument is entitled to share in the proceeds of the cash flow. For example, CMOs entitling the holder to principal payments are especially valuable in times of declining interest rates, since holders of the underlying mortgages are likely to refinance their existing mortgages to avail themselves of the lower rates, thereby increasing principal prepayments. Conversely, CMOs linked to interest payments typically increase in value during times of rising interest rates, since mortgage holders are less likely to refinance, thereby decreasing principal prepayments and increasing interest payments.

Primavera Familienstiftung v. Askin, Nos. 95 CIV.8905 (RWS), 97 CIV.1856 (RWS), 1998 WL 128823, at *3 (S.D.N.Y. Mar. 19, 1998).

would have to put up more equity to refinance¹⁴⁵

a. Prepayment Models Used by GTF's Underwriters

Prior to 1994, GTF's underwriters priced GTF pass-through certificates they sold using the PSA model, which used HUD and FHA data to estimate the rate at which conventional mortgages would be prepaid.¹⁴⁶ In 1994, GTF and Lehman Brothers introduced "a new pricing method for manufactured housing deals called the MHP [Manufactured Housing Prepayment] Curve."¹⁴⁷ The MHP curve "essentially assume[d] lower prepayment speeds over the life of the deal and longer average lives on the securities issued [which allowed GTF to] assume greater excess cash flow in the deal."¹⁴⁸ In other words, the MHP curve reflected GTF's experience in a market characterized by unsophisticated borrowers and limited competition, characteristics that were changing at the time the MHP curve was introduced.

Through early 1995, Lehman priced GTF's manufactured housing transactions at 100% of the MHP Curve.¹⁴⁹ In June, 1995, pricing speeds were increased to 125% MHP to "address investor concerns."¹⁵⁰ GTF's chief financial officer, John Brink, noted at the time that "[p]repayments are still not the factor that they are in site-built housing, but with the decline in interest rates there has been some increase in prepayments."¹⁵¹ In July, 1995, however, a GTF deal was again priced at 100% MHP because, according to Brink, "the underlying pool of loans were not under prepayment pressure, or

145. Investment Dealers' Dig., Inc., *Lehman Devises Default Model for Mobile Home Loans*, 7 MORTGAGE-BACKED SEC. LETTER (May 4, 1992), available in 1992 WL 2746475 (noting that Lehman Brothers had "constructed a default model for manufactured housing securities" based on GTF's experience). See also Investment Dealers' Dig., Inc., *First Boston Develops Prepayment Model for Manufactured Housing*, 7 MORTGAGE-BACKED SEC. LETTER (May 25, 1992), available in 1992 WL 2746441 (noting that First Boston had also developed a prepayment model for manufactured housing loans "in cooperation with" GTF and concluding that prepayment rates were "much less sensitive to interest rate movements" and "resemble[d] the PSA standard prepayment model, rising steadily for 30 months and then leveling off" while "[d]efaults and losses [were] closely associated with the degree of homeowner equity in the property").

146. See FRANK J. FABOZZI, MORTGAGE-BACKED SECURITIES: NEW STRATEGIES, APPLICATIONS AND RESEARCH 377-78 (1987).

147. Am. Banker, Inc., *Green Tree to Securitize Excess Spread from Manufactured Housing ABS*, 8 ASSET SALES REP. (Jan. 31, 1994).

148. *Id.* The MHP Curve assumed that prepayments start at around 3% (rather than PSA levels of zero) and quickly level off at 6% in month 24 (whereas the PSA leveled off in month 30 at higher rates). *Id.*

149. See Am. Banker, Inc., *Green Tree Issues 1st Non-Investment Grade Public Asset-Backed Security*, 7 ASSET SALE REP. (Dec. 20, 1993), available in WL 5862567.

150. Am. Banker, Inc., *Green Tree Ups Pricing Speed*, 9 ASSET SALES REP. (June 19, 1995), available in 1995 WL 6919277.

151. *Id.*

'in the money,' because the issuer lowered its financing rates by 50 basis points since its last manufactured housing deal."¹⁵²

In January 1996, Lehman again increased pricing speeds to 125% MHP as a result of increasing manufactured housing prepayments.¹⁵³ Lehman officials noted that GTF's "current coupon prepayments are faster than anticipated"¹⁵⁴ and also stated that they "generally believe that the rise in current coupon prepayments [resulted] from the improvement in the borrower base for manufactured housing."¹⁵⁵ Lehman observed that GTF would need "to take [the increased prepayments] into account when calculating their excess servicing spread which would likely result in a reduction [in its] gain on securitization [which] could be lower than in the past for comparable spreads."¹⁵⁶ GTF, however, remained optimistic about its 1996 earnings and stated that it expected "little impact from new competition, below market industry delinquencies, a catch-up in spreads, and the impact of new lending programs."¹⁵⁷

From January to August of 1996, manufactured housing pass-through certificates issued by GTF continued to be priced at 125% MHP.¹⁵⁸ However, in December, 1996, a portfolio securitized by GTF for which Merrill Lynch was the lead underwriter was priced at 150% MHP.¹⁵⁹ In early 1997, Lehman Brothers revised its pricing model for securitizations to reflect

152. Am. Banker, Inc., *Issuance Rebounds to \$1.85 Billion for the Week*, 9 ASSET SALES REP. (July 17, 1995), available in 1995 WL 6919361.

153. See Am. Banker, Inc., *ABS Spreads Tighter Despite Selling*, 10 ASSET SALES REP. (Jan. 29, 1996), available in 1996 WL 5617457.

154. Millman, *supra* note 83.

155. *ABS Spreads Tighter Despite Selling*, *supra* note 153.

156. Millman, *supra* note 83.

157. L. Asher, *Green Tree Financial: Keeps Doing It*, First Call Notes (Merrill Lynch), Apr. 17, 1996.

158. See, e.g., Investment Dealers' Dig., Inc., *Observations: Merrill Structures Manufactured Housing Deal*, 11 MORTGAGE-BACKED SEC. LETTER (June 24, 1996), available in 1996 WL 8090857 (GTF's 1996-5 deal priced at 125%); Investment Dealers' Dig., Inc., *Lehman Guides Green Tree Deal*, 11 MORTGAGE-BACKED SEC. LETTER (July 29, 1996), available in 1996 WL 8090941 (noting a report issued by Merrill Lynch which found that GTF's "deals have shown a considerable increase in prepayments during the past two or three months [but] expecting slower short-term prepayments going forward due to the current interest rate and economic environment"). See also Investment Dealers' Dig., Inc., *Associates Launches Largest-Ever Manufactured Housing Deal*, 11 MORTGAGE-BACKED SEC. LETTER (Sept. 30, 1996), available in 1996 WL 13554357 (disclosing that Associates Corp. of North America securitized the "largest-ever" manufactured housing portfolio of \$920 million in September, 1996, utilizing prepayment speeds of 150% MHP); Investment Dealers' Dig., Inc., *Prudential Guides UCFC MH Transaction*, 12 MORTGAGE-BACKED SEC. LETTER (June 23, 1997), available in 1997 WL 8651980 (noting that Prudential Securities, Inc., priced its third manufactured housing portfolio assuming a 175% MHP prepayment rate).

