# Disasters and Disclosures: Securities Fraud Liability in the Shadow of a Corporate Catastrophe

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*Many securities fraud lawsuits follow corporate disasters of some sort or another, claiming that known risks were concealed prior to the crisis. Yet for a host of doctrinal, pragmatic and political reasons, there is no clear-cut duty to disclose these risks. The SEC has imposed a set of requirements that sometimes forces risk disclosure, but does so neither consistently nor adequately. Courts in 10b-5 fraud-on-the-market cases, in turn, have made duty mainly a matter of active rather than passive concealment and thus, literally, wordplay: there is no fraud-based duty to disclose risks unless and until the issuer has said enough to put the particular kind of risk "in play." The resulting incoherence could be rationalized by a more thoughtful assessment of how words matter to investors and better appreciation of the variable role that managerial credibility plays in the process of disclosure and interpretation, the main focus of this Article. Yet even with this, other hurdles remain that too often unnecessarily diminish the deterrence and compensatory value of these lawsuits. This study of disasters and disclosures offers a distinctive reference point for thinking about contemporary controversies associated with bringing matters of social responsibility (e.g., law abidingness) and sustainability (environmental compliance, cybersecurity, product safety, etc.) into the realm of securities law.*

TABLE OF CONTENTS



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## INTRODUCTION

Corporate disasters happen with unnerving frequency. Some are triggered by visibly dramatic events like fires, explosions, or toxic leakage that cause physical and economic harm both inside and outside the firm. The BP Deepwater Horizon oil rig catastrophe is a well-publicized example, with loss of life, environmental damage across many states, and great consequential economic loss.[1] Many can be described as legal compliance disasters, when massive fines, penalties, or tort liabilities are imposed or threatened because authorities determine that the corporation has surreptitiously violated the law.[2] Other corporate disasters may be smaller in scale yet still painful, such as the failure of a product on which the

1. *See* NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL AND OFFSHORE DRILLING, DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING (2011), https://www.gpo.gov/fdsys/pkg/GPO-OILCOMMISSION/pdf/GPO-OILCOMMISSION.pdf (analyzing causes and effects of oil spill based upon a six-month investigation); *see also* Russell W. Mills & Christopher J. Koliba, *The Challenge of Accountability in Complex Regulatory Networks: The Case of the* Deepwater Horizon *Oil Spill*, 9 REG. & GOVERNANCE 77, 77–78, 82 (2015) (explaining that the Deepwater Horizon explosion "killed [eleven] rig workers, injured [sixteen] others, and unleashed the largest oil spill in US history") (citing John J. McKinlay, *Regulation, Renegotiation, and Reform: Improving Transnational Public-Private Partnerships in the Wake of the Gulf Oil Spill*, 87 IND. L.J. 1315, 1315 (2012)).

2. *See, e.g.*, *In re* Volkswagen Clean Diesel Mktg., Sales Practices Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,817, 2017 WL 3310179, at *3–4 (N.D. Cal. July 19, 2017) (explaining that civil and

company had pinned its hopes, or the departure of a key leader under questionable circumstances.[3]

High-profile events like these nearly always produce high-stakes litigation, and if the company is publicly traded, among those suing almost certainly will be investors who own, or owned, the firm's securities.[4] A defining characteristic of such corporate disasters is that when news of the event becomes public, the company's stock price drops immediately and sharply, often erasing billions of dollars in market capitalization. Investors consider themselves unjustly damaged and demand compensation. The most potent post-disaster remedy involving publicly traded issuers is usually a federal class action under either section 11 of the Securities Act of 1933[5] or the fraud-on-the-market theory for the implied private right of action under section 10(b) of the Securities Exchange Act of 1934[6] and the Securities and Exchange Commission's implementing regulation, Rule 10b-5.[7] The latter is most common, and is thus the main subject of attention here.

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criminal penalties imposed on Volkswagen for its "defeat device" scheme were expected to cost Volkswagen approximately $20 billion).

3. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 315 (2007) (describing class action brought by shareholders against executive for allegedly making statements that demand for flagship product continued to grow when actually waning); Retail Wholesale & Dep't Store Local 338 Ret. Fund v. Hewlett–Packard Co., 845 F.3d 1268, 1271 (9th Cir. 2017) (discussing class action by shareholders against executive after he resigned due to allegations of sexual harassment, doctoring expense reports, and lying to investigators).

4. Indeed, there is an elite legal practice specialty in representing the "corporation in crisis" that includes managing and helping resolve fast-spreading legal risk across federal and state, and public and private domains. This is part of a larger enterprise risk arising in the event of a crisis, creating reputational consequences that in turn affect the severity of the legal risk—the inevitable consequences of "publicness." *See, e.g.*, Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1629, 1642–55 (2014) (explaining how the "publicness" of J.P. Morgan led to numerous consequences when faced with a crisis).

On the connection between publicness and shareholder litigation, see Hillary A. Sale & Robert B. Thompson, *Market Intermediation, Publicness and Securities Class Actions*, 93 WASH. U. L. REV. 487 (2015) (positing that securities regulation and shareholder litigation are motivated not only by individual investors but also by impact on society and public citizens). On the interaction between reputation, crisis and firm value, see Jiuchang Wei et al., *Well Known or Well Liked? The Effects of Corporate Reputation on Firm Value at the Onset of a Corporate Crisis*, 38 STRATEGIC MGMT. J. 2103 (2017) (finding that generally favorable reputation buffers loss in firm value after crisis, being known increases loss in firm value, buffering effect of favorable reputation is stronger when attribution of crisis responsibility is lower, and buffering effect of favorable reputation is weaker when firm is better known).

5. Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74, 82 (codified as amended at 15 U.S.C. § 77k (2012)). Section 11 creates an express remedy for misrepresentations and omissions in registration statements filed in the course of a registered public offering. *See, e.g.*, Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1323 (2015) (alleging that registration statement contained an untrue statement of material fact or omitted a material fact under section 11). Public offerings are at best episodic in the corporate lifecycle; hence these cases are relatively less common than Rule 10b-5 cases, even though the cause of action established in the Securities Act of 1933 is more plaintiff-friendly.

6. Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)).

7. 17 C.F.R. § 240.10b-5 (2018). Enforcement of Rule 10b-5 comes through SEC civil actions and DOJ criminal prosecutions as well.

A fraud-on-the-market lawsuit allows for recovery of damages on behalf of investors who bought or sold publicly traded securities in an efficient marketplace at a price distorted by fraud on the part of the issuer or its management.[8] To recover in the aftermath of a corporate disaster,[9] purchaser plaintiffs must offer three main clusters of proof on the merits capable of withstanding a multitude of potential defenses. The first burden goes to deception. Plaintiffs must prove that one or more corporate statements were materially false or misleading when made, which plausibly distorted the stock price to the investors' detriment.[10] In disaster cases, these are usually claims that the company hid or misstated the risk of occurrence in the months, weeks, or days before the blow-up. The second burden is to establish scienter—that is, that these corporate statements were deliberately false or made recklessly.[11] The last is a set of showings related to causation. This requires both a causal link between the deception and subsequent investor purchases (reliance) and a causal link between the revelation of the truth and the loss in value of the stock for which plaintiffs seek compensation (known as loss causation).[12]

Disaster-related fraud-on-the-market lawsuits can be controversial for a number of reasons. There may be doubts about the propriety of letting investors seek compensation when other victims are more directly—sometimes horrifically—injured by the disaster, because shareholders may have been the intended beneficiaries of the risky business when the other victims were simply put in harm's way. As in almost all such securities class actions, moreover, the main defendant is usually the corporation itself rather than individual wrongdoers, so that amounts paid in settlement or judgment (putting aside insurance) come indirectly out of the pockets of all current shareholders[13] even though they, too, were

8. An efficient market is one in which prices quickly respond to new information, so that trading disadvantages disappear within a short period of time. *See, e.g.*, Halliburton Co. v. Erica P. John Fund, Inc. (*Halliburton II*), 573 U.S. 258, 278–79 (2014). The underlying idea behind the fraud-on-the-market theory is that fraud in efficient markets harms all traders who assumed that the price was honestly and fairly set. *Id.* at 268.

9. I make no effort to define "disaster," and acknowledge that word can be used loosely to describe any bad news serious enough to lower a company's stock price. On the overuse of the term, see Elisa Gabbert, *What Separates Ordinary Bad News From True 'Disaster'?*, N.Y. TIMES MAG. (Apr. 10, 2018), https://www.nytimes.com/2018/04/10/magazine/what-separates-ordinary-bad-news-from-true-disaster.html [https://nyti.ms/2HnsK13].

10. *See Halliburton II*, 573 U.S. at 268.

11. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313–14 (2007) (applying a heightened pleading standard by requiring plaintiffs to state with particularity the facts evidencing scienter and "facts giving rise to a strong inference that the defendant acted with the required state of mind" (quoting 15 U.S.C. § 78u-4(b)(2))).

12. *See Halliburton II*, 573 U.S. at 269–71 (applying presumption of reliance for all traders who relied on corporations alleged misrepresentations simply by buying or selling stock in the marketplace); *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347 (2005) (requiring plaintiffs to show economic loss and that corporate action was the proximate cause of loss at pleading stage). Separately, plaintiffs must justify the use of the class action device by demonstrating that common issues predominate, which is the primary function of the reliance presumption.

13. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 73 (2011).

harmed by the catastrophe. The class of plaintiffs seeking recovery under Rule 10b-5 is limited to those who can demonstrate that they purchased shares after the deception began. Hence, there is a feverish effort by the plaintiffs' lawyers to maximize the size of the class—and the resulting recovery—by identifying as many false or misleading statements tied to the disaster, as far back in time as possible. Shareholders who bought after the alleged fraud began have some chance of recovery. Shareholders who bought before are double losers, suffering the share value loss from the disaster itself and from the additional litigation costs.[14]

Legal scholars have generated an abundance of literature examining each of the individual elements of the cause of action (and sub-elements, affirmative defenses, and so on) in an effort both to assess the soundness of prevailing doctrine and to contribute to the ongoing debate over whether such cases have positive net social value in the compensation they offer or the deterrence they provide.[15] Less attention, however, has been given to the interplay of all of the elements, or to identifying the unifying themes that lead to the success or failure of the lawsuit.

As just noted, disaster fraud cases are primarily about distortions regarding the alleged misrepresentation or concealment of risk factors prior to the crisis. In an ideal world, all serious risk factors would naturally be subject to a duty to disclose—there is no compelling social value to justify deliberate concealment of serious danger. Yet for a host of doctrinal, pragmatic, and political reasons, there is no such clear-cut duty, even when what is concealed is plainly material. The Securities and Exchange Commission (SEC) has imposed a set of requirements that forces risk disclosure in some circumstances, but it does so neither consistently nor adequately.[16] When asked to fill the SEC's regulatory gap, courts considering fraud-on-the-market cases, in turn, have made a company's duty to disclose largely a matter of active rather than passive concealment—literally, wordplay. There is no antifraud-based duty to disclose risks unless—perhaps—the SEC has declared such a duty by rule, or the issuer has otherwise said enough

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14. *See* Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1437–40 (1994).

15. *Compare* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006) (arguing that securities litigation fails to effectively achieve optimal deterrence), *with* James Cameron Spindler, *We Have a Consensus on Fraud on the Market—And It's Wrong*, 7 HARV. BUS. L. REV. 67 (2017) (arguing that securities litigation adequately compensates defrauded purchasers and deters fraud by incentivizing investors to take precautionary costs). *See also* James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164 (2009) (arguing that although private securities litigation statutes typically achieve their intended purposes, SEC enforcement efforts focus on weak targets while allowing "big fish" to get away).

16. *See infra* Section I.C.

to put the particular kind of risk in play.[17] But explaining when and why there is a duty to reveal hidden risks or not flummoxes courts.

A particularly striking example can be found in the litigation following what is said to be Brazil's worst environmental disaster: the collapse of the Fundão dam in November 2015.[18] The dam, which held back forty million liters of toxic sludge from mining operations, was owned by a joint venture between two global companies with mines nearby, Vale and BHP Billiton.[19] Because both companies had securities traded in the United States, 10b-5 lawsuits were filed separately against each in the Southern District of New York for making statements touting their commitment to the safety and sustainability of their projects while not revealing facts, allegedly known to both Vale and BHB Billiton, indicating that Fundão was at risk.[20] The public statements each made with respect to each company's commitment to safety and the environment were comparably soft and filled with marble-mouthed generalities. For example, some of the statements at issue in the proceedings against Vale were made at the company's Capital Markets Day conference, during which company officials stated that "we are striving to build a company of solid values"—including "respect for the environment and genuine care for the safety and well-being of fellow colleagues and respect for the communities in which our company operates"—that and "we seek nothing less than zero harm."[21] Similarly, statements at issue against BHP Billiton were made during a full-year earnings presentation, during which company officials stated that "[t]he health and safety of our people must come first and so across BHP Billiton we've interacted with the whole workforce to reaffirm our commitment to their safety and wellbeing, and to insist any work that is unsafe must be stopped."[22] Yet the reactions of the two district judges, ruling just a few months apart, were palpably inconsistent on whether statements like these could mislead the reasonable investor. No, said the judge in the Vale case, because the touting was "inactionable puffery" with no solid communicative

17. For a relatively early expression of this, see *In re Craftmatic Securities Litigation*, 890 F.2d 628, 640 (3d Cir. 1989) (holding that corporation has duty to disclose unlawful marketing practice in light of affirmative statements touting marketing prowess). For more on the topic of risk disclosure, see J. ROBERT BROWN JR. & ALLISON HERREN LEE, THE REGULATION OF CORPORATE DISCLOSURE § 10.03[D] (rev. 4th ed. Supp. II 2018).

18. GlobalPost, *Brazil's Worst Environmental Disaster, In Pictures*, PUB. RADIO INT'L (Jan. 17, 2016, 12:00 PM), https://www.pri.org/stories/2016-01-17/brazils-worst-environmental-disaster-pictures [https://perma.cc/FT96-2BZH].

19. Dom Phillips & Davilson Brasileiro, *Brazil Dam Disaster: Firm Knew of Potential Impact Months in Advance*, GUARDIAN (Mar. 1, 2018, 1:55 AM), https://www.theguardian.com/world/2018/feb/28/brazil-dam-collapse-samarco-fundao-mining [https://perma.cc/5SAC-4M5U].

20. Consol. Amended Class Action Complaint, *In re* Vale S.A. Sec. Litig., No. 1:15-CV-9539-GHW, 2017 WL 1102666 (S.D.N.Y. Mar. 23, 2017), 2016 WL 3125908 [hereinafter Vale Complaint]; Consol. Amended Complaint for Violations of the Fed. Sec. Laws, *In re* BHP Billiton Ltd. Sec. Litig., 276 F. Supp. 3d 65 (S.D.N.Y. 2017) (No. 1:16-cv-01445-NRB), 2016 WL 8117329 [hereinafter BHP Complaint].

21. Vale Complaint, *supra* note 20, at 45–46.

22. BHP Complaint, *supra* note 20, at 72.

content.[23] Yes, said the judge in the BHP case, because although the touting statements might indeed be general, they were nonetheless made in a way that stressed the importance of mine safety "over and over and over," suggesting that the company knew that reasonable investors cared about these risks, and further suggesting the possibility that the company was intentionally misleading its investors.[24]

So which judge was right, and why? This incoherence could be rationalized by a more thoughtful assessment of how words matter to investors and a better appreciation of the variable role that managerial credibility plays in the process of disclosure and interpretation.[25] Yet it is fair to ask whether wordplay, even if more thoughtfully assessed, should make so much of a difference in determining whether a company has breached its duty to disclose, or whether instead our impoverished conception of the duty to disclose deserves the more thorough makeover. Certainly, the fraud-on-the-market suit is not the only enforcement device for dealing with managerial fraud and concealment, and courts are not statutorily charged with optimizing the disclosure system. A comprehensive study of a corporation's duty to truthfully disclose impending and in-progress disasters would extend beyond the topics discussed in this Article. Nonetheless, what this Article does cover is woefully undertheorized and capable of improvement even if it is only a piece of a larger puzzle.

There are many payoffs from this kind of inquiry, both academic and practical. By looking closely at alleged falsity over the course of a disaster timeline, we get a better glimpse of how disclosure works in real time, as corporate executives and the company's lawyers craft strategic responses to the line-item disclosure obligations that the SEC imposes and negotiate the murky world of voluntary disclosure.[26] Among these considerations is whether to reveal more than the SEC requires about the risks the company confronts in the face of marketplace pressures from analysts, institutional investors, the media, and other vocal

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23. *In re Vale*, 2017 WL 1102666, at *21–22 (concluding that "the challenged statements [were] a set of aspirational generalizations which are 'too general to cause a reasonable investor to rely upon them' and . . . are 'precisely the type of "puffery"' that Second Circuit [Court of Appeals] has 'consistently held to be inactionable'" (quoting ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009))). The court did, however, allow the case to go forward with respect to separate allegations that Vale misled investors as to the mitigation plans and procedures in place and in certain post-accident public statements. *Id.* at *35.

24. *In re BHP Billiton*, 276 F. Supp. 3d at 80 (concluding that "[b]y touting its commitment to safety to such a degree, BHP put the topic 'at issue'"). Although in footnote four, the court distinguished the alleged misrepresentations in *In re Vale* as "significantly more specific" than the ones before it, it is hard to see much of a distinction from a side-by-side comparison of the disclosures in question. *Id.* at 79 n.4. For a similar holding, see *In re Electrobras Securities Litigation*, 245 F. Supp. 3d 450, 463–64 (S.D.N.Y. 2017).

25. For a discussion of the misalignment between the disclosure requirements of the federal securities laws and the private causes of action available to investors to enforce those requirements, see Ann M. Lipton, *Reviving Reliance*, 86 FORDHAM L. REV. 91 (2017).

26. *See* Zahn Bozanic, Preeti Choudhary & Kenneth J. Merkley, *Securities Law Expertise and Corporate Disclosure*, 94 ACCT. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2662096 [https://perma.cc/AU9S-JGR5] (finding evidence that elite securities lawyers successfully help clients avoid disclosing what they don't want to disclose).

stakeholders. Financial economics research is paying more attention to these complex interactions, essentially, the microstructure of corporate communications. These interactions are far more nuanced than the simplified assumptions about market efficiency that prevailed for so long in law and economics.[27] Courts seem to be a step behind in understanding these nuances, and lawyers have learned how to exploit the doctrinal soft spots that result. As we shall see, small differences in language matter, and these differences invite obfuscation, gamesmanship, and avoidance.

In terms of fraud-on-the-market liability exposure, disasters are an ideal, if disturbing, setting for thinking through the background norms of corporate discourse—the implicit rules for how marketplace actors interpret what issuers do and do not say, whether in formal SEC disclosures, conference calls, press conferences, or even executive tweets.[28] Corporate disasters also offer a distinctive reference point for thinking about contemporary controversies associated with importing matters of social responsibility, law abidingness and sustainability—for example, environmental compliance, cybersecurity, product safety—into the realm of securities law.[29] Especially as the attention paid to environmental, regulatory, and social risks increases, alongside mounting fears of future disasters, this subject will surely grow in both interest and importance.

To this end, Part I explores the duty to disclose disaster-related risks, separating between two main sources of disclosure obligations in the run-up to catastrophe: SEC mandated disclosures and fraud-based obligations such as the half-truth doctrine, which enable much of the gamesmanship. Part II then examines the especially problematic duty questions that arise when what was concealed was either an investigation by regulators or prosecutors or the unlawful behavior itself. Part III turns to the duty to disclose once the crisis has become public, so that the issuer is narrating the disaster as it unfolds. The Article then turns to ways in which the duty to disclose interacts with other elements of the 10b-5 cause of action as applied to corporate disasters. Part IV considers the connections between duty and scienter; Part V does the same with respect to causation and damages. Part VI then applies all the foregoing to the burgeoning subject of sustainability disclosure.

27. *See infra* notes 65–68.

28. *See* Gregory S. Miller & Douglas J. Skinner, *The Evolving Disclosure Landscape: How Changes in Technology, the Media, and Capital Markets Are Affecting Disclosure*, 53 J. ACCT. RES. 221 (2015) (examining how changes in technology and the creation of new platforms for corporate disclosures have altered the norms of corporate discourse).

29. *See generally* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999) (arguing for expanded social disclosures to promote corporate social transparency).

# I. DISASTERS AND DECEPTION

## A. THE CENTRALITY OF DUTY

The law at work in determining whether there was deception in the course of a corporate disaster—and if so, when it began—derives from a fundamental question: Does, or should, the issuer have a duty to disclose material inside information that indicates that a disaster is looming, if not already in progress? In principle, at least, it is hard to see why there should not be, assuming that we wish for stock prices to be as accurate as possible.[30] Corporate disaster information is not the sort that we privilege from disclosure in the interest of encouraging production and innovation—the main reason for truncating disclosure duties.[31] Although the issuer that makes such disclosure will suffer—as will its shareholders—the benefit of candor to the market at large, coupled with the socially beneficial externalities in the allocation of capital, better corporate governance, and otherwise, seem to trump the company's self-interest in hiding bad news.

This is not to deny that there are real costs to consider when mandating this kind of risk disclosure. These include the cost of collecting information and weeding out the immaterial risks from the material ones, and the concern that premature speculation may lead to overreaction by investors and other stakeholders.[32] More subtly, there is fear of the self-fulfilling prophecy: that disclosure of a possibility, such as a threatened government lawsuit, by itself makes the disaster more likely or weakens the company's ability to prevent it. All of this is part of the balancing the SEC is supposed to conduct when deciding what to mandate or whether to bring enforcement actions. This Article does not attempt to formulate ideal disclosure policy for disaster-related risks in general. My sense, for what it is worth, is that the SEC has fallen far short of the optimal solution in its policies relating to risk disclosure,[33] and that this failing has had an unfortunate spillover effect on fraud litigation.

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30. *See, e.g.*, Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 312 (stating that greater disclosure increases share price accuracy, which in turn reduces risk); Sale & Thompson, *supra* note 4, at 530–31 (discussing how securities regulation and enforcement facilitate investor confidence in the marketplace, which fosters growth and innovation).

31. *See* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 856 (1995) (discussing how innovation and risk-taking would occur less frequently under an expansive disclosure regime requiring firms to disclose all "the thoughts and plans" of management).

32. A recent study of cyberattack-related disclosures observes that issuers that address these kinds of risks are often perceived by the market as signaling a higher than normal level of trouble, causing a negative price reaction vis-à-vis those who avoid the issue. Edward A. Morse et al., *SEC Cybersecurity Guidelines: Insights into the Utility of Risk Factor Disclosures for Investors*, 73 BUS. LAW. 1, 30–32 (2017).

33. *See* Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753 (1997) (discussing adequacy of risk disclosure requirements under federal securities regulation in context of investment technology). For a thoughtful argument that such problems might be effectively addressed by allowing issuers to bargain with interested users to allow limited selective access to their disclosures, see generally Kevin S. Haeberle & M. Todd Henderson, *Making a Market for Corporate Disclosure*, 35 YALE J. REG. 383 (2018).

The courts play a backup role to SEC regulation, imposing disclosure duties only to the extent that nondisclosure constitutes fraud. Courts naturally insist that the concealed truth must be material—that is, of importance to a reasonable investor.[34] But that is only the starting point, even if many plaintiffs and their lawyers wish otherwise. There is no liability simply because investors would consider the secret important and would like to know it.[35] There must also be a duty to speak. Although there are several duty theories that plaintiffs can invoke, the most important by far is the half-truth doctrine: once the issuer speaks, it must tell both the literal truth and the whole truth, including any hidden facts necessary to make what is said not misleading.[36] This potent coupling is found in the text of the most important express antifraud provisions under the securities laws[37] as well as in Rule 10b-5.[38] In its recent *Omnicare* decision, the Supreme Court had much to say about finding half-truths in statements of opinion, which in that case related to a large compliance failure.[39] *Omnicare* is informative in all disaster cases, as we shall see.[40]

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34. These same challenges arise in the assessment of materiality. *See* Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 30 (2011). Though usually treated as a stand-alone requirement, the materiality determination is really just a part of assessing whether a misstatement or omission was deceptive. *Id.* at 38–45 (assessing materiality but emphasizing that it is a fact-specific inquiry that considers the source, content, and context to determine how a reasonable investor would view the information).

35. In other words, materiality does not itself create a duty. This step was not obvious as a matter of law until the early 1980s, when it emerged out of dicta in two Supreme Court decisions: *Chiarella v. United States*, 445 U.S. 222, 235 (1980) ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."), an insider trading case, and *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("To be actionable, of course, a statement must also be misleading."), a materiality decision. As the law of duty formed in this indirect manner, there is no overarching theory. This has led to a "muddled" body of precedent. *See* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1646–74 (2004) (identifying major areas in which there is inconsistency on the basic duty question in the caselaw). On the duty to disclose prior to those two Supreme Court decisions, see Jeffrey D. Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

36. As courts often point out, this is not actually a disclosure obligation because the fraud is in what was said, rather than what was not said. Nonetheless, it operates as such if the only way to speak truthfully would be to reveal the hidden fact. *See* Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences By Investors and Others*, 52 STAN. L. REV. 87 (1999) (analyzing the connection between the half-truth doctrine and an affirmative disclosure duty). The other forms of duty include fiduciary obligations, and the duties to update and correct. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 722–26 (8th ed. 2017). Though, in theory, these can be raised in disaster cases, they tend not to be.

37. Securities Act of 1933 § 11, 15 U.S.C. § 77k (2012).

38. 17 C.F.R. § 240.10b-5 (2018).

39. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1327–32 (2015). *Omnicare* was a section 11 case brought pursuant to the Securities Act of 1933, but following this opinion, most courts have extended its reasoning to fraud-on-the-market litigation under Rule 10b-5. *See, e.g.*, City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 610 (9th Cir. 2017) (holding that "the three standards for pleading falsity of opinion statements articulated in [*Omnicare*] apply to Section 10(b) and Rule 10b-5 claims").

40. Hillary Sale and I recently explored both the discourse and corporate governance implications of *Omnicare*, the substance of which need not be repeated here. *See* Hillary A. Sale & Donald C. Langevoort, *"We Believe":* Omnicare*, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763 (2016); *see also* James D. Cox, *"We're Cool" Statements After* Omnicare: *Securities Fraud Suits*

The half-truth doctrine forces judges to assess claims of hidden risks by looking at whether what was undisclosed rendered what was said incomplete, thereby crossing the dividing line from passive to active concealment. For example, in the Deepwater Horizon securities lawsuit, the main pre-explosion storyline put forth by the plaintiffs was that BP was stressing enhanced safety measures that were put in place after a previous oil spill disaster, while failing to reveal the extent to which rigs not directly owned by BP, like Deepwater, were not subject to the same procedures.[41] In the Fundão dam cases, the touting allegedly covered up private warnings over a series of years from contractors, inspectors, and licensing authorities questioning the stability of the dam.[42] Any careful reader of judicial decisions in this area involving defendants' pretrial motions to dismiss will note how much time is spent going one by one through plaintiffs' often lengthy list of claimed misrepresentations and omissions to determine whether a reasonable investor would really have been misled by them, assuming the plaintiffs' claims about hidden risks are factually accurate.