159. See *New Securities Issues*, WALL. ST. J., Dec. 10, 1996, at C24. See also Am. Banker, Inc., *Whispers*, 10 ASSET SALES REP. (Dec. 16, 1996), available in 1996 WL 13975202 (noting that GTF changed its prepayment speeds "due to higher delinquencies and losses" from 135% to 150%).

prepayments of 175% MHP.¹⁶⁰ In late March 1997, Lehman Brothers disclosed that due to “increasing ‘housing turnover’ and ‘refinancing opportunities,’ it had *once again* revised its expected pricing model for GTF’s manufactured housing loan securitizations” to reflect prepayments of 185% MHP.¹⁶¹

The fact that GTF’s two lead underwriters were continually increasing pricing speeds on the manufactured housing loans securitized during 1996 and 1997 strongly suggests that, beginning in 1996, GTF should have revised the assumptions it used to calculate gain on the sale of manufactured housing loans. GTF’s optimistic comments suggest that GTF did not take such action.

b. Analyst’s Estimates of Prepayments

Analysts at Oppenheimer & Co. compiled actual prepayment data on thirty pools of manufactured housing loans securing pass-through certificates pools issued by GTF and found that there were “noticeable increases in prepayment speeds for late 1994 and mid-1995,” while the late-1995 and 1996 pools reflected slower prepayment rates.¹⁶² GTF’s underwriters had used prepayment assumptions of 150% MHP when pricing these deals.¹⁶³ When the analysts calculated actual prepayment rates for these pools, they discovered that some were experiencing significantly higher prepayments.¹⁶⁴ They explained: “Simply put, the manufactured housing lending industry has become more competitive, with the result that prepayments speeds have increased.”¹⁶⁵ The pools experiencing the highest prepayment speeds were those pools in which the loans had the highest weighted average coupons.¹⁶⁶ The analysts noted in their report that “[o]ur analysis is not an intellectual exercise [and] has important ramifications for Green Tree’s margins and earnings.”¹⁶⁷

160. See Jacob M. Schlesinger, *Treasury Increases Second Offering of Popular Securities Indexed to Protect Against Inflation*, WALL. ST. J., Apr. 3, 1997, at C20.

161. *Id.*

162. Oppenheimer & Co., Inc., *Green Tree Financial: Trimming Estimates Because of Decline in Gain-on-Sale Margin* (Oct. 20, 1997). The report credits Steven Eisman and Vincent Daniel. *See id.*

163. *See id.*

164. *See id.* For example, 1994-7, 1995-2 and 1995-5 had experienced prepayments of 13.7%, 15.8% and 13.7%, respectively, in the 24th month while 9.0% was anticipated by a 150% MHP prepayment speed. *See id.*

165. *Id.* (noting that contributing factors included the increasing quality of homes (more multiwide units attached to land) and borrowers (more able and more likely to refinance)).

166. *See id.* Pool 1994-7 had a weighted average coupon (“WAC”) of 11.4% and Pool 1995-2’s WAC was 12.0%. In contrast, 1996 pools had WAC’s of 9.9% to 10.5%. *See id.*

167. *Id.*

3. 1996 NIM Credit Enhancement

When GTF sold NIMs in 1994 and 1995, the accompanying prospectuses cautioned that given “the complexity of analyzing the credit risks,” the NIMs were an “appropriate investment only for persons familiar with manufactured housing contract performance and asset-backed security structures.”¹⁶⁸

GTF advised investors that unlike standard corporate bonds, the timing and amount of principal payments on the certificates is not fixed and will be determined by the timing and amount of cash flows in the trust property, which in turn will be dependent on the rate of prepayments and by the timing and amount of delinquencies and losses realized on the contracts.¹⁶⁹

GTF further cautioned that “if the contracts experience extreme prepayment rates, certificate holders may experience a reduction in yield or fail to recoup fully their initial investments.”¹⁷⁰

In October, 1996, GTF announced that it would “enhance” the return on about one-half of the NIMs because the performance of the excess servicing rights receivables that served as collateral was “somewhat different than assumed.”¹⁷¹ According to Lehman Brothers, faster prepayments and higher defaults resulted in less than anticipated excess interest.¹⁷²

GTF said it would add “25 basis points of [its] servicing fee to the net interest margin cash flow each month.”¹⁷³ In effect, GTF agreed to add approximately \$10 million in cash to the NIMs in the first year (and less in later years) to “bring the average life back to the originally anticipated level.”¹⁷⁴ An article in a trade newsletter observed:

168. GREEN TREE FIN. CORP., PROSPECTUS. Green Tree Securitized Net Interest Margin Trusts 1994-A, 1994-B and 1995-A (each noting in a section of the Prospectus entitled “Yield, Average Life and Prepayment Considerations” that these factors (the “two primary factors are defaults and voluntary prepayments”) “may affect the amounts and timing of the distributions on the trust property”). *Id.*

169. *Id.*

170. *Id.*

171. Michael Millman, *Green Tree: No Stock Concern from Enhancement of Residual Securities*, First Call Notes (Lehman Bros.), Oct. 14, 1996.

172. See Am. Banker, Inc., *Green Tree Adds Juice*, 10 ASSET SALES REP. (Oct 7, 1996), available in 1996 WL 5618253, quoting a Lehman analyst who explained that:

A prepayment means there is no more interest payment from that loan, which results in less cash being available to pay interest and principal on the [NIMs]. A default also results in a loss of future interest payments A rise in prepayments or defaults will generally tend to extend the average life of the [NIMs] as there is less monthly cash flow available to pay down the principal of the [NIMs].

173. *Id.*

174. Millman, *supra* note 171 (reducing the average life from three years to two years).

Green Tree's action demonstrate that defaults and prepayments in its manufactured housing loan portfolio had become unmanageable for the net interest margin deals, which are essentially interest-only "strip" securities created from cash flow left over after bondholders from other deals have been paid.¹⁷⁵

GTF's enhancement of the NIMs suggests that GTF may have overstated the fair value of its 25% subordinated interest in the NIMs at the end of 1996. GTF did state that the carrying value of its interest in the NIMs exceeded their fair value by \$13 million at December 31, 1996.¹⁷⁶ However, the enhancement suggests that there may have been a risk of default on NIMs sold to other investors, in which event it seems unlikely that the subordinated NIMs had a fair value of \$309 million.¹⁷⁷

The enhancement of the NIMs also indicates that GTF's management was aware in October 1996 that prepayments and defaults on the loans underlying the NIMs were exceeding its expectations. This strongly suggests that GTF should have undertaken a "special review" of its prepayment rate assumptions and its valuation of the NIMs, and announced an addition to reserves, at least a year before it did.

4. *Delinquency and Loss Experience*

GTF clearly had first hand knowledge of delinquencies in the loan portfolio it serviced. In early 1996, GTF disclosed that its 1995 rate of delinquencies (1.92%) and repossession losses (0.57%) were "currently at their lowest level."¹⁷⁸ In 1996, GTF's delinquencies increased to 2.33% of the number of loans serviced¹⁷⁹ and its repossession losses increased to 0.82% of the average principal amount of all loans serviced.¹⁸⁰ However,

175. Dow Jones & Co., Inc., *US Asset-Backeds: Advanta Units Shake Stigma; GTF Adds 0.25*, CAP. MARKET REP. (Mar. 26, 1997).

176. See 1996 GTF ANNUAL REPORT, *supra* note 74, at 28. GTF estimated the fair value of the NIMs exceeded carrying value by \$56.6 million at December 31, 1995. See *id.*

177. See *id.* (\$322 million carrying value reduced by \$13 million to reflect fair value).

178. L. Asher, *Green Tree Financial: Knocked the Cover off the Ball*, First Call Notes (Merrill Lynch), Jan. 30, 1996. See also, Paul A. Mackey, *DWR Raises EPS Estimates & Price Target on Green Tree Financial; Maintain Buy*, First Call Notes (Dean Witter), Jan. 31, 1996 (noting that a 1.92% delinquency rate is "right in the middle of [GTF's] historic range" of 1.49% to 2.25% during the past 12 years); David B. Hilder, *Green Tree Financial: 4Q Well Above Estimate*, First Call Notes (Morgan Stanley), Jan. 31, 1996 (noting that GTF has experienced delinquency rates of 1.49% to 2.25% since 1984 and that the 1995 year-end delinquency rate of 1.92% was lower than 8 of the 11 past years).