This task is taken on by judges with surprising boldness, even though that question is decidedly difficult to answer given how many different kinds of investors interact in our financial markets and the varying mixes of information to which they have access.[43] Indeed, questions of how reasonable investors think seem like mixed questions of law and fact of the sort commonly left to fact finders at trial.[44] Yet many judges unapologetically take on these questions of meaning to decide on their own. This stepped-up judicial role has been noted by a number of legal scholars, some of whom have expressed concern about whether such judges are usurping the fact-finding prerogative of juries.[45]

*for Failures to Comply with the Law*, 68 SMU L. REV. 715 (2015) (discussing the implications of *Omnicare* in assessing whether statements of opinion are misleading).

41. *See In re* BP P.L.C. Sec. Litig., 922 F. Supp. 2d 600, 608–09 (S.D. Tex. 2013). There were also post-explosion disclosure issues, discussed *infra* at notes 171–72. A prior BP disaster also triggered high-profile shareholder litigation and was the background for the subsequent Deepwater claims. *See* Reese v. Malone, 747 F.3d 557, 563 (9th Cir. 2014).

42. *See supra* text accompanying notes 18–24.

43. For just a sampling of the literature discussing these challenges, see David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 539–40 (2006) (discussing difficulties in assessing who and what is a "reasonable" investor); Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581 (2017) (arguing that the intended audience for disclosure requirements should be sophisticated investors); Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461, 462 (2015) (arguing that disclosure regulations are founded on a "fallacy of homogenous investors"). Some courts describe this as a materiality inquiry, but that is incorrect. The question is not whether a reasonable investor would consider the statement important on its face but rather whether the reasonable investor would be misled by the omission of a material fact. *See supra* note 35.

44. It is well understood in both the caselaw and academic commentary that fraud-on-the-market trials almost never occur, because the high-stakes case will be settled beforehand. *See* COX ET AL., *supra* note 36, at 699–702 (discussing controversy over "extortionate" litigation). Hence the stepped-up pretrial judicial role on these fact-like questions mainly helps to determine whether there will be a settlement (yes, in all likelihood, unless the case is dismissed) and how much money defendants will agree to pay.

45. How courts make such decisions as a matter of law is unclear. One influential article claims that judges are disinterested in these kinds of cases, and employ simple, often empirically doubtful, heuristics. Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way*

Here, I want to put both motivation and procedural legitimacy to the side and dig deeper into the norms of implicature associated with a looming or imminent disaster—what investors are likely, or should be entitled, to draw from corporate statements about the risk and reality beyond the strict confines of the words employed. Implicature is a word used by philosophers who study truth-telling and lies to explain, for instance, why it is deceitful to respond accurately to a request for directions to a gas station from a hapless out-of-town visitor without mentioning that the gas station is closed.[46] It is deceitful because the speaker was signaling a willingness to be helpful and cooperative and was instead being just the opposite. Our question is whether corporate executives should be held to a similarly cooperative signal when communicating with investors.

Certain patterns of argument are typical in these cases. Defendants commonly claim that whatever was said, no matter how positive, was too general, speculative, or vague to be anything more than "puffery," such that it was neither material nor misleading regardless of what was left unsaid.[47] The reasonable investor, these defendants argue, knows not to rely on statements devoid of hard facts or concrete representations, and can read between the lines well enough to know what is not being said; the investor would thus tread carefully rather than assume that he has been told all that is important. Soft language, in other words, does not matter at all. Moreover, this defense is often coupled with the argument that the securities laws are not meant to force corporations to accuse themselves of

*Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 86 (2002); *see also* Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 904 (2002) (exploring the development and implications of the use of heuristics in securities law cases). Or perhaps politics are at work, so that business friendliness is the real driver behind the rate of aggressive dismissals. Sale, *supra*, at 911–12. I have argued that judges are inclined to substitute themselves for the reasonable investor and ask whether they would have felt misled, which introduces a bias when the judge has an inflated sense of self-efficacy or unrealistically demanding sense of how investors *should* react to disclosures. Donald C. Langevoort, Review Essay, *Are Judges Motivated to Create "Good" Securities Fraud Doctrine?*, 51 EMORY L.J. 309, 317–18 (2002).

As to how judges justify taking on the role of interpreter as a matter of law, the answer probably is a mixture of insistence on heightened fraud pleading and a long tradition, especially in contract law, of giving judges primacy of the meaning of the written word. *See* William C. Whitford, *The Role of the Jury (and the Fact/Law Distinction) in the Interpretation of Written Contracts*, 2001 WIS. L. REV. 931, 932 n.3; *see also* Antilles S.S. Co. v. Members of the Am. Hull Ins. Syndicate, 733 F.2d 195, 202–06 (2d Cir. 1984) (Newman, J., concurring).

46. *See* PAUL GRICE, STUDIES IN THE WAY OF WORDS 22–40 (1989). For a sampling of the literature putting implicature to use in business settings, see Robert J. Bloomfield, Commentary, *A Pragmatic Approach to More Efficient Corporate Disclosure*, 26 ACCT. HORIZONS 357, 362–63 (2012) (discussing implicature versus explicature in corporate disclosure obligations); Langevoort & Gulati, *supra* note 35, at 1664–71 (discussing half-truths in the context of 10b-5 obligations); Peter Tiersma, *The Language of Silence*, 48 RUTGERS L. REV. 1, 50–56 (1995) (discussing how silence can constitute fraud). *See generally* Gregory Klass, *The Law of Deception: A Research Agenda*, 89 U. COLO. L. REV. 707, 718–25 (2018) (describing varied rules of interpretation in the "law of deception").

47. *See* City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG (*City of Pontiac*), 752 F.3d 173, 183 (2d Cir. 2014) ("It is well-established that general statements about reputation, integrity, and compliance with ethical norms are inactionable 'puffery,' meaning that they are 'too general to cause a reasonable investor to rely upon them.'" (quoting ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009))). For a good recent discussion of cases going both ways, see Lipton, *supra* note 25, at 112–16.

wrongdoing or mismanagement, so that reasonable investors will not expect such confessions against the corporate self-interest.[48] All this becomes the contested territory that judges have to work their way through.

There are countless examples of the battling: the Deepwater Horizon and Fundão dam cases have already been noted, but many others could be plucked from recent headline news (Volkswagen[49] and Wells Fargo,[50] among others). An especially intriguing example involves a lesser kind of disaster: the Hewlett–Packard (HP) corporate governance scandal, wherein HP's highly regarded CEO was forced out after allegations of sexual harassment and a cover-up.[51] Were the CEO and others' statements touting HP's improved code of conduct—a response to an earlier corporate governance disaster at the company—misleading for a failure to disclose the CEO's apparent disregard of the code? The Ninth Circuit said no—the statements were too vague or aspirational for the reasonable investor to take as a commitment.[52] The remainder of this Part seeks a better approach to issues like this.

### B. "VOLUNTARY" DISCLOSURES

We start the search by asking whether the disclosure in question was voluntary or required pursuant to a SEC rule. Presumably, investor assumptions and expectations change when a message is offered voluntarily as compared to one made under the compulsion of a disclosure regime meant for the investor's benefit. Because the SEC is Congress's chosen disclosure-standard setter, it might seem appropriate to start with its mandates. But for reasons that will become clear, most disaster-related disclosure issues arise out of voluntary disclosures, where judicial responses focus almost entirely on whether what was said was misleading, as opposed to whether one or more line items imposed a duty. So, we begin there.

It has long been acknowledged that investors have a strong thirst for information well beyond what mandatory disclosure offers, especially with respect to forward-looking information. The value of any financial asset depends on the future stream of earnings it is expected to generate, for which the past is simply a baseline (and sometimes a misleading one). Securities analysts take the lead here

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48. *See, e.g.*, *City of Pontiac*, 752 F.3d at 184. There is a long history of similar dicta, going back to the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 478 (1977) (noting Rule 10b-5 is not meant to provide a remedy for corporate mismanagement).

49. *In re* Volkswagen Clean Diesel Mktg., Sales Practices Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,817, 2017 WL 3310179 (N.D. Cal. July 19, 2017).

50. *In re* Wells Fargo & Co. S'holder Derivative Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,900, 2017 WL 4557745 (N.D. Cal. Oct. 4, 2017).

51. Jonathan Stempel, *HP, Ex-CEO Hurd Win Dismissal of Lawsuit Over Harassment Scandal*, REUTERS (Aug. 12, 2013, 2:13 PM), https://www.reuters.com/article/us-hewlettpackard-ceo-lawsuit-idUSBRE97B0OG20130812 [https://perma.cc/L8V5-ZXGM].

52. *See* Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett–Packard Co., 845 F.3d 1268, 1276 (9th Cir. 2017). For a broader discussion of how corporate and securities law apply to claims of sexual harassment, see Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583 (2018).

by gathering data and generating projections about the issuer's future prospects for the benefit of institutional clients—and, on the sell side, the public investors who read their reports. They seek access to management insights via both conference calls and private audiences with management, within the limits set by the SEC.[53] Pressure on management to disclose comes from other sources as well, such as the financial media, stock exchanges, regulators, and social and investor activists. In the aggregate, these are part of the uncomfortable demands of publicness.[54]

Of course, managers have considerable discretion in whether and how to respond. They may be hesitant, especially given advice from their lawyers, to make disclosures that might inflate expectations and generate future litigation. And they would certainly prefer not to reveal their failures or troublesome risks. But they cannot ignore the financial market pressures.[55] Failure to develop a reputation for real-time candor will result in a depressed stock price. To avoid this, most companies choose to make voluntary disclosures on an ongoing basis, with an emphasis on future performance.

These are purely investor-driven incentives to disclose. But as society in general—now facing many environmental and other sustainability threats—becomes more sensitive to private sector risk-taking, worries about looming disasters generate economic and political interest as well.[56] Climate change palpably triggers similar short- and long-term concerns, as do matters of safety, cybersecurity, and human rights. Hence, there is considerable pressure on companies to address

53. *See generally* Lawrence D. Brown et al., *The Activities of Buy-Side Analysts and the Determinants of Their Stock Recommendations*, 62 J. ACCT. & ECON. 139 (2016) (providing evidence of the scope of buy-side security analysts' private communications with management); Lawrence D. Brown et al., *Inside the "Black Box" of Sell-Side Financial Analysts*, 53 J. ACCT. RES. 1 (2015) (same with respect to sell-side security analysts). The SEC's Regulation F–D bars selective disclosure to analysts, in order to force issuers into public disclosure of any material nonpublic information they want to disclose at all.

54. *See supra* note 4.

55. Research in financial markets shows that firms' disclosure choices both influence and are influenced by the kinds of investors the firm attracts. *See, e.g.*, Brian J. Bushee & Christopher F. Noe, *Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility*, 38 J. ACCT. RES. 171 (2000) (showing different practices with respect to transient and long-term investors). An important legal debate emerged in academia in the 1980s, and continues to this day, about whether mandatory disclosure was necessary in light of the pressures and incentives for voluntary disclosure and, if so, how and why. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (analyzing efficiency-based justifications for mandatory disclosure); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (finding that mandatory disclosure may be unnecessary given incentive for voluntary disclosure); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (finding that mandatory disclosure is the socially optimal system given trade-offs in choice of disclosure regime); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (arguing that competitive state regulation is preferable to mandatory federal regime). For a more recent assessment by financial economists, see generally Luca Enriques & Sergio Gilotta, *Disclosure and Financial Market Regulation*, *in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION 511 (Niamh Moloney et al. eds., 2015).

56. For examples of recent environmental and sustainability disasters generating significant interest from the public, see *supra* notes 1, 18–19, 49–50.

these issues on a regular basis for a broader audience, increasingly in elaborate, written "sustainability reports." The content of these reports will often be at issue in disaster-related securities fraud claims, as we shall see. The growing interest in environmental, social, and governance (ESG) disclosure is at least partly non-financial—prodding companies toward greater social responsibility for its own sake—but the distinction is fuzzy.[57] Companies indifferent to sustainability may lag financially, and an increasing number of long-term investors report an interest in how management addresses these diffuse risks and handles stresses.[58] In other words, there is a large group of people interested in ESG disclosures for financial reasons that are impossible to separate from the more public policy-based ones.

This public curiosity naturally tempts those who speak on the issuer's behalf to try to manage and promote favorable public and investor opinions. Voluntary disclosures thus tend to accentuate the positive, though that optimism may be tempered by lawyer-driven warnings about generic risks and forward-looking uncertainty. And that takes us back to fraud-on-the-market litigation. After a disaster occurs, plaintiffs' counsel will comb through every pre-disaster upbeat statement to identify what may have had the propensity to mislead investors, all of which (with the accompanying scienter allegations) become the core of their fraud-on-the-market lawsuit. Plaintiffs search for blatant lies if possible but are more likely to find plausible allegations of half-truths based on what was concealed. Complaints usually offer scores of individual statements said to have deceived, which courts will individually evaluate in response to defendants' motion to dismiss denying that any of the omissions were fraudulent. How judges do this evaluation is worth more careful attention than it has gotten.

1. Language Matters, Even in Efficient Markets

Probably the most common judicial explanation for a skeptical approach to whether a reasonable investor would be misled by any kind of soft pre-disaster optimism is that investors are a savvy lot, steely-eyed, and not easily tricked. Of course, judges understand that average investors are often not that sophisticated, but at least in fraud-on-the-market cases, they work on the assumption that sophisticated institutional investors drive securities prices, thus justifying heightened rigor on how and when they might be deceived. This is the assumption, for

57. *See* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 667–68 (2016) (describing the link between financial and non-financial risk reduction in ESG disclosures).

58. *See generally* Chitru S. Fernando et al., *Corporate Environmental Policy and Shareholder Value: Following the Smart Money*, 52 J. FIN. & QUANTITATIVE ANALYSIS 2023 (2017) (examining evidence of negative financial impact of sustainability indifference and finding institutional investors invest less in firms with high environmental risk exposure). There is evidence of a separating equilibrium between long-term patient investors and short-term traders, with the demand for sustainability disclosures being from the former and not the latter. *See generally* Laura Starks et al., Corporate ESG Profiles and Investor Horizons (Oct. 9, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049943 [https://perma.cc/Q388-N9B4]. In turn, the level of voluntary ESG disclosure is higher in firms that attract more of the former to their shareholder base. *Id.*

example, behind the puffery doctrine noted earlier,[59] whereby courts routinely dismiss fraud claims based on general statements of optimism, no matter how ugly the concealed truth might be.[60] Puffery is the label courts most often use in disaster cases when dismissing cases on duty grounds; in so doing, those courts are essentially saying that because investors are unlikely to pay any attention to what was said in the first place, they could not have been misled by what was omitted.[61] The same thing happens in the treatment of forward-looking statements, embodied in such doctrines as the "bespeaks caution" doctrine (dismissing claims where investors were warned about future uncertainties)[62] or the notion that projections or estimates are not actionable unless characterized as reasonably certain to occur.[63]

Although many of these holdings simply accord with common sense, reflexively invoking the presumed mindset of the hyper-sophisticated investor to decide these cases has two problems. The first is that it proves too much. A thoroughly savvy, skeptical investor would never draw *any* inference beyond what was explicitly said, and would assume instead that any hedged or limited statement was an effort to avoid revealing more. But that renders the half-truth doctrine useless, contrary to the prominence it has in the text of Rule 10b-5 and the ample judicial embrace the doctrine has received. A meaningful half-truth principle must have some room for credulity.[64]

The other problem is an empirical one. In examining actual investor behavior—or price formation—in well-organized markets, what do we observe with respect to the influence of wordplay? For a long time, as noted earlier, assumptions about

59. *See supra* text accompanying notes 47–48.

60. *See, e.g.*, David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1405–1411 (2006) (describing the success of puffery defenses in securities cases). For critiques on the prevalence of the puffery defense, see Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 341 (2008) (finding that "between 33% and 84% of reasonable investors surveyed deemed the statements [in a Puffery Survey] material" whereas judges concluded otherwise), and Cox, *supra* note 40, at 718–19, 723–24 (arguing that courts should reconsider so readily accepting puffery defenses in the security context post-*Omnicare*).

61. *See, e.g.*, City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 183 (2d Cir. 2014) ("It is well-established that general statements about reputation, integrity and compliance with ethical norms are inactionable 'puffery,' meaning that they are 'too general to cause a reasonable investor to rely upon them.'" (quoting ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009))).

62. *See generally* Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994) (analyzing the evolution of the "bespeaks caution" doctrine); *see also* Hoffman, *supra* note 60, at 1406–09 (explaining how caselaw has developed to favor puffery defenses in the forward-looking statement context).

63. *See, e.g.*, Raab v. Gen. Physics Corp., 4 F.3d. 286, 290 (4th Cir. 1993) (holding that projections were immaterial puffery as a matter of law).

64. One could take this argument a step further and ask why any truly savvy person would ever rely on *anything* said by someone with conflicting interests, absent some form of proof. This, of course, is the economists' famous "lemons problem." *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). The law of fraud is an entitlement that invites and protects reliance in the face of doubts about credibility, thereby lowering transaction costs.

market efficiency supported a rigorous stance in fraud-on-the-market cases.[65] If market prices adjust immediately and in unbiased fashion to all news that becomes publicly available, we can surmise that in equilibrium the prevailing market price accurately reflects the fundamental value of the issuer's shares.[66] Credulousness could not possibly survive the rigors of market discipline. As this view ascended in law as well, courts simply assumed that these investors—the smart money—were thoroughly immune to puffery or cheap talk.[67]

Today, however, there is greater inclination to accept that market imperfections exist and are somewhat persistent. Although well-oiled markets surely remain the best available source of valuation even with these imperfections, market efficiency is viewed more as an idealized goal than a descriptive reality, largely because of high information costs.[68] Even professional investors have limited resources and capacity for attention.[69] As Andrew Lo puts it, markets may be *adaptively* efficient in that they continuously learn and hence improve toward the ideal, but repeatedly fall short in an always changing and costly informational environment.[70] This revisionism has received considerable scholarly attention in both law and finance, and made its way into the arguments before the Supreme Court in 2014 where the Court decided the fraud-on-the-market presumption of reliance was still viable even in the face of less-than-perfect efficiency.[71]

That more nuanced approach, however, does not by itself prove that wordplay matters. Highly relevant here, yet less familiar to lawyers, is a fast-emerging body of research in financial economics on the role of language in corporate disclosure. The impetus for this empirical work is the desire to improve the prediction of both good and bad futures for issuers using machine learning that looks

65. The classic article describing this subject—market efficiency assumptions (comprising the "efficient market hypothesis" or "efficient capital market hypothesis" as it is referred to therein)—is Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). For a more recent discussion, see generally Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L. REV. 313 (2014).

66. For some time, sociologists and organizational behavior scholars have argued that companies often successfully use sleights of hand to mislead investors. *See, e.g.*, James D. Westphal & Edward J. Zajac, *The Symbolic Management of Stockholders: Corporate Governance Reforms and Shareholder Reactions*, 43 ADMIN. SCI. Q. 127 (1998).

67. On the tendency of earlier courts to invoke unrealistically demanding views of market efficiency in fraud-on-the-market cases, see Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151.

68. *See generally* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992) (describing a critique of the efficient market hypothesis, in part, based on information costs). There is also considerable interest in the possibility that behavioral biases may influence market prices. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002).

69. *See* David Hirshleifer et al., *Driven to Distraction: Extraneous Events and Underreaction to Earnings News,* 64 J. FIN. 2289, 2296 (2009).

70. Andrew W. Lo, *Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis*, 7 J. INV. CONSULT. 21, 22 (2005).

71. Halliburton II, 134 S. Ct. 2398, 2410 (2014). The Court explicitly said that imperfect efficiency is not inconsistent with the reasons for the presumption of reliance in well-organized markets. *Id.*

for clues in how corporate disclosures speak to investors—tone, use of key words, length of sentences, focal points, etc.—separate and distinct from the hard information explicitly contained in the disclosures, such as the latest earnings per share.[72] For example, a shift over time to less readability (signaling obfuscation) correlates with a drop in later financial performance even though nothing actually said in the disclosures warned of the reasons for that decline.[73]

One important implication of this work is that ordinary language indeed matters more than we previously thought. These empirical findings give sophisticated investors new arbitrage opportunities to trade on such cues,[74] and so this work has become of substantial interest as an algorithmic tool.[75] At the same time, it also appears to demonstrate *ex ante* that the market is susceptible to language-based impression management. Wording, syntax, hyperbole, euphemisms, and tone can carry value-relevant messages, though how much and for how long will vary.[76] There is evidence as well that the price effects of this kind of soft deception may persist for some time.[77]

A plausible explanation for this—taking us back to our discussion of linguistic implicature—is that sophisticated investors use management credibility as a

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72. A good survey of this work is Tim Loughran & Bill McDonald, *Textual Analysis in Accounting and Finance: A Survey*, 54 J. ACCT. RES. 1187 (2016).

73. *E.g.*, Gerard Hoberg & Craig Lewis, *Do Fraudulent Firms Produce Abnormal Disclosure?*, 43 J. CORP. FIN. 58, 82 (2017); *see also* Xuan Huang et al., *Tone Management*, 89 ACCT. REV. 1083, 1111 (2014) (finding that abnormal positive tone in earnings press releases predicts negative future earnings and cash flows); *cf.* David F. Larcker & Anastasia A. Zakolyukina, *Detecting Deceptive Discussions in Conference Calls*, 50 J. ACCT. RES. 495, 496–99 (2012) (analyzing linguistic features present in CEO and CFO statements during quarterly earnings conference calls); Jonathan L. Rogers et al., *Disclosure Tone and Shareholder Litigation*, 86 ACCT. REV. 2155, 2179 (2011) (finding that optimistic language in earnings announcements is associated with greater litigation risk).

74. There is substantial evidence, for example, that sophisticated analysts pick up on tone-related tips and tells. *See* Marina Druz et al., *Reading Managerial Tone: How Analysts and the Market Respond to Conference Calls* 34 (Harv. Kennedy Sch. Faculty Research Series, Working Paper No. 16-004, 2016). Presumably this arbitrage will improve pricing in light of what the cures reveal, though one wonders whether managers will then change their language in response.

75. Recent advances in algorithmic trading apply syntax and tone assessments to various forms of news releases to trigger high-speed trades. The result of enough arbitrage, of course, would be to eliminate the advantages. For an expression of concern about this kind of trading, see Yesha Yadav, *How Algorithmic Trading Undermines Efficiency in Capital Markets*, 68 VAND. L. REV. 1607, 1664–65, 1670 (2015). Not surprisingly, the SEC is also interested in this work as a tool for the early identification of fraud risk. *See, e.g.*, Scott W. Bauguess, Acting Director and Acting Chief Economist, DERA, Champagne Keynote Address: The Role of Big Data, Machine Learning, and AI in Assessing Risks (June 21, 2017), https://www.sec.gov/news/speech/bauguess-big-data-ai [https://perma.cc/B8PS-G4PP].

76. *E.g.*, Kate Suslava, "Stiff Business Headwinds and Uncharted Economic Waters": The Use of Euphemisms in Earnings Conference Calls 22 (July 17, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2876819 [https://perma.cc/LN2F-2CGK].

77. *E.g.*, Joshua Lee, *Can Investors Detect Managers' Lack of Spontaneity? Adherence to Predetermined Scripts During Earnings Conference Calls*, 91 ACCT. REV. 229, 239, 247 (2016); *see also* Huang et al., *supra* note 73, at 1111 (uncovering strong evidence of tone misleading market actors). To be sure, one insight from this work is that investors underreact to such information, which does not necessarily mean that they are deceived by it. But the studies as a whole offer some evidence of successful deception, and ample evidence contrary to the assumptions that investors pay no attention to soft language at all, or should simply ignore it.

heuristic to simplify their task. There is ample evidence that credibility is a variable in the fundamental valuation calculus; over time, investors form impressions of how reliable managers are and act accordingly.[78] When management's credibility is high based on investors' prior experience, even general optimism can be influential on matters to which management has exclusive knowledge. So, if management is asked how the current quarter is shaping up compared to last year, "fine" (or "beautifully") could mislead if the truth was substantially at odds. And merely warning that the future is unpredictable and that things could go awry would not undermine the value of a revenue estimate when there is high credibility. Unfortunately, looming disasters often enough cause previously credible managers to spend, if not waste, their reputational capital to avoid blame by misrepresenting or concealing information on what is happening or about to happen.[79] When this occurs, soft language can indeed deceive.

Hiding behind euphemisms, puffery, or what might be technically true but nonetheless misleading can be especially pernicious. Psychological evidence shows that speakers tend to believe that such "artful paltering" is less objectionable than making a positive misrepresentation—in other words, the internal norms that warn us not to lie are weaker with respect to half-truths.[80] Thus, individuals may deceive both more frequently and more effectively by paltering than telling an abject lie.[81] If language does matter, courts should be especially alert for such temptations when disaster threatens, and certainly not assume them away.

2. Normative Guidance

We have now seen that there are problems in simply assuming away the influence of soft language in the pre-disaster stage, particularly when credibility is high. But none of this tells courts what to do instead. To some extent, for the reasons just given, my suggestions are to weigh on the side of contextualism rather than assessing the propensity to mislead by concentrating on words and phrases in isolation. But I hope to be more helpful than that.

The essential starting point here is to remember that the goal in fraud-on-the-market cases is not just about predicting how investors respond to words. Rather, the remedy is an entitlement given to investors to facilitate reliance even where it might be palpably risky given asymmetric information and management's self-

78. *E.g.*, Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 ACCT. HORIZONS 185, 194 (2004). This is one reason for stock price drops in the aftermath of disaster that seem to exceed the fundamental value of the bad news in question—they reflect a downward revision of credibility as well, calling into question other value assumptions.

79. Nor must such deception necessarily be intentional: there are non-verbal cues in managerial communications that signal cognitive dissonance (the unconscious discomfort of seeking to reconcile prior beliefs and commitments with new disconfirming information), which can blind people to the truth. *See* Jessen L. Hobson et al., *Analyzing Speech to Detect Financial Misreporting*, 50 J. ACCT. RES. 349, 351 (2012) (defining cognitive dissonance and studying it as a vocal marker of deception).

80. *See, e.g.*, Todd Rogers et al., *Artful Paltering: The Risks and Rewards of Using Truthful Statements to Mislead Others*, 112 J. PERSONALITY & SOC. PSYCH. 456, 457 (2017).

81. *Id.*

interest in hiding bad news. In other words, it is more about *right* to rely than but-for causation. This idea underlies the fraud-on-the-market presumption as what I have described as an offering of "juristic grace."[82] The Supreme Court in both *Basic* and *Halliburton II* affords investors a presumption of reliance on the integrity of the prevailing market price not because smart investors naïvely assume management integrity, but because offering it stimulates socially valuable investment in the face of risk.[83]

We can see this normative reliance-encouraging turn in other Supreme Court decisions as well. In *Virginia Bankshares Inc. v. Sandberg*, the Court rejected the idea that reasonable investors necessarily treat statements of opinion by boards of directors as immaterial, even if (as in that case) the board was chosen by the interested party to a transaction, a controlling shareholder.[84] They still have a right to rely, said the Court, given the board's superior access to information and the norms of fiduciary responsibility.[85] And more recently in *Omnicare*, the argument was made that statements of opinion surely convey nothing to the cautious investor beyond the honesty of the underlying belief, if that.[86] But the Court rejected this argument, too, and opened the door for plaintiffs to draw inferences from what was said that go beyond the strict textual confines of the words used,[87] thereby weakening what had been a powerful defense tactic embraced by many lower courts.[88] *Omnicare* is a strong endorsement of contextualism. But the opinion too quickly reduces the inquiry to a factual question on propensity to mislead, on which it simply assumes lower courts have ample experience and expertise. As a result, the Court's exegesis is limited in terms of guidance for future cases (or even for the one at hand); its dicta has been read as encouraging, restrictive, or both in terms of the scope of the half-truth doctrine as applied to statements of opinion.[89] *Omnicare* is thus not as helpful as it might have been.