179. See 1996 GTF ANNUAL REPORT, *supra* note 74, at 5 (an increase from 1.92% in 1995 and 1.49% in 1994).

180. See *id.* (an increase from 0.60 in 1995 and 0.53 in 1994).

GTF's 1996 provision for credit losses, as a percentage of sales, declined from 5.3% in 1995 to 4.7% in 1996.¹⁸¹

In October 1997, a Minneapolis-St. Paul business newspaper reported that GTF expected to repossess more units in 1997 than it had in 1996 and estimated that repossession in 1997 would be 18,000 manufactured homes.¹⁸² This article suggests that GTF knew prior to the end of the third quarter of 1997 that its default and repossession rates were increasing.

The day after issuing its November 1997 press release, GTF disclosed that during 1997 it had been using loss assumptions of 6% to 8% on new manufactured housing loans¹⁸³—rates much higher than GTF's 4.7% provision for credit losses at the end of 1996. Had GTF used a 6% loss assumption in 1996, its provision for credit losses on 1996 sales of manufactured housing loans of \$5 billion would have increased by \$75 million, which would have reduced GTF's 1996 income, net of taxes, by \$46.5 million; an 8% loss assumption would have reduced 1996 income, net of taxes, by \$108 million.¹⁸⁴

It is possible, of course, that GTF's losses on new manufactured housing loans increased sharply beginning in 1997 or that GTF experienced a much lower rate of losses on other kinds of loans.¹⁸⁵ However, we are aware of no changes that occurred in early 1997, in the economy in general or in the market for manufactured housing loans, that would have precipitated a sharp increase in defaults on manufactured housing loans. In addition, one analyst opined in November 1997 that GTF's proposed addition to reserves "wasn't just a result of refinancings but also of increasing defaults, particularly tied to a new lending program that requires only a 5% down payment."¹⁸⁶ Consequently, the information about defaults that GTF disclosed in November 1997 suggests that GTF should have increased substantially its provision for credit losses as of the end of 1996. It also suggests that, well before November 1997, GTF knew that more manufactured housing loans were being prepaid as a result of a significant increase in defaults.

181. See David B. Hilder, *Green Tree Financial: 4Q Exceeds Forecast; Raising 1997E EPS*, First Call Notes (Morgan Stanley), Jan. 28, 1997.

182. See Tim Huber, *Green Tree Sees More Delinquent Loans*, MINNEAPOLIS-ST. PAUL CITYBUSINESS, Oct. 24, 1997, at 4.

183. See M. Hughes, *Green Tree: Lowering Ratings Based on Charge*, First Call Notes (Merrill Lynch), Nov. 14, 1997.

184. These are only estimates of the impact an increase in loss provisions (from 4.7% to 6% or 8%) on the sale of manufactured housing loans would have had on GTF's 1996 reported income.

185. The 1996 provision for credit losses is reflected in the aggregate for all loan types serviced by GTF; the portion relating solely to manufactured housing loans is not separately disclosed.

186. Andrew Osterland, *How Green Tree Got Pruned*, BUS. WK., Dec. 1, 1997, at 37 (quoting Jeffrey K. Eveanson of Piper Jaffray, Inc.)

5. GTF's Assumptions in Comparison to its Competition

As we noted above, GTF disclosed in its financial statements that it calculated gain on sale using assumptions concerning prepayments and defaults "which it believes market participants would use" but did not disclose the specifics of those.¹⁸⁷ However, the day after GTF announced its proposed addition to reserves, it did disclose that it had been moving up its prepayment speeds on new transactions throughout 1997 as follows:¹⁸⁸

- a. 140% to 160% manufactured housing prepayment
- b. 600 to 800 basis points loss assumptions
- c. 11 to 11.5% discount rate
- d. prepayment speeds are ramped (ramp not disclosed).¹⁸⁹

One implication of this statement was that GTF had used slower prepayment speeds prior to 1997.

Data available to us suggested that GTF's assumptions were more aggressive than those used by its competitors.¹⁹⁰ A report by Morgan Stanley noted that GTF's projected adjustment to reserves would have been 50% smaller had GTF been using discount rates similar to those used by its competitors.¹⁹¹ However, because GTF had previously disclosed the discount rate it used to calculate gain on sale, we did not believe a claim of disclosure

187. 1996 GTF ANNUAL REPORT, *supra* note 74, at 9.

188. See M. Hughes, *Green Tree: Lowering Rating Based on Charge*, First Call Notes (Merrill Lynch), Nov. 14, 1997.

189. Ramping gives effect to the cyclical nature of prepayments over the life of a loan (i.e., prepayments on a portfolio will increase annually after year one, peaking in years 5-6, and then level out for the life of the loan).

190. Oppenheimer & Co. noted in its October 20, 1997 report:

When we began covering Green Tree in fall of 1993, there were few public companies using gain-on-sale accounting. Since then, dozens of financial services companies that use gain-on-sale accounting have gone public. We cover 14 such specialty finance companies and over the last few years, have gained a better understanding of gain-on-sale accounting. Part of our education has been that the companies that employ gain-on-sale accounting have increased their disclosure levels. We know the gain-on-sale assumptions at 13 out of these 14 companies from their 10 Qs or conversations with management. Green Tree is the sole exception.

Oppenheimer & Co. Inc., *Green Tree Financial: Trimming Estimates Because of Decline in Gain-on-Sale Margin* (Oct. 20, 1997).

We reviewed Forms 10-K filed by several other specialty finance companies that use gain on sale accounting in an effort to ascertain the assumptions they used, but were not able to find the details of any of their assumptions. Our assumption is that those companies disclosed information about their assumptions in meetings with analysts from Oppenheimer and other companies.

191. See Kenneth Posner, *Mortgage Lenders: Implications of Green Tree Residual Valuation Charge*, First Call Notes (Morgan Stanley), Nov. 17, 1997 (noting that discount rates used by Ocwen, Countrywide and INMC Mortgage for subprime home equity and manufactured housing loan securitization ranged from 18% to 23%).

fraud could be made on the basis of the difference between the (fully-disclosed) discount rate used by GTF and the rates used by its competitors.¹⁹²

We also ascertained that one of GTF's competitors, INMC Mortgage, used a prepayment assumption of more than 10% of the constant prepayment rate ("CPR"), whereas GTF announced that it was increasing its stabilized CPR prepayment assumption from 6% to 9%.¹⁹³ An analyst at Oppenheimer concluded that GTF's assumptions were still "inadequate" and needed to be raised by one-third on the 1996 and 1997 manufactured housing pools.¹⁹⁴ We did not believe, however, that this was enough to support a reasonable belief that the prepayment assumptions used in 1996 and 1997 were fraudulent. INMC Mortgage may have competed in the same market as GTF, but we had no data about its (or GTF's) actual prepayment experience. Thus, the information about INMC's assumption did not allow us to comfortably assert that a "market participant" in GTF's position clearly would have used prepayment assumptions different from those GTF used.

E. Evidence Suggesting Mr. Coss (and therefore GTF) had a Motive to Deceive

Mr. Coss was the highest paid executive in the United States in both 1995 and 1996.¹⁹⁵ He received \$102 million in salary and bonuses in 1996 and \$65.6 million in salary and bonuses in 1995.¹⁹⁶ These payments were made pursuant to an employment agreement that GTF and Mr. Coss signed in 1991. The agreement covered the years 1992 through 1996; it provided that GTF would pay Mr. Coss an annual base salary of \$400,000 and a bonus equal 2.5% of GTF's pretax income, payable 50% in cash and 50% in stock.¹⁹⁷ The agreement stipulated that, for purposes of calculating the bonus,

192. See *supra* note 124. In addition, GTF could make a persuasive argument that choosing a discount rate is a matter of business judgment and that the rate it used was not patently unreasonable.