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82. *See* Langevoort, *supra* note 67, at 161.

83. Halliburton II, 134 S. Ct. 2398, 2407–08 (2014); Basic Inc. v. Levinson, 485 U.S. 224, 245–47 (1988); *see also* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 766–81 (2006) (arguing that the fraud-on-the-market theory is justified when markets are inefficient for promotion of investment).

84. 501 U.S. 1083, 1088, 1090–91 (1991).

85. *Id.* at 1090–91.

86. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1328 (2015).

87. *Id.*

88. *E.g.*, Fait v. Regions Fin. Corp., 655 F.3d 105, 113 (2d Cir. 2011) (finding no liability for any form of opinion absent evidence of subjective disbelief). The Second Circuit has acknowledged that *Fait*'s per se holding does not stand after *Omnicare*. *See* Tongue v. Sanofi, 816 F.3d 199, 209 (2d Cir. 2016) ("The [*Omnicare*] holding altered the standard announced by this Court in *Fait* . . . .").

89. *See, e.g.*, *Omnicare*, 135 S. Ct. at 1332 (noting that showing an actionable omission is "no small task for an investor"). Sadly, too many lower courts have taken that particular language in the Court's opinion as encouragement to hold onto their overly rigid pre-*Omnicare* ways even though the Court invited them to think more expansively. For surveys of *Omnicare* and its aftermath, see generally Sale & Langevoort, *supra* note 40, at 779–80; Robert A. Van Kirk & John S. Williams, *The Supreme Court's Decision in* Omnicare*: The View From Two Years Out*, BLOOMBERG BNA (Aug. 7, 2017), https://www.wc.com/portalresource/lookup/poid/Z1tOl9NPluKPtDNIqLMRVPMQiLsSwWZCm83!/document.name=/The%20Supreme%20Court's%20Decision%20in%20Omnicare%20The%20View%20From%20Two%20Years%20Out.pdf.

There are some useful first principles from which to derive an approach to interpretation in half-truth cases. The fraud-on-the-market theory is focused on price distortion, which includes price maintenance as well as price movement in response to what was said and not said. Price formation is a product of a reasonably sophisticated "conversation" that goes on continuously among the issuer's management and a diverse set of investors, in which credibility varies and plays a key role as we have just seen. Participants draw meaning from the issuer's representations in this expansive context. From that, it seems to me, courts should use the cooperation principle as the *presumptive* background norm for interpretation: normally (but not always), soft words and phrases should be read as intended to help guide investors toward accurate inferences about value and risk, not as gamesmanship about which to be skeptical.

This is not a justification to dumb down the standard for a right to rely to the most unsophisticated investor. Some of the heuristic principles courts have used in fraud-on-the-market cases are perfectly sound in this light. For example, such investors can fairly be held to draw from other information readily available in the public domain in forming impressions, so that they should not expect to be told what is already readily findable.[90] Or, as the Court stressed in *Omnicare*, the careful use of words to frame a statement as an opinion naturally send a cautionary note that distinguishes such a message from one that is totally unqualified.[91]

What we are looking for are patterns of ordinary discourse to assess the reliability of what management is saying. Crucially, the setting in which the communication is made matters. In *Omnicare*, the fact that the opinion about legal compliance was made in a registration statement signaled that it was the product of the intense labor and scrutiny that comes with due diligence in a registered public offering.[92] Such a statement signals that the words derive from a particularly rigorous process of eliciting information, and thus convey more than a top-of-the-head opinion.[93] An executive tweet would probably be the opposite, conveying informality. This does not mean that it comes without implications, but rather that the implications suggest some less rigor from which to draw extended inferences. When, for example, the controlling shareholder of Tesla, Elon Musk, recently tweeted that financing was in place for a transaction he would lead to take the company private, the medium alone might have given investors pause as to whether this was reliable information signaling that such a deal was happening.[94] However, given the high level of investor concern about

90. For a case where, in the court's opinion, finding the facts might have been possible but too difficult, see *In re Massey Energy Co. Securities Litigation*, 883 F. Supp. 2d 597, 618–19 (S.D.W. Va. 2012).

91. *Omnicare*, 135 S. Ct. at 1329.

92. *Id.* at 1330.

93. Hillary Sale and I argue elsewhere that the Securities Exchange Act disclosure process is much closer to the Securities Act than different from it, so that a comparable inference is fair for the public company reporting process generally. *See* Sale & Langevoort, *supra* note 40, at 782.

94. *See* Peter J. Henning, *How the S.E.C. May Pursue a Case Against Elon Musk and Tesla*, N.Y. TIMES (Aug. 24, 2018), https://www.nytimes.com/2018/08/24/business/dealbook/tesla-elon-musk-sec.

Tesla's direction and the explicit reference to the key factor (financing) that drives deals like this, there was a good argument for allowing investors to take communication on this medium seriously, notwithstanding the informality.

Attention to context and background norms sounds obvious in setting principles of inference, but as noted earlier, the caselaw shows how often courts operate differently,[95] acting as if there is a dictionary of words and phrases that everyone understands lack communicative content. That is dangerous, even though we might agree that, sometimes, the proper inference is that one is not being told anything of importance. If, for example, the corporate communication responds to a legitimate question with a positive generality and there is no obvious means for further clarification, the implication should at least be that the hidden truth is not thoroughly bad.[96] So, too, with half-truths. The worse the unrevealed news, the less fair it is to opportunistically use literal truth as a means to conceal, especially if the matter has already sparked investor interest.[97]

These interpretive principles are helpful in addressing the main issue in so many disaster cases: the extent to which the statements made put the fact that was concealed sufficiently "in play" that the duty to disclose applies. Merely touching on a subject does not put it in play, nor does the simple fact that a code of ethics or some other general statement promises a commitment to integrity.[98] But if the apparent motivation for what is said, however soft, was to respond to a matter of palpable interest to investors and hide a harsher truth, the case for deception is strengthened. In those circumstances, courts are right to find an issue to be in play by reference to how many times the issuer repeated the soft assurances.[99] The same can be said of evidence showing high levels of investor interest in a matter (for example, oil rig safety).

These principles of inference suggest, in particular, that the Ninth Circuit was wrong to summarily dismiss the claims in the Hewlett–Packard case, described

html [https://nyti.ms/2BIZrXD]; s*ee also* Press Release, Elon Musk Charged with Securities Fraud for Misleading Tweets, Sec. & Exch. Comm'n (Sept. 27, 2018), https://www.sec.gov/news/press-release/2018-219 [https://perma.cc/8VT3-2EQV].

95. Indeed, the idea that plaintiffs' allegations of misrepresentation must be analyzed one-by-one in isolation is inconsistent with a common-sense approach to inference in context.

96. *See* Eisenstadt v. Centel Corp., 113 F.3d 738, 745 (7th Cir. 1997).

97. I explored the connections among puffery, contextualism, and half-truth in Langevoort, *supra* note 36, at 121–24. For more recent literature, see Cox, *supra* note 40, at 717–19; Lipton, *supra* note 25, at 140–41; Sale & Langevoort, *supra* note 40, at 779.

98. For discussions of the caselaw from a contextualist standpoint, see *In re Braskem S.A. Securities Litigation*, 246 F. Supp. 3d 731, 754–57 (S.D.N.Y. 2017), and *In re Cognizant Technology Solutions Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 100,242, 2018 WL 3772675, at *15–17 (D.N.J. Aug. 8, 2018).

99. In the pre-explosion portion of the Deepwater Horizon case, the court stressed how often BP seemed to emphasize its vaunted safety procedures and processes without disclosing that the procedures did not fully apply to BP's non-wholly owned assets. *See In re* BP P.L.C. Sec. Litig., 922 F. Supp. 2d 600, 623 (S.D. Tex. 2013); *see also In re* BHP Billiton Ltd. Sec. Litig., 276 F. Supp. 3d 65, 80 (S.D.N.Y. 2017) (stressing that BHP made representations related to its "commitment to safety over and over and over"); *In re* Petrobras Sec. Litig., 116 F. Supp. 3d 368, 381 (S.D.N.Y. 2015) (taking into account repeated efforts to parry and reassure investors in light of growing concerns about compliance).

earlier.[100] Although corporate ethics statements might be deemed trivial to sophisticated investors in the abstract, the contextual background driving the case seemed to be HP's ability to emerge from its earlier governance scandal, to which the strong leadership of its CEO, Mark Hurd, was crucial. I see HP's statements as an arguably deliberate effort to assuage investor unease and identify strength and integrity as strong points.[101] If so—and if Hurd had gained credibility among analysts and investors—this conversation thread may have mattered more than the court assumed, and the failure to reveal the disdain and ethical risk-taking would be decidedly consequential. In addressing this same kind of issue, the Second Circuit more convincingly explained that liability makes sense when there are statements by the issuer "that emphasize its reputation for integrity or ethical conduct as central to its financial condition or that are clearly designed to distinguish the company from other specified companies in the same industry."[102]

A final—and admittedly more complicated—principle of inference goes to the degree of voluntariness of the statement. This connects closely to the "in play" idea just noted. Properly understood, what courts that find a duty seem to recognize is that when the disclosure is unprompted and apparently voluntary, investors should be able to infer that the issuer is motivated by a genuine desire to reveal. Thus, investors should be entitled to draw somewhat broader inferences consistent with what is explicitly said, especially if the issuer keeps insistently repeating a message for emphasis. On the other hand, when an issuer makes a statement reflecting that it does not want to speak but is under external pressure or compulsion to do so, the investor should be more hesitant to draw strong inferences regarding things unsaid. This situation, as we will see shortly, arises frequently with respect to legal risks.

Contextualism, of course, runs up against the familiar concern that it is too indeterminate, offering insufficient guidance for either the courts or marketplace actors—even more so if there is reason to doubt that fraud-on-the-market litigation is a good vehicle for investor protection.[103] But if investors in sophisticated markets do rely on soft language when credibility is high, too easily dismissing such cases increases management's ability to hide evidence that a disaster is looming. My preference—and one that, in my reading, is more coherent with *Omnicare* and *Halliburton II*—is that an enhanced ability to sanction intentional concealment is worth some legal indeterminacy.

### C. REPORTING OBLIGATIONS AND LINE-ITEM DISCLOSURES

Having developed an approach for the interpretation of voluntary pre-disaster disclosures, we can now turn to mandatory disclosure obligations. As noted,

100. *See* Stempel, *supra* note 51.

101. The court acknowledged that Hurd led a charge to change perceptions of HP's integrity and conduct norms after the earlier scandal and suggested that it would have been a closer case had the sexual scandal been more closely related to the prior governance scandal. *See* Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett–Packard Co., 845 F.3d 1268, 1272, 1278 (9th Cir. 2017).

102. Ind. Pub. Ret. Sys. v. SAIC, Inc., 818 F.3d 85, 97–98 (2d Cir. 2016).

103. *See supra* note 15 and accompanying text.

courts today are insistent that broad disclosure duties are for the SEC or Congress to formulate, not for the courts to invent.[104] Thus, when seeking liability for pre-disaster concealment, plaintiffs naturally look to the numerous line items, mostly found in the SEC's Regulation S–K, that impose a requirement to reveal information investors supposedly want and need in periodic filings, many of which are instantly made available on the Internet.[105] Buttressing this is the SEC's own half-truth rule, forcing issuers to add further material information necessary to make the responses complete.[106]

This route to liability under Rule 10b-5 has numerous obstacles. Regulation S–K is extensive and dense, to such an extent that Congress and the SEC are both currently seeking to prune it.[107] Yet what is striking about these line-item requirements is how much potentially material information is *not* subject to any disclosure obligation. The current mandatory disclosure regime does little to force issuers to address issues deeply relevant to the modern corporation, especially as to sustainability matters like intellectual property and human capital.[108] Instead, disclosure operates mainly with a short- to medium-term horizon—even though many long-term investors and sustainability proponents want and need a longer outlook—and focuses more on what has happened rather than what will

104. *See, e.g.*, Gallagher v. Abbott Labs., 269 F.3d 806, 809 (7th Cir. 2001) ("[J]udges have no authority to scoop the political branches and adopt continuous disclosure under the banner of Rule 10b-5."). The SEC has adopted a specific half-truth prohibition for SEC filings under Rule 12b-20. 17 C.F.R. § 240.12b-20 (2018). There are two other fraud-based exceptions: the "duty to correct" and the "duty to update." The "duty to correct" holds that if the issuer previously made a misstatement in good faith such that no liability follows, it nonetheless has a duty to correct it when the truth is discovered. *See Gallagher*, 269 F.3d at 810–11 (comparing a "duty to correct" with a "duty to update" by way of example). The "duty to update" holds that an issuer must update an earlier statement that no longer is accurate even though it was accurate when originally made, if (but only if) the earlier statement implied to a reasonable investor that it could be relied upon beyond the time of its making, such that it was "still alive" in the marketplace. *See* COX ET AL., *supra* note 36, at 723. Seeing the duty to update as a judicial usurpation of the SEC's responsibilities, the court in *Gallagher* rejected it as a viable theory. *See id.* at 809–11. Other courts, however, have been more open to it. *See, e.g.*, Backman v. Polaroid Corp., 910 F.2d 10, 16–18 (1st Cir. 1990) (expressing in dicta concerns in accepting a "duty to update").