193. See Kenneth Posner, *Mortgage Lenders: Implications of Green Tree Residual Valuation Charge*, First Call Notes (Morgan Stanley), Nov. 17, 1997. When the MHP curve was developed in 1994, prepayments leveled off at 6% (6% CPR) in month 24. See *supra* note 148. The CPR is "the percentage of the principal outstanding at the beginning of a period that prepay during the period, expressed on an annualized basis." FABOZZI, *supra* note 146, at 378.

194. See Heather Timmons, *Green Tree Prepayments Seen Triggering a Charge*, AM. BANKER, Dec. 18, 1997. Apparently, the manufactured housing sector experienced actual CRPs between 13.3% and 14.3% in the summer of 1997. See *Prepayments on Home-Equity ARMs*, 12 MORGAGE-BACKED SEC. LETTER (Aug. 4, 1997), available in 1997 WL 12803946.

195. See Eric S. Hardy, *Executive Pay*, FORBES, May 17, 1997, at 58; Eric S. Hardy, *America's Highest Paid Bosses*, FORBES, May 20, 1996, at 180, 184.

196. See 1996 GTF ANNUAL REPORT, *supra* note 74.

197. See GREEN TREE FIN. CORP., EMPLOYMENT AGREEMENT, KEY EXECUTIVE BONUS PROGRAM, AND STOCK OPTION PLAN (Apr. 20, 1991) [hereinafter GTF EMPLOYMENT AGREEMENT, KEY EXECUTIVE BONUS PROGRAM, AND STOCK OPTION PLAN].

shares of GTF stock would be valued at \$23.75, their price at the date of the agreement.¹⁹⁸ This price would be adjusted to take account of stock splits, stock dividends and comparable events.¹⁹⁹ As a result of three stock splits, the nominal value of the shares of stock used to pay the stock portion of Mr. Coss' bonus was reduced to \$2.96875 per share by the end of 1995. This adjustment, together with sharp increases in the price of GTF stock, accounted in large measure for the size of Mr. Coss' bonus.²⁰⁰

In April 1996, GTF and Mr. Coss entered into a new, ten year employment agreement that took effect on January 1, 1997. The 1997 agreement increased Mr. Coss' base salary to \$600,000, granted him an option to purchase two million shares of GTF stock,²⁰¹ and provided for an annual bonus equal to 2.5% of GTF's net income *in excess of a 12% return on equity*.²⁰²

The difference between the basis on which Mr. Coss' bonus was calculated under these two agreements clearly provided Mr. Coss with a strong motive to defer until some time in 1997 making any adjustments to GTF's prepayment and default assumptions that would reduce GTF's income for 1996 or the value GTF assigned to its excess servicing rights receivables and its subordinated interest in the NIMs. As CEO of GTF, Mr. Coss also clearly had the opportunity to influence the prepayment and default assumptions that GTF used.

F. The Bottom Line: There's a Hole in Our Theory

The information we were able to gather about GTF²⁰³ made us confident of two things:

- Information concerning (i) changes in the quality of manufactured housing and the market for manufactured

198. *See id.* (the closing price for GTF's stock on the New York Stock Exchange on the day the 1991 Employment Agreement was entered into).

199. *See* GTF EMPLOYMENT AGREEMENT, KEY EXECUTIVE BONUS PROGRAM, AND STOCK OPTION PLAN, *supra* note 197.

200. That is, because GTF stock was trading at more than ten times the nominal value of the stock used to pay Coss, the cash value of the stock portion of his bonus was more than ten times what it would have been had the agreement provided that the number of shares payable to Coss would be calculated using current market values.

201. *See* GREEN TREE FIN. CORP., CHIEF EXECUTIVE CASH BONUS AND STOCK OPTION PLAN, Exhibit 10 to Form 10-Q (filed with the SEC on Aug. 13, 1996). The 10-year stock option plan begins vesting in five years with an exercise price of \$30.88 per share. *See id.*

202. *See id.*, para. 4.1. Return on equity is computed as net income for the current year as a percentage of equity as of the last day of the immediately preceding year, computed in accordance with GAAP in effect at December 31, 1995.

203. We devoted about 150 hours to gathering and analyzing the information we have described.

housing, (ii) increased competition in the market for manufactured housing loans, (iii) changes in interest rates, (iv) increases in defaults on manufactured housing loans, (v) increases in the prepayment speeds GTF's underwriters used to market GTF's pass-through certificates, and (vi) analysts' calculations concerning GTF's actual prepayment experience on manufactured housing loans, considered collectively, clearly was sufficient to give rise to a strong inference that a market participant would have used considerably more conservative assumptions to calculate GTF's gain on sale and to value its excess servicing rights receivables and subordinated interest in the NIMs in 1996 than such a market participant would have used in the years prior to 1996. Consequently, that information also gives rise to a strong inference that, *if GTF did not use considerably more conservative assumptions in 1996 than it used in prior years*, GTF either recklessly or consciously issued materially false or misleading financial statements for 1996 and the first three quarters of 1997.

- Mr. Coss had a motive and the opportunity to prevent GTF from adopting considerably more conservative prepayment and default assumptions to calculate GTF's gain on sale and to value its excess servicing rights receivables and its subordinated interest in the NIMs in 1996 and the first three quarters of 1997.

Because GTF had not disclosed the prepayment and default assumptions it used in 1996 and the first three quarters of 1997, we did not know whether GTF in fact used substantially the same assumptions in 1996 that it used in prior years or whether GTF modified its assumptions to take account of the information set forth above.²⁰⁴

We undertook various forms of financial analysis to attempt to "back out"

204. In a situation such as this, where the information in question relates directly to a corporation's business operations, courts generally assume that a corporation's executives are aware of that information and do not require plaintiffs to plead facts indicating that that was the case. *See Epstein v. Itron, Inc.*, No. CS-97-214-RHW, 1998 WL 54944, *10 (E.D. Wash. Jan. 22, 1998) ("[F]acts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers."); *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994) (accepting allegation that company's officers "were 'fully familiar with all aspects of [its] business and financial condition and operations.'")

from GTF's financial statements the assumptions it had used or whether those assumptions had changed, but our efforts were to no avail. In its financial statements, GTF lumped together its gains on sale, excess servicing rights receivables and loan loss reserves for its portfolios of manufactured housing loans, home equity and home improvement loans, and commercial revolving credit loans. As a result, we found it impossible to estimate with any precision GTF's assumptions concerning prepayments and defaults on manufactured housing loans. Further complicating our calculations was the fact that, through 1996, GTF had securitized more than 800,000 manufactured housing loans, each with its own coupon rate, maturity date, and loan to value ratio, each of which would impact assumptions with respect to anticipated prepayments and defaults.