Ultimately, lawyers came to see that the "duty to update" could largely be disclaimed by stating in the original disclosure that it spoke only to the moment and that the issuer was assuming no duty to update. *See, e.g.*, Greenthal v. Joyce, No. 4:16-CV-41, 2016 WL 362312, at *3 (S.D. Tex. Jan. 29, 2016). As a result, duty to update cases are less frequent today. *But see* Finnerty v. Stiefel Labs., Inc., 756 F.3d 1310, 1317 (11th Cir. 2014) (finding sufficient evidence to uphold jury determination that facts gave rise to a duty to update); *In re* Facebook, Inc., IPO Sec. & Derivative Litig., 986 F. Supp. 2d 428, 464–66 (S.D.N.Y. 2013) (accepting plaintiffs' argument that there may be a duty to update as a matter of law).

105. *See* 17 C.F.R. § 229 (2018). There are many examples of such cases. *See, e.g.*, Stratte–McClure v. Morgan Stanley, 776 F.3d 94, 103 (2d Cir. 2015).

106. 17 C.F.R. § 240.12b-20 (2018).

107. *See* Business and Financial Disclosure Required by Regulation S–K, Securities Act Release No. 10,064, Exchange Act Release No. 77,599, 113 SEC Docket 4731, ¶¶ 204–10 (April 13, 2016) (seeking comment on proposed changes to Regulation S–K requirements). *See generally* Roberta S. Karmel, *Disclosure Reform—The SEC Is Riding Off in Two Directions at Once*, 71 BUS. LAW. 781 (2016) (discussing disclosures initiatives in Congress).

108. *See generally* Baruch Lev, *Evaluating Sustainable Competitive Advantage*, 29 J. APPLIED CORP. FIN. 70, 71–72 (2017) (discussing the inadequacy of the current disclosure and accounting rules with respect to research and development).

happen.[109] The SEC has long adhered to a policy limiting disclosure to historical, backward-looking facts rather than forward-looking information, even though the latter is the more value-relevant to investors. Although this view has softened, the effects of the SEC's earlier reluctance are still felt today. There is still an uneasy acceptance of the need for corporate secrecy on many forward-looking matters, lest the company be hampered in its ability to compete or not invest in strategies or products whose value would disappear if the information were publicly available to competitors and others. Unfortunately, the effect of a duty limited to line-item instructions is to offer this zone of secrecy irrespective of whether there are truly good reasons for it as to particular facts or fears. The pressure from investors for more extensive voluntary disclosures stems from these limits.

Two line-item requirements are most often invoked by plaintiffs in disaster cases who are looking for actionable omissions.[110] One such requirement, found in the instructions to the 10–K and 10–Q forms, seems particularly promising to plaintiffs: companies have to identify the most significant risk factors they face, updated on a quarterly basis.[111] But this has turned out to be a disappointing early warning device for a handful of reasons. First, and most importantly, it requires identification but not assessment—that is, it requires describing kinds of risk but does not explicitly require discussion of either the probability that the risks described will come to pass or the impact on the company if they do. The disclosures can easily devolve into boilerplate, offering a recitation of risks the majority of which an intelligent investor could surmise even without the disclosure. This is not to say that the risk disclosure line item is worthless.[112] Careful readers of an issuer's SEC filings can notice changes from quarter to quarter that signal the emergence of something that caused its lawyers to add to the recitation, suggesting that the level of worry about that particular subject has risen. These sophisticated investors can then follow up with questions to the company or do further

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109. Other major countries around the world (most notably European Union countries and Australia) have more expansive corporate disclosure requirements. *See* Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations:* "*Are We There Yet?*," 20 CARDOZO L. REV. 135, 158–65 (1998) (discussing the disclosure regimes of Australia and New Zealand); Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493, 550 (2005) (discussing the expanded disclosure regime in the UK).

110. These are not the only possible line items, but they are the most likely to relate to a concealed risk. As to corporate governance, the SEC has a specific requirement to describe the extent of the board of directors' role in risk management and how it undertakes that role. 17 C.F.R. § 229.407(h) (2018).

111. 17 C.F.R. § 229.503(c) (2018). The 1934 Act filing instructions for Forms 10–K cross-references Item 503(c) of Regulation S–K, which involves risk disclosures in public offerings. FORM 10-K: ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934: GENERAL INSTRUCTIONS, U.S. SEC. & EXCH. COMM'N (2018), https://www.sec.gov/about/forms/form10-k.pdf.

112. *See* Ole-Kristian Hope et al., *The Benefits of Specific Risk-Factor Disclosures*, 21 REV. ACCT. STUD. 1005, 1032 (2016) (explaining that investors actually "find specific risk disclosures incrementally valuable in assessing firms' accounting information" depending on the level of specificity). In addition, the SEC staff comments on a filing may draw attention to deficiencies and force the issuer to be more forthcoming.

research. But the identification itself is little more than a potential conversation starter, revealing little about what might be a looming, serious risk. Finally, like all quarterly reporting obligations, it is not a real-time requirement triggered when the risk level increases, but one that can wait for the next filing to become due, which may be weeks or months away.

Item 303 of Regulation S–K, management's discussion and analysis (the MD&A), is potentially much more useful to investors.[113] In the eyes of the SEC, this line item is clearly meant as an early warning device, designed to alert investors as to risks, trends, and uncertainties with respect to the conduct of business that might make it unwise for investors to rely on past performance as a future indicator.[114] The SEC has highlighted the MD&A as quite relevant to disclosure of environmental risks,[115] for example, as well as risks of cybersecurity and other hot button topics.[116] As mentioned earlier, an emerging body of empirical work using machine learning shows that the MD&A can be important for not only what the issuer reveals explicitly (particularly with changes from period to period), but how it "speaks."[117] Companies with something to hide appear to change their tone, use longer and more complex sentences, and seek to redirect reader attention away from the sensitive topic. There is some evidence that the obfuscation works.

The MD&A, however, is also less than entirely reliable as an early warning device.[118] It has built-in limits, most importantly that the events, trends, and uncertainties have to be "known" to management and "reasonably likely" to occur.[119]

113. 17 C.F.R. § 299.303 (2018); *see also* Karen K. Nelson & A.C. Pritchard, *Carrot or Stick? The Shift from Voluntary to Mandatory Disclosure of Risk Factors*, 13 J. EMPIRICAL LEGAL STUD. 266, 287–96 (2016) (discussing the steady increase in risk factor disclosures in absolute terms and as a fraction of management's discussion and analysis (MD&A) since the SEC's 2005 mandate requiring risk factor disclosures).

114. *See* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8350, 81 SEC Docket 2905 (Dec. 19, 2003).

115. *See* Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, Exchange Act Release No. 48,960, 97 SEC Docket 2414 (Feb. 2, 2010).

116. *See* Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Securities Act Release No. 10,459, Exchange Act Release No. 82,746, 2018 WL 993646 (Feb. 21, 2018). For concerns, see Jacob Rund, *Few Companies Report Hacks to Investors, SEC's Jackson Says*, BLOOMBERG BNA (Mar. 15, 2018), https://www.bna.com/few-companies-report-n57982089944/ [https://perma.cc/JP58-6WZU]. The SEC brought its first cybersecurity disclosure case in a settled action involving Yahoo. *In re* Altaba Inc., Securities Act Release No. 10,485, Exchange Act Release No. 83,096, 2018 WL 1919547 (Apr. 24, 2018).

117. *See generally* Hoberg & Lewis, *supra* note 73 (using text-based analysis of 10–K MD&A disclosures for abnormal text).

118. *See generally* Stephen V. Brown & Jennifer Wu Tucker, *Large-Sample Evidence on Firm's Year-over-Year MD&A Modifications*, 49 J. ACCT. RES. 309 (2011) (discussing a number of factors, such as timeliness and the potential to mislead, that have called into question the reliability and usefulness of MD&A disclosures).

119. *See* Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, Exchange Act Release No. 47,264, 79 SEC Docket 1251 (Jan. 28, 2003) (proposing to revisit the "reasonably likely" standard); *see also* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48

Precisely what level of probability makes something reasonably likely has been debated for decades without closure. This standard thus leaves wiggle room for management to determine that something, however worrisome, has not yet met that subjective threshold. The knowledge requirement can also be troublesome with respect to the kind of risk-related information that gets diffused, distorted, or suppressed within the corporate bureaucracy.

Given the soft spots in the MD&A structure, its efficacy depends heavily on enforcement intensity.[120] SEC enforcement seems somewhat muted; cases tend to settle on cease-and-desist-type terms, without large penalties.[121] That then takes us back to our main subject here—the fraud-on-the-market action—which can put a much larger price tag on issuer noncompliance. There is an apparent split of authority in the circuits about whether private plaintiffs can invoke Item 303 (or indeed, any line-item requirement) to argue that its violation gives rise to damages under Rule 10b-5.[122] The Supreme Court granted certiorari on the issue in early 2017[123] but later withdrew the grant at the request of the parties when the case settled.[124] The question thus remains: does the MD&A mandate establish a duty to disclose, the breach of which creates a 10b-5 violation assuming that the plaintiffs satisfy all other elements of the fraud cause of action, including materiality and scienter? The negative view is that SEC line items create no independent private right of action but instead should be left entirely to SEC enforcement. Although that is partially true, it misses the point. To me, the answer to the duty question is fairly easy.[125] Surely a blatant lie in the MD&A would be actionable fraud; no court has suggested that a lie's placement in a 10–K somehow takes it out of Rule 10b-5. Given this, we simply have to invoke the familiar coupling:

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VILL. L. REV. 1245, 1269–71 (2003) (describing the SEC's scuttled plans to alter the "reasonably likely" standard). In the Fundão dam case—otherwise allowed to go forward for fraudulent misstatements and omissions in its voluntary disclosures—the court rejected plaintiffs' Item 303 claim for lack of sufficient knowledge of a reasonably likely event. *See In re* BHP Billiton Ltd. Sec. Litig., 276 F. Supp. 3d 65, 87–88, 94 (S.D.N.Y. 2017).

120. For doubts about the SEC's interest in environmental disclosure enforcement, see David W. Case, *Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective*, 76 U. COLO. L. REV. 379, 410–12 (2005). For discussion of enforcement failure undermining the intentions for creating the disclosure in the first place, see Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 66–67 (2010).

121. *See, e.g.*, *In re* Coca–Cola Co., Cease-and-Desist Order, Securities Act Release No. 8569, Exchange Act Release No. 52,565, 85 SEC Docket 601 (Apr. 18, 2005).

122. *Compare* Stratte–McClure v. Morgan Stanley, 776 F.3d 94, 103 (2d Cir. 2015) (failure to disclose can serve as a basis for securities fraud claim), *with In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1054 (9th Cir. 2014) (finding failure to disclose under Item 303 not actionable under section 10(b) or Rule 10b-5). For an argument that the impression of a circuit split is in large measure illusory, see Matthew C. Turk & Karen E. Woody, *The* Leidos *Mixup and the Misunderstood Duty to Disclose in Securities Law*, 75 WASH. & LEE L. REV. 957, 987–94 (2018).

123. *See* Ind. Pub. Ret. Sys. v. SAIC, Inc., 818 F.3d 85 (2d Cir. 2016), *cert. granted sub nom.* Leidos, Inc. v. Ind. Pub. Ret. Sys., 137 S. Ct. 1395 (2017) (mem.).

124. *See* Leidos, Inc. v. Ind. Pub. Ret. Sys., 138 S. Ct. 2670 (2018) (mem.) (granting dismissal pursuant to SUP. CT. R. 46.1).

125. *See* Langevoort & Gulati, *supra* note 35, at 1680–81.

the Rule also prohibits misstatements and omissions necessary to make what was said not misleading.[126] So the question comes down to whether intentionally failing to disclose something required under Item 303 would mislead a reasonable investor. In other words, assume that an issuer deliberately omits from the MD&A a serious and known risk out of fear that its revelation would damage the company near-term. Other risks, trends, and uncertainties are fully disclosed. Would a reasonable investor infer from what is said that no other matters were required to be disclosed as per SEC instructions, so that we have the "omi[ssion] . . . [of] a material fact necessary in order to make the statements made . . . not misleading"?[127] Ordinarily, yes. As courts have stressed, SEC rulemaking is authoritative on what public companies affirmatively have to disclose, and investors are surely the intended beneficiaries of the mandate.[128] It follows that investors should be entitled to assume compliance unless on notice otherwise. The duty element would thus be satisfied, which was the Second Circuit's holding in *Leidos*.[129]

Without such a rule, there would be a critical enforcement gap with respect to the MD&A, which could severely reduce its efficacy as an early warning device. But even if the Court eventually does what it should, the efficacy of Item 303 is moderate, at best, because of the built-in limits, the scienter requirement, and the various reasons that private class actions deliver imperfect deterrence when managers have selfish reasons to obfuscate but bear little personal risk of liability. That said, the evidence supports an inference that private securities litigation adds a necessary dose of deterrence to SEC enforcement.[130] Those worried about corporate candor with respect to disaster risk should pay close attention to future battling over the duty issue.

### D. THE (SOMETIMES) FRUSTRATING STATUTORY SAFE HARBOR

In developing an approach to corporate implicature for fraud-on-the-market cases, we have so far ignored a powerful statutory innovation created in the Private Securities Litigation Reform Act of 1995[131] that is often invoked in disaster litigation.[132] The so-called "safe harbor for forward-looking statements" declares that such information is not fraud for purposes of private securities

126. *See* 17 C.F.R. § 240.10b-5 (2018).

127. *Id.*

128. *See supra* note 104 and accompanying text.

129. *See Ind. Pub. Ret. Sys.*, 818 F.3d at 96. This result would be different if the issuer made clear that it was not responding fully and completely, though it would not sit well with the SEC.