By examining the monthly Forms 8-K that GTF filed, which compared the principal balance due on one issue of NIMs (NIM Trust 1995-A) to the value of the excess servicing rights receivables that collateralized those NIMs, we were able to ascertain that, at some time between March 17, 1997, and April 15, 1997, GTF apparently did revise the assumptions it was using to value those receivables. That seemed to be the only plausible explanation for a 19.6% decline, during that period, in the value GTF assigned to those receivables during that period.²⁰⁵

205. At issuance, the NIMs reflected 76.9% of the collateral's estimated value (\$308 million/\$400.6 million). See GREEN TREE FIN. CORP., PROSPECTUS, 7.25% Securitized Net Interest Margin Certificates (Trust 1995-A), Aug. 4, 1995. At the end of 1995, the percentage had decreased to 72.3%, and by the end of 1996, it had decreased to 71.3%. See GREEN TREE FIN. CORP., FORM 8-K, Exhibit 99 (Jan. 19, 1996); GREEN TREE FIN. CORP., FORM 8-K, Exhibit 99 (Dec. 20, 1996). The data for 1997 were as follows:

| Payment Date | Principal Balance | Collateral Value | Principal Balance as % of Collateral |
|----------------|-------------------|------------------|---|
| Jan. 17, 1997 | \$207,725,303 | \$291,388,414 | 71.3% |
| Feb. 17, 1997 | \$201,321,654 | \$287,302,525 | 70.1% |
| Mar. 17, 1997 | \$195,949,871 | \$283,669,476 | 69.1% |
| Apr. 15, 1997 | \$194,012,358 | \$227,977,765 | 85.1% |
| May 15, 1997 | \$191,976,187 | \$224,216,746 | 85.6% |
| June 16, 1997 | \$189,630,709 | \$220,682,032 | 85.9% |
| July 15, 1997 | \$187,680,281 | \$216,579,451 | 86.6% |
| Aug. 15, 1997 | \$186,359,006 | \$209,817,259 | 88.8% |
| Sept. 15, 1997 | \$185,512,327 | \$204,906,994 | 90.5% |
| Oct. 15, 1997 | \$184,984,147 | \$201,403,142 | 91.8% |
| Nov. 17, 1997 | \$184,411,588 | \$198,283,243 | 93.0% |
| Dec. 15, 1997 | \$181,668,388 | \$171,153,583 | 106.2% |

In the 8-K filings, GTF disclosed:

Present value of the projected remaining cash flows is based on the estimated future performance of the underlying loans. These projections are subject to ongoing evaluation based upon a number of factors, including historical performance. As such, this projected value may change

This apparent change was an additional indicator that GTF should have revised its prepayment and default assumptions well before November 1997. However, it did not allow us to draw any strong inferences as to whether GTF had (or had not) revised the prepayment and default assumptions it used to calculate gains on the sales of manufactured housing loans during 1996. Because GTF's apparent revision of its assumptions did not cause the collateral securing NIM Trust 1995-A to fall below the principal due,²⁰⁶ we could draw no inferences from GTF's failure to write down the value of its subordinated interest in those NIMs. In addition, it also was possible that the make up of the pool of mortgages that generated the receivables that collateralized those NIMs differed materially from the make up of the pools of mortgages that GTF sold during 1996.

Consequently, the Reform Act would create a Catch-22 for a plaintiff seeking to prosecute a claim of securities fraud against GTF.²⁰⁷ Due to the Discovery Stay, a plaintiff would not be able to examine GTF's books and records to ascertain whether GTF had used essentially the same prepayment and default assumptions to prepare its financial statements for 1996 and the first three quarters of 1997 as it had used in prior years.²⁰⁸ Yet without access to GTF's books and records, the most we believe a plaintiff prudently could assert would be that she conducted a diligent investigation, that she could not ascertain from that investigation what assumptions GTF used to prepare its financial statements for 1996 and the first three quarters of 1997, and that her "best guess" was that GTF used substantially the same assumptions that it used in prior years.²⁰⁹ The information set forth above, concerning GTF, its business, and Mr. Coss' compensation arrangements, should be deemed sufficient to give rise to a strong inference that GTF violated section 10(b) and Rule 10b-5 if GTF used essentially the same assumptions in 1996 as it used in prior years. But a complaint that relies on a plaintiff's "best guess" to support a key factual allegation—that GTF used those assumptions—does

periodically, not only as a result of actual experience but also as a result of revisions made to the assumptions upon which such projections are based.

See GREEN TREE FIN. CORP., FORM 8-K, Exhibit 99 (Jan. 17, 1997; Feb. 17, 1997; Mar. 17, 1997; Apr. 15, 1997; May 15, 1997; June 16, 1997; July 15, 1997; Aug. 15, 1997; Sept. 15, 1997; Oct. 15, 1997; Nov. 17, 1997; Dec. 15, 1997).

The 19.6% decline is particularly significant in light of the fact that during the same one-month period, the principal due on this issue of NIMs declined by less than 1%.

206. See *supra*.

207. Based on information available prior to January 27, 1998.

208. We assume that GTF, having kept those assumptions secret for many years, would not have responded positively to a potential plaintiff's request to GTF to disclose them voluntarily.

209. We assume that she believed GTF had used those assumptions and that she further believed that discovery would produce evidence to support her belief.

not, in our view, satisfy the Reform Act's pleading requirements. The question that remains, then, is how a court could—and should—deal with a plaintiff who sought to prosecute an action for securities fraud against GTF on the basis of such a complaint.

IV. WHAT A COURT COULD—AND SHOULD—DO

A court reasonably could conclude that plaintiff's complaint should be dismissed because, absent particularized factual allegations that GTF used essentially the same assumptions in 1996 that it used in prior years, the complaint failed to negate the possibility that GTF used modified assumptions in 1996.²¹⁰ As a consequence, any claim that GTF had engaged in securities fraud could be fairly termed speculative. True, discovery might produce facts supporting a plaintiff's speculation, but one of Congress' principal objectives in passing the PSLRA was to protect defendants from discovery conducted by plaintiffs seeking to corroborate speculative claims. Congress appreciated that the Reform Act might preclude plaintiffs from investigating some claims that would prove to have merit but Congress ultimately concluded that a plaintiff who is unable to plead particularized facts sufficient to give rise to a strong inference of fraud "should not be able to go on a 'fishing expedition' merely because, from time to time, fishing expeditions really do catch fish."²¹¹

Our case study illustrates some of the problems this line of argument poses. The facts we developed seem more than sufficient to suggest a reasonable possibility that GTF engaged in securities fraud. GTF

210. See, e.g., *Gross v. Summa Four, Inc.*, 93 F.3d 987, 996 (1st Cir. 1996) (general allegation of inflated earnings not sufficient where plaintiff did not specifically allege the amount of the putative overstatement or the net effect it had on the company's earnings); *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 522 (5th Cir. 1993) (allegation that company had adjusted the accounting of its inventory to inflate revenues and earnings does not sufficiently plead fraud where complaint does not explain, *inter alia*, how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position); *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (allegation that company "failed to establish adequate reserves for its excessive and outdated inventory" does not satisfy Rule 9(b) where investor does not allege "what the reserves were or suggest how great the reserves should have been"); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 116 (2d Cir. 1982) (allegation that company's failure to write down value of obsolete equipment does not sufficiently plead fraud where plaintiff did not allege amounts at which equipment was carried—or should have been carried—on company's books).

211. Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1068 (1996); see also John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 353 (1996) (proponents of reform sought to screen out both claim that were frivolous and those that were speculative).

subsequently disclosed additional information that suggests a considerably stronger possibility of fraud. But if courts interpret the Reform Act to require the dismissal of every complaint that fails to allege with sufficient particularity every fact critical to a claim of fraud, corporations like GTF will have a strong incentive to delay or avoid disclosure of information, within their exclusive control, that will allow plaintiffs to fill holes in otherwise untenable complaints.

More importantly, pre-Reform Act case law suggests that there are likely to be numerous situations in which, absent some discovery, plaintiffs with potentially meritorious claims will find it impossible to plead facts with sufficient particularity to satisfy the Reform Act's pleading requirements.²¹² As a consequence, strict interpretation of those requirements will undermine another of Congress' goals—preserving the ability of private securities litigation to compensate investors who have been defrauded and to deter wrongdoing in American securities markets.²¹³

To avoid such results, courts may well be inclined to deny a motion to dismiss where a plaintiff has filed a well-documented complaint that suggests a strong possibility of fraud, but that includes one or more allegations a plaintiff cannot substantiate because the defendants control the relevant information. Courts imbued with the values of a notice pleading system that for sixty years has emphasized that no complaint should be dismissed unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief"²¹⁴ are likely to find this option especially attractive. True, courts have applied Rule 9(b)'s more stringent pleading requirements to claims of fraud, but generally they have held that a plaintiff satisfies Rule 9(b) if she makes "allegations [concerning facts that] lie peculiarly within the opposing parties' knowledge and [those allegations] are accompanied by information that raises a strong inference of fraud."²¹⁵ As Judge Richard Posner recently explained in a RICO case governed by Rule 9(b):

We don't want to create a Catch-22 situation in which a complaint is dismissed because of the plaintiff's inability to obtain essential

212. See Hillary A. Sale, *Still "Pleading" for the Reform of Securities Litigation*, 76 WASH. U. L.Q. 537 (1998).

213. See *supra* text accompanying note 12.

214. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

215. *Ouaknine v. MacFarlane*, 897 F.2d 75 (2d Cir. 1990); see also *In re Craftmatic Sec. Litig.*, 890 F.2d 628, 646 (3d Cir. 1990) (allowing plaintiffs to proceed on the basis of unsubstantiated allegations made on information and belief when "the necessary information lies within defendants' control").

information without pretrial discovery (normally of the defendant, because the essential information is in his possession and he will not reveal it voluntarily) that she could not conduct before filing the complaint. But Rule 9(b) is relaxed upon a showing of such inability. . . . Rule 9(b) is satisfied by a showing that further particulars of the alleged fraud could not have been obtained without discovery.²¹⁶

The Third Circuit has gone further. It requires a plaintiff to make an “effort to obtain, before filing the complaint, the information needed to plead with particularity”²¹⁷ and stipulates that a plaintiff’s effort should involve “thoroughly investigat[ing] all possible sources of information, including but not limited to all publicly available relevant information. . . .”²¹⁸ If a plaintiff then cannot plead facts sufficient to create a strong inference, she still will be allowed to proceed if she delineates “the nature and scope” of her efforts to develop such facts.²¹⁹

Our efforts to ascertain GTF’s prepayment and default assumptions, described in Part III,²²⁰ would appear to satisfy this requirement. Nonetheless, we do not believe that a complaint should be held to satisfy the Reform Act’s pleading requirements if it depends, at its core, on a plaintiff’s “best guess” that GTF used assumptions that it knew or should have known were outdated. A decision denying a motion to dismiss such a complaint and allowing a plaintiff to proceed with discovery cannot be reconciled with Congress’ basic goal of ensuring that defendants will not be forced to incur the costs associated with discovery unless plaintiffs “state with particularity facts giving rise to a strong inference that the defendant” engaged in fraud. Moreover, if courts were to create an “unavailable facts” exception for a

216. *Emery v. American General Fin., Inc.*, 134 F.3d 1321, 1323 (7th Cir. 1998). *See also* *Katz v. Household Int’l, Inc.*, 91 F.3d 1036, 1040 (7th Cir. 1996); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3d Cir. 1997); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1279 n.3 (D.C. Cir. 1994); *Devaney v. Chester*, 813 F.2d 566, 569 (2d Cir. 1987).

217. *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 284 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992).

218. *Id.* In an earlier case where plaintiffs had alleged simply that “there was no reasonable basis” for defendants’ projections, the Third Circuit held:

Under a flexible application of Rule 9(b), plaintiffs need not necessarily allege the specific information at defendants’ disposal at the time the projections were made. However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants’ control.

Craftmatic, 890 F.2d at 646. The court held that plaintiffs’ complaint did not satisfy Rule 9(b) and remanded to allow plaintiffs an opportunity to replead.

219. *Id.*

220. *See supra* text accompanying notes 125-94.

complaint similar to the one we could have been filed against GTF, reasoning that it reflects considerable effort on the part of a plaintiff and suggests at least a reasonable possibility that fraud has occurred, a substantial danger exists that this exception soon will swallow up the Act's defendant-protective rules.

From the point of view of a plaintiffs' attorney, the lowest cost route to finding out whether a corporation knew or recklessly disregarded certain material information at the time the corporation made an allegedly false or misleading statement, almost always will be to obtain access to the corporation's books and records.²²¹ Were courts to allow a plaintiff to begin discovery whenever she alleged that she had conducted a thorough investigation and was not able to substantiate facts central to her claim because the relevant information was under defendants' exclusive control, plaintiffs' attorneys predictably would begin to file large numbers of complaints containing exactly such allegations. Plaintiffs' attorneys would find that strategy particularly attractive because such complaints would create a dilemma for defendants. The most effective way for a defendant to discredit a plaintiff's claim, in many cases, would be to point to publicly available information that a plaintiff could have acquired had she conducted a diligent investigation. But in so discrediting a plaintiff's claim, a defendant would end up providing a plaintiff with a road map to where she could find information relevant to defendant's alleged fraud.

In short, if a court's only options were to grant or deny a motion to dismiss, the Reform Act would appear to create a Catch-22 in cases where a plaintiff files a complaint that sets forth substantial information suggesting fraud but where she also is unable to document certain aspects of her claim because defendants control the relevant information. However the court rules, it would likely frustrate an important purpose of the Reform Act. If courts dismiss all such complaints, much fraud will go unremedied. If courts interpret the All Facts and Strong Inference Requirements in a relaxed fashion and deny motions to dismiss, corporate and other defendants will again be required to incur substantial costs to respond to speculative claims. There is no way to interpret the Reform Act's *pleading* requirements, in our view, that will allow courts to escape from this box.

However, courts can interpret the Discovery Stay so as to eliminate this Catch-22. Recall that the Reform Act directs a court to stay all discovery in a securities class action unless it "finds upon the motion of any party that *particularized discovery is necessary* to preserve evidence or to prevent

221. See *supra* text accompanying notes 26-27.

undue prejudice to that party."²²² The only legislative history discussing this provision suggests it would be appropriate to allow discovery when "the terminal illness of an important witness might require the deposition of the witness prior to the ruling on the motion to dismiss."²²³ This example clearly pertains to the first exception and provides no indication of what Congress believed constitutes "undue prejudice" that would justify granting a plaintiff permission to conduct "particularized discovery."

In our view, a court should find that a plaintiff who set forth the facts concerning GTF that we set forth in Part III would be unduly prejudiced by the discovery stay and should be allowed to take discovery of GTF limited to ascertaining the assumptions GTF used to prepare its 1996 financial and whether they were substantially the same as the assumptions GTF used in prior years.²²⁴ More generally, we believe that a plaintiff should be deemed to be unduly prejudiced and should be allowed to take particularized discovery where she (i) alleges particularized facts sufficient to make out almost all the elements of a claim of securities fraud; (ii) asserts, in a manner that the court concludes is plausible, that she has made a diligent effort to obtain the remaining information necessary to flesh out her claim and that such information, if it exists, can be obtained only from defendant;²²⁵ and (iii) further asserts that she has a good faith belief that particularized discovery will produce the evidence necessary to flesh out her claim and pleads particularized facts (such as the information concerning Mr. Coss' incentive compensation arrangements) sufficient to convince a court that her belief is reasonable. The court also should allow a plaintiff to amend her complaint to reflect the results of discovery. But if, after discovery, a plaintiff is still unable to state a claim that meets the Reform Act's stringent pleading standards, the court should dismiss her complaint with prejudice.

222. 15 U.S.C. § 78u-4(b)(3)(B) (Supp. II 1996) (emphasis added).