130. For discussions of the deterrence value of fraud-on-the-market cases, see DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 53–56 (2016); Christopher F. Baum et al., *Securities Fraud and Corporate Board Turnover: New Evidence from Lawsuit Outcomes*, 48 INT'L REV. L. & ECON. 14, 14–25 (2016); Cox & Thomas, *supra* note 15, at 182–83; see also Dain C. Donelson et al., *The Role of Directors' and Officers' Insurance in Securities Fraud Class Action Settlements*, 58 J.L. & ECON. 747, 750–52 (2015) (discussing the positive role of the merits of cases in influencing settlements).

131. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77a to 78j-1 (2012)).

132. *See, e.g.*, *In re* Vale S.A. Sec. Litig., No. 1:15-CV-9539-GHW, 2017 WL 1102666, at *23 (S.D. N.Y. Mar. 23, 2017).

litigation if it is either made without actual fraudulent intent or is accompanied by "meaningful cautionary statements" that warn investors of the risk that the forward-looking information may not transpire as predicted.[133] The Act codified the judge-made "bespeaks caution" doctrine, albeit without the nuance some courts had created in applying that principle.[134] When the issuer speaks to the future in addressing a risk or lack thereof, the Act incentivizes the issuer to add a disclaimer drawing investors' attention to risk factors—usually, the same risk factors already set forth in the 10–K or 10–Q as per the line-item instructions discussed above[135]—that could affect the likelihood of whatever future circumstance the issuer is addressing. If this language is considered meaningfully cautionary, the risk of liability disappears.[136] The potency of the safe harbor is obvious in pre-crisis disaster cases because, in such cases, what is being challenged is often a forward-looking risk assessment.

In terms of disclosure theory and practice, the safe harbor is a near absurdity. Imagine that an issuer stated that its assessment of a powerplant indicated that a catastrophic failure at the powerplant was highly unlikely. At the same time, there was also private evidence of internal doubts about the accuracy of the risk assessment. That would be false and misleading; it would be no less so if the issuer added a disclaimer pointing to some risk factors. This is the same point made about risk-factor disclosure: it is of limited use if it fails to reveal internal probability estimates and instead simply states that a bad event is possible. What is important is management's determination that a bad event is highly unlikely, assuming that it has a reputation for credibility.[137] Otherwise, the warning is just noise.[138]

Because the protection is a statutory command, absurdity does not matter. At best, the statutory safe harbor is a trade-off: effective immunization of forward-looking information from liability so as to encourage honest voluntary disclosures that would otherwise not be made because of fear of liability. The empirical literature on the safe harbor is mixed as to whether the trade is a good one.[139]

133. Private Securities Litigation Reform Act of 1995 § 21E, 15 U.S.C. § 78u-5 (2012).

134. *See generally* Langevoort, *supra* note 62 (explaining various court applications of the "bespeaks caution" doctrine).

135. *See supra* note 111 and accompanying text.

136. *See* Nelson & Pritchard, *supra* note 113, at 267; *see also* Ann Morales Olazábal, *False Forward-Looking Statements and the PSLRA's Safe Harbor*, 86 IND. L.J. 595, 602 (2011).

137. *See* Jonathan L. Rogers & Phillip C. Stocken, *Credibility of Management Forecasts*, 80 ACCT. REV. 1233, 1252 (2005).

138. On investors' perception of having been wronged in the face of cautionary language, see H. Scott Asay & Jeffrey Hales, *Disclaiming the Future: Investigating the Impact of Cautionary Disclaimers on Investor Judgments Before and After Experiencing Economic Loss*, 93 ACCT. REV. 81, 90–96 (2018).

139. For a good summary of costs and benefits, see Marilyn F. Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 J. ACCT. RES. 297, 323 (2001) (explaining that the safe harbor increased disclosures but did not diminish disclosure accuracy).

There is some good news for plaintiffs, however, in the contextualism that many courts instinctively bring to two interpretive questions that often arise in deciding whether the safe harbor protects some alleged falsity. The first question is whether the issuer is truly speaking to the future or instead—fully or partially—addressing the present, which eliminates the statutory protection entirely.[140] This is an exercise in implicature because there are many statements that appear forward-looking on their face, but either say or imply something about current conditions. The other interpretive question is whether the cautionary language is sufficiently meaningful. Particularly striking here is the inclination of many courts to deny protection to the issuer when the language implies that a predicted risk is merely possible although management knows privately that it is actually certain. That, they say, makes the cautionary language itself misleading.[141] So although the safe harbor is indeed a frequent obstacle for plaintiffs in disaster cases, it is not quite as forbidding as it might at first seem.

## II. GETTING CLOSER: GOVERNMENT INVESTIGATIONS AND UNCHARGED CRIMINALITY

### A. INVESTIGATIONS AND REGULATORY PROCEEDINGS

Further along the disclosure timeline in the run-up to a corporate disaster, plaintiffs may allege that the issuer concealed either the occurrence of some government investigation triggered by suspicion that something was wrong, or a routine inspection finding something amiss. Such government inquiries are a common part of the administrative state; they can be regulatory or criminal in nature, and at varying stages of formality and cause for concern. When the following weeks or months bring a large-scale criminal prosecution or regulatory fine imposed on the issuer, there is a natural temptation to see the investigation itself as a fraudulently concealed or down-played risk.

There is a substantial body of caselaw on the materiality of unpublicized government investigations. The materiality determination turns on the probability that the case will become serious, with specific attention paid to the implications for the issuer and the magnitude of the impact (such as fines, loss of business, or disqualifications) if it does.[142] These are hardly easy calculations; suffice it to say

140. *See* Wendy Gerwick Couture, *Mixed Statements: The Safe Harbor's Rocky Shore*, 39 SEC. REG. L.J. 257, 261–65 (2011). On the distinction between present and forward-looking information when the two are bundled, see *In re Quality Systems, Inc. Securities Litigation*, 865 F.3d 1130, 1141–42, 1150 (9th Cir. 2017), which holds that there is no safe harbor protection for the non-forward-looking parts of the bundle.

141. *See, e.g.*, *In re* Harman Int'l Indus., Inc. Sec. Litig., 791 F.3d 90, 102 (D.C. Cir. 2015); Slayton v. Am. Express Co., 604 F.3d 758, 770 (2d Cir. 2010). In *Loritz v. Exide Technologies*, the court observed that a warning that the corporation could not "be certain that it has been, or will at all times be, in complete compliance with all environmental requirements" was not meaningful enough when it knew of significant environmental exposure. No. 2:13–cv–2607–SVW–Ex., 2014 WL 4058752, at *7 (C.D. Cal. Aug. 7, 2014).

142. *See* David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 BUS. LAW. 973, 974 n.6 (2009) (noting that several courts have endorsed the SEC's materiality analysis framework); *see also* Jonathan N. Eisenberg, *Are Public Companies Required to Disclose Government Investigations?*, HARV. L. SCH. F. CORP. GOVERNANCE &

that there will be many situations where the threat emanating from an investigation tilts in favor of materiality even if the matter is far from resolved and might never result in any enforcement action or prosecution.

But once again, there is no per se duty to disclose an investigation even if it is deemed material. Whether there is a duty depends partially on what we have already surveyed. As to mandatory disclosure in SEC filings, is this a new risk factor or something that triggers the need for comment in the MD&A? If so, duty kicks in as per the earlier discussion.[143] But there is another more specific line item to consider: Item 103, which requires a brief description of any material and pending non-routine legal proceeding against the issuer or one of its subsidiaries.[144] The instructions add—somewhat ominously—that issuers must disclose "any such proceedings known to be contemplated by governmental authorities."[145] Beyond this general obligation, there are some particularized instructions in the same line item with respect to proceedings involving allegations of environmental law violations.[146] This was part of an understanding reached between the SEC and environmental activists back in the 1970s.[147] Of more recent vintage, there are special rules on the disclosure of both pending and resolved enforcement actions taken by the Mine Safety and Health Administration against mining companies that are registrants under the 1934 Act.[148] This additional mine safety disclosure is noteworthy; researchers have found evidence that the addition in 2011 of this new public form of disclosure resulted in a noticeable reduction in safety violations, deaths, and injuries—that is, a higher level of care—even though these data were already known to mine safety regulators and discoverable (albeit with considerable effort) online.[149] It is a pointed reminder that the benefits from salient public disclosure are not simply making the issuer's stock price more accurate, but are also often about influencing better behavior.

Courts, however, seem surprisingly reluctant to invoke the generic line-item requirements to compel disclosure of investigations, especially when issuers have made boilerplate risk-factor disclosures pointing out the inevitable risks that

FIN. REG. (July 22, 2015), https://corpgov.law.harvard.edu/2015/07/22/are-public-companies-required-to-disclose-government-investigations/ [https://perma.cc/7QS5-8NMT] (describing a district court case's holding that disclosure is not required until the investigation is such that litigation is "substantially certain to occur"). The Supreme Court endorsed the "probability/magnitude" test in *Basic Inc. v. Levinson*, 485 U.S. 224, 238–39 (1988). *See generally* COX ET AL., *supra* note 36, at 628–31 (discussing the application of the *Basic* "probability/magnitude" test by other federal courts).

143. *See supra* Section I.C.

144. 17 C.F.R. § 229.103 (2018).

145. *Id.*

146. *Id.*

147. For a good history of the environmental disclosure mandates, see Williams, *supra* note 29, at 1246–73 (explaining the history of the environmental reporting requirements in Item 103).

148. 17 C.F.R. § 229.104 (2018).

149. *See* Hans B. Christensen et al., *The Real Effects of Mandated Information on Social Responsibility in Financial Reports: Evidence from Mine-Safety Records*, 64 J. ACCT. & ECON. 284, 298–99 (2017).

highly regulated companies face with respect to legal compliance.[150] Of course, the mere fact of an investigation triggers none of these line items. But once government enforcers indicate that an action is under serious consideration, that would seem to at least satisfy Item 103's "known to be contemplated" language. Strangely, courts have said that such a phrase requires disclosure only of actions "substantially certain to occur."[151] To an issuer busily trying to persuade the government not to act or to impose only minor sanctions, this standard truncates the duty considerably. MD&A and risk factor disclosures have not fared well as triggers for a duty to reveal investigations either.

Once again, half-truth seems to be the doctrine of choice for resolving these cases, especially when what the plaintiffs want revealed is not just the fact of the investigation, but an assessment of its seriousness at the time of the disclosure. This implicates the background norm set forth earlier about matters of special sensitivity,[152] and may be one place where the presumption of cooperativeness in drawing inferences is less justifiable. Legal risk is something on which a company cannot speak in depth without revealing too much of its hand in the ongoing negotiations with regulators. Although merely disclosing that an enforcement action is possible does not necessarily compromise a negotiating position, it is hard for the company to stop there. Stakeholders will ask for an assessment of claims and defenses, which is fraught territory. As suggested, it is probably fair to say that the response, as to both the possibility and impact of an investigation, will be grudging and cautious, giving no reason for investors to draw strong inferences one way or the other about things not said. In the last few years, a notable handful of cases have rejected omission claims arising out of undisclosed—or minimally disclosed—investigations.[153]

Issuers and their lawyers may try to finesse the nondisclosure of some pending investigation by saying something like, "We are not aware of any pending government investigations that in our view would have a material impact on the company or its operations." They are hoping that the investigation will not in fact lead to a material sanction. If it does, they will say that they misestimated in good faith, latching onto phrases like "in our view," "we expect," or similar equivocations—appealing to a legacy from the pre-*Omnicare* days when courts reflexively protected statements of opinion absent evidence of deliberate deceit. This is risky. Invoking the norm of fair play mentioned earlier, some judges have recently shown a willingness to declare such statements to be potential half-truths when what was undisclosed was a palpably serious threat, even though the extent of the

150. This reluctance is sometimes justified by reference to the regulatory agency's own policy, for example, at the SEC, of treating its enforcement investigations as confidential.

151. *See, e.g.*, *In re* Lions Gate Entm't Corp. Sec. Litig., 165 F. Supp. 3d 1, 12 (S.D.N.Y. 2016); Richman v. Goldman Sachs Grp., Inc., 868 F. Supp. 2d 261, 274–75 (S.D.N.Y. 2012).

152. *See supra* notes 82–103.

153. *See Lions Gate*, 165 F. Supp. 3d at 21–22; *see also In re* Inv. Tech. Grp., Inc. Sec. Litig., 251 F. Supp. 3d 596, 617 (S.D.N.Y. 2017); Lubbers v. Flagstar Bancorp. Inc., 162 F. Supp. 3d 571, 580 (E.D. Mich. 2016).

threat was indeterminate at the time and may be indeterminate even still.[154] But that is not yet a clear trend.

### B. ILLEGALITY BY ITSELF

Compliance-related corporate disasters are usually produced by an investigation that eventually uncovers evidence of lawbreaking on which the government then brings charges. In that case, securities fraud plaintiffs can point not only to the concealed investigation but to the hidden fact of the underlying wrongdoing itself as a possible fraud. If the argument succeeds,[155] this sets the starting date of the scheme to defraud further back in time, enlarging the plaintiff class. Once again, however, duty becomes a crucial obstacle: there is no per se obligation to reveal unlawful conduct, no matter how material.[156]

Even apart from the challenge in establishing a duty to disclose, these are particularly hard cases for plaintiffs if there was no admission by the issuer of its wrongdoing or finding of such by a court or agency. Courts are not particularly anxious to undertake a case-within-a-case that requires litigation of the fact of the underlying misconduct followed by a determination of whether the nondisclosure was fraudulent in light of that fact. Courts thus impose a high level of particularized pleading in support of the illegality.[157] But compliance-related corporate disaster cases are usually ones where the government has already done the heavy lifting on investigating the illegality of what transpired; furthermore, the issuer may be precluded from denying the wrongdoing after a plea or non-prosecution deal. This prosecutorial work eases plaintiffs' burden. Yet even when the fact of wrongdoing is fairly clear, many judges remain reluctant to make liability turn on the company's failure to disclose its own wrongdoing.[158] They often cite caselaw saying that the securities disclosure is not "a rite of confession,"[159] nor is it meant to force self-incrimination.[160]

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154. The most notable case here is *Menaldi v. Och-Ziff Capital Management Group LLC*, 164 F. Supp. 3d 568, 584 (S.D.N.Y. 2016). *See also In re* BioScrip, Inc. Sec. Litig., 95 F. Supp. 3d 711, 727 (S.D.N.Y. 2015); *In re* FBR Inc. Sec. Litig., 544 F. Supp. 2d 346, 359 (S.D.N.Y. 2008).