223. Conf. Rep., *supra* note 2, at 70.

224. We are not convinced that the first complaint filed against GTF, *Chill v. Green Tree Financial Corp.*, No. 97-CV-2666 (D. Minn. filed Dec. 2, 1997), contains information that would satisfy these conditions. The bulk of that complaint is made up of quotations of statements made by GTF and by securities analysts about GTF. The complaint's allegations of fraud, *see, e.g.* ¶ 61, are stated in conclusory terms. Moreover, to the extent that they turn on information concerning prepayments that GTF is alleged to have "revealed in a conference call to analysts on Friday, November 14, 1997," *id.*, we were unable to locate in the complaint any description of, quotation from, or source for that alleged conversation. We did not review plaintiffs' amended complaint, filed after GTF's January 1998 press release, to determine whether it includes more detail.

225. Or some identified third party. The discovery stay applies to discovery of third parties as well as discovery of defendants. *See In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1270 (D. Minn. 1997) (granting plaintiffs leave to serve subpoenas duces tecum upon third parties for sole purpose of ensuring that they will preserve relevant documents). Cases may arise in which a third party, rather than defendant, controls some piece of evidence critical to plaintiff's claim.

Medical Imaging Centers of America, Inc. v. Lichtenstein,²²⁶ the only case that addresses the question of what constitutes “undue prejudice” sufficient to justify lifting the discovery stay to allow a party to take particularized discovery, supports our approach.²²⁷ There the court held that “‘undue prejudice’ means improper or unfair detriment,” which is “something less than ‘irreparable harm.’”²²⁸

The Court finds that such an interpretation is not only consistent with a plain reading of the statute, but is also consistent with both the underlying objectives of the securities law in general and with the stated purposes of the Reform Act. The introductory paragraphs of the Statement of Managers for the Reform Act noted that Congress, in passing this new legislation, was “prompted by significant evidence of abuse in private securities lawsuits,” which Congress found to include, “the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle.” Congress also noted, however, the broader purpose of the federal securities laws, “to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.” Using an “undue prejudice” standard in applying the exception to the statutory discovery stay appropriately attempts to balance the competing concerns of maintaining truth and integrity in the marketplace while curbing meritless litigation.²²⁹

Moreover, the court also stated: “If in fact, [plaintiff] had shown that the discovery stay would prejudice it because the [defendants] would be shielded from eventual liability for any material violations of the securities laws, the Court would find that an ‘undue prejudice’ exception to the statutory stay had been shown.”²³⁰

226. 917 F. Supp. 717 (S.D. Cal. 1996).

227. *Medical Imaging Centers* was an injunctive action. However, in *In re Glenayre Technologies, Inc. Sec. Litig.*, 982 F. Supp. 294, 299, n.6 (S.D.N.Y. 1997), the court granted defendants’ motion to dismiss, but noted that it had “asked plaintiffs whether limited discovery . . . would aid plaintiffs in meeting the stringent PSLRA requirements” and that “[r]ather than accept this offer, plaintiffs asserted that they believe the amended Complaint meets the requirements.”

228. *Medical Imaging*, 917 F. Supp. at 720.

229. *Id.* at 720-21 (citations omitted).

230. *Id.* at 721 n.3. However, given the circumstances in which the motion was made, which involved an effort by a corporation to enjoin certain shareholders who were seeking to elect an alternate slate of directors, the court held plaintiffs would have an adequate opportunity to take discovery, “following a favorable resolution of the Motion to Dismiss, . . . prior to the preliminary injunction hearing or the special shareholders meeting.” *Id.*

Michaels Building Co. v. Ameritrust Co., N.A.,²³¹ followed a very similar approach. Four class actions involving RICO claims were filed against a number of banks. Plaintiffs alleged that they had agreed to pay interest to the banks at rates keyed to the “prime rate,” which generally was understood to mean the rate of interest a bank charges its best commercial customers. Plaintiffs further alleged that the banks had defrauded them by posting “prime rates” of interest higher than the rates the banks actually were charging their best commercial customers.²³² The banks declined to answer plaintiffs’ interrogatories, secured a stay of discovery, and moved to dismiss on the grounds that plaintiffs’ claims relied on generalized allegations that the banks had made below-prime loans to preferred customers but contained no particulars of those loans. Plaintiffs’ counsel admitted “that he was unable to provide the names of favored borrowers, but urged that he not be shut out for that reason.”²³³ The district court nonetheless dismissed the complaints with prejudice, holding that Rule 9(b) requires details such as the names of customers, the amounts of loans and the interest actually charged.²³⁴

The court of appeals reversed. It acknowledged “the dilemma of the trial judge who struggles to sketch lines separating what are strike suits and illegitimate complaints from claims which bear more credibility.”²³⁵ But in this case, the court concluded, “the court below was too exacting.”²³⁶

We will not demand clairvoyance from pleaders. Corporate entities who jealously guard the names of their clients or other information, as they should, would be forever victorious in their motions to dismiss under Rule 9(b) if courts demanded the level of specificity at issue in this stage of a case. We are reluctant to punish the plaintiffs for their ignorance of a specific factual detail, as long as defendants have adequate notice of why they are being sued and are capable of preparing a responsive pleading. If some limited discovery has been taken (under a protective order if necessary), and the district court learns that in fact plaintiffs are still unable to produce the names of favored borrowers, then the action may be properly disposed of.²³⁷

231. 848 F.2d 674 (6th Cir. 1988).

232. *See id.* at 676.

233. *Id.* at 681.

234. *See id.* at 677-79.

235. *Id.* at 681.

236. *Id.*

237. *Id.* *See also* *Nichols v. Merrill Lynch*, 706 F. Supp. 1309, 1350 (N.D. Tenn. 1990) (where complaint included only conclusory allegations concerning defendant Laventhal but also provided “a reasonable basis exists for inferring that defendant Laventhal could have been a party to the fraud alleged in the complaint,” court dissolved discovery stay and granted plaintiffs 90 days to conduct

We consider it important that in *Michaels*, the surrounding facts and circumstances clearly supported plaintiffs' belief that the defendant banks had made loans at less than prime. Banks compete vigorously for the business of big corporate customers who, in turn, are quite sensitive to the interest rates banks charge. There were widespread reports that large banks around the country had been making loans to their best corporate customers at rates well below their published prime.²³⁸ Consequently, it seemed very likely that the defendant banks had succumbed to the same competitive pressures that had led their rivals to make loans below prime.

In addition, as *Michaels* pointed out, if the defendants had not made such loans, that fact would soon become obvious and the plaintiffs' claims would be dismissed. Consequently, allowing the plaintiffs to proceed was not likely to burden innocent defendants unduly.

The approach we recommend clearly creates some advantages for plaintiffs, at least in cases where courts otherwise would dismiss their complaints. Our approach, however, also creates advantages for defendants. First, there is the risk that, if courts do not view allowing particularized discovery as a viable alternative, they will decide to give plaintiffs the "benefit of the doubt" and deny motions to dismiss complaints that they think have some merit.²³⁹ Defendants in such cases, even if they are confident the facts do not support plaintiff's claim, then will be forced to bear the costs of full-scale discovery before they can file a motion for summary judgment.²⁴⁰

A defendant clearly would be better off, in such a situation, if the court allowed her to point out that the plaintiff is relying on an unsubstantiated allegation to support some critical element of her claim and to move to dismiss, subject to allowing the plaintiff to conduct discovery limited to the subject matter of that allegation. Consider *In re Silicon Graphics Securities*

discovery and file amended complaint.); *Eaby v. Richmond*, 561 F. Supp. 131 (E.D. Pa. 1983) (where plaintiffs had made sufficiently particularized allegations to support most of their RICO claim, but lacked specific information about the nature of an alleged racketeering enterprise, court granted plaintiffs leave to conduct discovery for 60 days and to amend their complaint, after which defendants could renew their motions to dismiss).

238. See Daniel Hertzberg, *Challenges to Prime Rate as Base For Loans Stir Fears Among Banks*, WALL ST. J., Apr. 3, 1984, available in 1984 WL-WSJ 240403.

239. See *supra* text accompanying notes 214-15.

240. Defendants also run the not insubstantial risk that, in the course of discovery, plaintiffs will become aware of information that will support claims of securities fraud different from those set forth in their initial or amended complaints. Several of the attorneys interviewed by one of the authors remarked that a skilled plaintiffs' attorney obtains access to a large volume of corporate books and records almost always will be able to find references to some arguably material fact that was known to the corporation and that arguably should have been disclosed. As a consequence, settlements frequently reflect not the litigation risks associated with the claims plaintiffs initially asserted but the risks associated with claims that, after discovery, they would be able to assert.

*Litigation.*²⁴¹ One of the plaintiffs' central claims was that Silicon Graphics had failed to disclose problems it was experiencing in producing its most important new product, the Indigo2 IMPACT workstation. Plaintiffs alleged that Silicon Graphics' management had received "internal reports" detailing those problems and that Silicon Graphics had issued "stop ship" orders with respect to Indigo2 IMPACT workstations. However, the plaintiffs provided no specifics concerning the dates, sources, or authors of the internal reports or the dates and contents of the "stop ship" orders. Defendants, relying on the incorporation by reference doctrine,²⁴² attempted to demonstrate that the alleged Indigo2 Impact "stop ship" reports did not exist by filing an affidavit attached to which were "all the stop ship reports issued [by Silicon Graphics] during the class period".²⁴³

The court held that these reports were "arguably outside the scope of the pleadings and should not be considered in evaluating a Rule 12(b)(6) motion to dismiss."²⁴⁴ The court ultimately granted the defendants' motion to dismiss because the plaintiffs' allegations were "too generic to create a strong inference of fraud under the [Reform Act],"²⁴⁵ but that ruling is now the focus of the plaintiffs' pending appeal. It strikes us that it would have been far more efficacious, from the defendants' point of view, for the court to have allowed the plaintiffs' to discover all "stop ship" orders and to depose two or three Silicon Graphics officials concerning whether any "stop ship" or comparable orders, relating to the Indigo2 IMPACT workstation, had been issued during the class period.²⁴⁶ First, an appeal—and the possibility of a reversal and remand—might have been avoided. More importantly, either the plaintiffs would have succeeded in confirming that they had a valid claim, or the defendants would have demonstrated dispositively that the plaintiffs' claims were based on mere speculation.²⁴⁷

241. 970 F. Supp. 746 (N.D. Cal. 1997), *appeal docketed*, No. 97-16204 (9th Cir. July 9, 1997).

242. This doctrine allows a defendant to attach to a motion to dismiss documents referred to in the complaint that are central to plaintiff's claim. *See* Branch v. Tunnell, 14 F.3d 449, 454 (9th Cir. 1994); Venture Assoc. Corp. v. Zenith Data Sys. Corp., 987 F.2d 429, 431 (7th Cir. 1993); Kramer v. Time Warner, Inc., 937 F.2d 767, 774 (2d Cir. 1991).

243. *Silicon Graphics*, 970 F. Supp. at 759.

244. *Id.*

245. *Id.* at 767. For a fuller description of the parties' maneuvering in *Silicon Graphics*, see D. M. Osborne, *Getting Back at Lerach*, AM. LAW. 49 (Sept. 1997).

246. Assuming that either defendants consented to such limited discovery or plaintiffs (i) alleged particularized facts sufficient to make out the other elements of a claim relating to the Indigo2 IMPACT workstation; (ii) plausibly claimed that they had made diligent efforts to obtain the stop ship reports but and that those reports are under the control of defendants; and (iii) demonstrated that they had reasonable grounds to believe that "stop ship" reports were issued. *See supra* text accompanying notes 222-25.

247. *See* Osborne, *supra* note 245, at 53 (reporting that defendants' attorney was convinced

We recognize that, if courts begin to interpret the Discovery Stay as we suggest, the danger exists that plaintiffs will claim undue prejudice in virtually every case in which they suspect fraud but cannot easily ferret out facts that to give rise to a strong inference of fraud.²⁴⁸ But our proposal is not that a plaintiff should be allowed to take discovery in every such case. A plaintiff must be able to show that defendants control information critical to her claim and *also* must (i) plead particularized facts sufficient to make out most elements of a claim of securities fraud; (ii) show that she has made a diligent effort to obtain the remaining information necessary to flesh out her claim; and (iii) convince the court that she has reasonable grounds to believe that particularized discovery will produce that information.²⁴⁹

One question remains. Assuming some plaintiffs will be able to show undue prejudice, will they also be able to develop suitably limited discovery requests?²⁵⁰ It is difficult to answer this question in the abstract; the nature of the information that a plaintiff will be seeking will vary considerably from case to case. We can, however, suggest what we believe would be a suitably limited discovery request directed at GTF.

That request would have three parts: interrogatories, a document request, and depositions. The interrogatories would ask GTF to set forth the assumptions it used, concerning prepayments, delinquencies and defaults. The interrogatories would require GTF to calculate gain on sale and the value of its excess servicing rights receivables and its subordinated interest in the NIMs for each quarter from the first quarter of 1994 through the third quarter of 1997. The document request would ask GTF to provide a copy of every document that sets forth those assumptions for each of those quarters.

To verify the information received, depositions would be sought from Edward L. Finn, who served as GTF's chief financial officer during the

"plaintiffs were merely speculating about the ["stop ship"] report.").

248. As we have pointed out, *see supra* text accompanying notes 26-27, the easiest way for a plaintiff to develop a claim of fraud often is to obtain access to defendants' files.

249. Our proposal will not help plaintiff in a situation where defendants control almost all information that suggests fraud. However, we believe such situations are rare. In most situations in which fraud has occurred, we believe plaintiffs should be able to develop sufficient information, without discovery, to be meet either the Act's pleading standards or the test for showing "undue prejudice" that we suggest. To be sure, there will be cases in which plaintiffs will not be able to find such information and fraud will go undeterred. In such cases, Congress' decision to insulate defendants from the high cost of responding to speculative claims will generate other, more systemic costs. *See* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996).

250. The Discovery Stay allows a court that finds "undue prejudice" to order "particularized discovery." Congress' use of that term, we believe, makes clear that such discovery must be limited in scope as well as duration.

period in question.²⁵¹ Depositions would also be sought from Mr. Coss, and the individual (to be identified after Mr. Finn and Mr. Coss are deposed) who had primary responsibility for calculating GTF's gain on sale, the value of its excess servicing rights receivables and its subordinated interest in the NIMs for each of those quarters. However, depositions would be limited to (i) questions relating to deponents' knowledge of the assumptions GTF used to calculate its gain on sale, the value of its excess servicing rights receivables, and its subordinated interest in the NIMs for each of those quarters; (ii) deponents' responsibilities with respect to developing, reviewing or revising those assumptions; and (iii) deponents' knowledge of the other persons at GTF responsible for developing, reviewing or revising those assumptions or for calculating GTF's gain on sale, the value of its excess servicing rights receivables, and its subordinated interest in the NIMs for each of those quarters.²⁵²

Similarly constrained and targeted discovery, we believe, has the potential to eliminate the Catch-22 that otherwise will arise in numerous other situations where substantial evidence suggests that securities fraud has occurred.

251. See Complaint, *Chill v. Green Tree Fin. Corp.*, No. 97-CV-2666, ¶ 10 (D. Minn. filed Dec. 2, 1997).

252. If the information produced through discovery allowed plaintiff to fill in the "hole" in her complaint and state a valid claim against GTF, plaintiff would, of course, then be entitled to conduct all appropriate additional discovery. If it did not, her complaint would be dismissed.