155. For an overview of arguments made to treat undisclosed criminality as fraud, see Alison B. Miller, Note, *Navigating the Disclosure Dilemma: Corporate Illegality and the Federal Securities Laws*, 102 GEO. L.J. 1647 (2014).

156. *See* Roeder v. Alpha Indus., Inc., 814 F.2d 22, 27 (1st Cir. 1987) (explaining the "prevailing view" among the courts that there is no affirmative duty to disclose when there is "no insider trading, no statute or regulation requiring disclosure, and no inaccurate, incomplete, or misleading prior disclosures").

157. *See, e.g.*, *Menaldi*, 164 F. Supp. 3d at 578.

158. *See, e.g.*, *In re* Braskem S.A. Sec. Litig., 246 F. Supp. 3d 731, 752 (S.D.N.Y. 2017) (emphasizing that there was no "freestanding legal duty to disclose the bribery scandal, no matter how unseemly the scandal was and no matter how significant the scandal would have been to the market"); *Menaldi*, 164 F. Supp. 3d at 582 (declining to find a duty to disclose alleged criminal conduct because to "hold otherwise would be to subject corporations to a preemptive duty to 'confess' as soon as a regulatory agency begins an investigation" (citing City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 184 (2d Cir. 2014))).

159. *City of Pontiac*, 752 F.3d at 184 (quoting *In re* Morgan Stanley Info. Fund. Sec. Litig., 592 F.3d 347, 365 (2d Cir. 2010)).

160. United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986).

To be sure, most courts understand that corporations cannot lie about compliance without remedial consequences, nor—as the Supreme Court specifically held in *Omnicare*—can they make affirmative statements about law-abidingness that may literally be true but are nonetheless misleading because of what is not said.[161] But even here, many courts still seem skeptical about undisclosed criminality claims.[162] Take a situation where a pattern of bribery enabled a significant—that is, material—amount of revenue during the most recent fiscal period, thereby boosting earnings per share over what they would have been or indicating fast growth for the firm. It would seem obvious that omitting the fact of the illegality makes the reported financial results misleading. Yet most courts say just the opposite: "[T]he allegation that a corporation properly reported income that is alleged to have been, in part, improperly obtained is insufficient to impose section 10(b) liability."[163] That is especially jarring given the well-established principle in criminal cases that compliance with generally accepted accounting principles does not necessarily protect against a claim of fraud.[164] For better or worse, it usually takes more to cross the line, such as repeated touting of a commitment to compliance in the face of a pervasive criminal pattern,[165] or where the issuer puts its competitive success at issue without revealing that a material reason for the apparent success was the wrongdoing[166]—in other words, something close to a scheme to defraud.[167]

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161. 135 S. Ct. 1318, 1327–28 (2015).

162. *See, e.g.*, *Menaldi*, 164 F. Supp. 3d at 583 (finding statements about transparency and risk management commitments puffery); *see also* Menaldi v. Och-Ziff Capital Mgmt. Grp. LLC, 277 F. Supp. 3d 500, 511–13 (S.D.N.Y. 2017) (same). For a thorough discussion of how *Omnicare* affects the law here see *In re BioScrip, Inc. Securities Litigation*, 95 F. Supp. 3d 711, 728–32 (S.D.N.Y. 2015), which found the company's statements to be potentially misleading.

163. *In re* Marsh & McLennan Cos. Sec. Litig., 501 F. Supp. 2d 452, 470 (S.D.N.Y. 2006).

164. *See, e.g.*, United States v. Ebbers, 458 F.3d 110, 125–26 (2d Cir. 2006); United States v. Simon, 425 F.2d 796, 805–06 (2d Cir. 1969).

165. *See, e.g.*, Meyer v. JinkoSolar Holdings Co., 761 F.3d 245, 251 (2d Cir. 2014) (finding potential for deception in description of compliance program if there was a known failure to prevent ongoing pollution problems). The bigger the hidden wrongdoing, moreover, the more likely it seems that a court will find enough evidence of deception. As an example, see *In re Volkswagen Clean Diesel Marketing, Sales Practices Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 99,817, 2017 WL 3310179 (N.D. Cal. July 19, 2017). There the court agreed with plaintiffs that the company's statements such as that reducing emissions was a top research and development priority and its risk factor disclosures were misleading because they omitted "their massive defeat device scheme." *Id.*

166. *See, e.g.*, *In re* Cognizant Tech. Sols. Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 100,242, 2018 WL 3772675, at *19–20 (D.N.J. Aug. 8, 2018) (finding statements stressing intense ethics and compliance training in a sustainability report potentially misleading for failure to disclose known bribery); *In re* Braskem S.A. Sec. Litig., 246 F. Supp. 3d 731, 758–61 (S.D.N.Y. 2017) (finding statements about pricing for a particular product misleading for failure to disclose bribes). For a case finding the potential for deception in both the company's generalized emphasis on a commitment to safety and its reliance on a particular safety metric that it tried to game even if the numbers might have been technically accurate, see *In re Massey Energy Co. Securities Litigation*, 883 F. Supp. 2d 597, 601 (S.D.W. Va. 2012).

167. *See* Lipton, *supra* note 25, at 132 ("At that point, it is not so much the company's statements, but its *business model* that acts as a fraud on shareholders . . . ."); *see also In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1153–54 (C.D. Cal. 2008) (listing just a few of the numerous examples of allegedly false statements made by the company). At some point in cases like these, resort to "scheme liability" instead of the more common half-truth approach seems plausible. *See, e.g.*, W. Va.

No doubt there are weighty reasons for the courts' hesitancy, even if corporations have no Fifth Amendment right against self-incrimination. Possibly it is because any such mandatory disclosure seems almost futile, on the assumption that few issuers will actually reveal their secret criminality in a timely fashion even with the most explicit duty to disclose. But that is not quite right, for there are many regulatory regimes that require self-reporting of illegal behavior with significant rates of compliance; in a well-governed corporation, discovery of wrongdoing should lead to immediate efforts at remediation, not an inevitable cover-up. And even if it does not actually generate disclosure because management directs a cover-up, a securities lawsuit at least allows compensation for those deceived, and potentially deters the underlying misconduct to the extent that an additional powerful sanction is added to the enforcement mix.

Perhaps a better reason for the heightened sensitivity here has to do with the inherent subjectivity of law. Relatively few legal corporate disaster cases are ones where there was absolutely no doubt about illegality; ordinarily, there would be contestable fact questions and legal defenses available to the company. Most large corporate criminal and regulatory cases are resolved without adjudication,[168] with insiders probably believing that they would, or at least should, prevail at trial but unwilling to bear the costs and risks. Any disclosure obligation arises at an earlier point in time, when legality is still contestable. As with government investigations, moreover, disclosure is not terribly useful without a candid risk assessment, which could compromise the company's ability to make or defend its case. So the background norm for implicature probably should be the issuer's strong desire to limit the risk of self-incrimination and not reveal weaknesses that might be exploited by regulators, prosecutors, competitors, and the like. In other words, investors should not liberally draw inferences inconsistent with that desire, but instead understand that the issuer is trying to manage a potentially risky situation without prejudicing its defense.[169] This is one of the few areas in the world of voluntary disclosure where the cooperativeness principle is something of a misfit. Beyond that, however, courts should stop mindlessly repeating the shibboleth that the securities laws are not meant to force disclosure of mismanagement or wrongdoing.[170] If both material and genuinely the subject of deception, such concealment claims about these matters amply deserve the courts' careful attention.

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Pipe Trades Health & Welfare Fund v. Medtronic, Inc., 845 F.3d 384, 393–94 (8th Cir. 2016) (allowing case involving paying doctors authorized by pharmaceutical company to proceed under scheme liability, thus obviating the need to focus entirely on the sequence of disclosures made by the issuer). If followed elsewhere, *Medtronic* offers an interesting alternative to breathing life into the duty to disclose.

168. *See generally* BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS (2014) (discussing the widespread use of non-prosecution and deferred-prosecution agreements against large corporations).

169. *See* Langevoort, *supra* note 36, at 102–16.

170. *See, e.g.*, Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 451 (2001) (arguing that the SEC "needs the cooperation of the judiciary" to effectively "pursue managerial accountability").

## III. NARRATING THE DISASTER

A disaster sometimes becomes public when announced by the corporation; other times, the news comes first from some other source—such as government prosecutors or financial media—or is so publicly visible that it needs no announcement. In any event, the company is now in crisis and someone will be expected to become the narrator and speak on its behalf, addressing the nature and scope of the event, why it happened, and most importantly, the consequences likely to flow from it. Those narrators know full well that millions (or billions) of dollars in liability risk—or other consequences—may depend on whether they are sufficiently candid; at the same time, they are desperate to avoid adding to the conflagration or upsetting their superiors by saying something wrong or disclosing too much.

There are numerous instances of firms handling such situations badly enough that a court finds a triable issue of fraud. In the BP Deepwater Horizon case, for example, the judge determined that the company's 1,000 barrel-per-day (bpd) estimation of the "flow rate" of oil discharged into the Gulf of Mexico in the days following the disaster—though not necessarily implausible or in bad faith—could be misleading because it failed to reveal higher estimates generated by other internal or external methodologies.[171] Even though the Coast Guard and others were publicly suggesting that the actual amount might be five times higher, BP could have misled investors by projecting too much confidence in a figure it kept trying to defend.[172]

This is difficult terrain to travel. Public relations experts usually advise firms in crisis to gain control of the story rather than let others frame it. Many different stakeholders, not just investors, will be vitally interested in what is said, perhaps inclined toward anger, fear, or panic. The natural desire is to project a sense of confidence and control, assuring others that the company and its management are on top of the situation.[173] The truth may be otherwise, of course, which makes this phase so crucial in any fraud-on-the-market lawsuit. Behind the scenes, palpable uncertainty, fears about blame, and the challenges of getting an unruly high-level team "on the same page" under severe time pressure often lurk. What is said may turn out to be unduly optimistic, thus becoming fodder for a lawsuit by purchasers who point to much more harm than was initially indicated. Fear of

171. *See In re* BP P.L.C. Sec. Litig., No. 4:10-MD-2185, 2016 WL 3090779, at *13 (S.D. Tex. May 31, 2016). The court was influenced by the Supreme Court's then-recent *Omnicare* decision as enlarging the scope of duty to disclose background facts that would alter the reasonable investor's assessment of the degree of uncertainty and likely state of affairs. It stressed the severe uncertainty under which all persons were acting, demanding "a bespoke pattern [to disclosure] rather than a blanket approach." *Id.*

172. *Id.* at *14. The court said that BP arguably "doubled down" on its original 1000 bpd figure. *Id.* Later on, the BP official expanded the range to somewhere between 1000 and 5000 bpd. *Id.* The court suggested that BP should have stressed the tentativeness of all the estimations rather than anchoring on a single point estimate, which then became difficult to let go of. *Id.* at *14–15.

173. *See* Anastasiya Zavyalova et al., *Managing the Message: The Effects of Firm Actions and Industry Spillovers on Media Coverage Following Wrongdoing*, 55 ACAD. MGMT. J. 1079, 1084 (2012) (describing this desire).

liability may in turn cause the company to truncate its disclosures, raising the risk of half-truth accusations based on the misleading inadequacy of what was said. Yet saying nothing is typically impracticable because the story has taken off (in social as well as conventional media), others may be spinning it in their own interests, and the risk of rumors and misinformation is abundant.

The legal principles to be applied here are chiefly the same as what was already covered. Although there may be SEC filings required in the midst of the crisis, they are not likely to play as large a role. Indeed, lawyers may advise delaying the filing of a 10–K or 10–Q if the situation is too fluid and uncertain to draft something in which everyone is confident.[174] The disclosures are almost always legally "voluntary," if not practically so, which makes the half-truth doctrine predominant once again.

The background norms for implicature in a crisis setting are precisely the opposite of what the Supreme Court described in *Omnicare*, where it noted the diligence and deliberateness that go into a filing accompanying a public offering (or any other SEC filing).[175] The company is reacting to a bad event under great pressure, and cannot be held to quite the same heightened expectations of candor or completeness. The reasonable investor presumably understands that the truth is hard to extract from a crisis situation, so that inferences should not be too liberally drawn one way or the other from things deliberately not said or affirmatively avoided. That said, at this stage we may well also have hyper-materiality—exceptionally intense trading and investor interest in what the company and others have to say, requiring a baseline of candor and completeness on which reliance is invited. Courts are walking another fine line, and as in the BP Deepwater Horizon case, the decisions here tend to reject narrations that are overly self-protective.[176]

## IV. KNOWLEDGE AND INTENTIONALITY

The foregoing discussion was an effort to understand, refine, and improve the approach to duty issues when there are allegations of disaster-related concealment. But there is another payoff to this exercise in terms of connecting those same insights to other elements of fraud-on-the-market that are contested alongside duty. This Part makes the connection to scienter; the next to causation and damages.

174. *See* 17 C.F.R. § 240.12b-25 (2018) (providing the steps to be taken if the company cannot timely file the required forms).

175. *See* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1330 (2015).

176. The Fundão dam case also had a narration aspect to it, as both joint venturers initially stated (falsely, according to the plaintiffs) that they were not in a position to be held derivatively liable for the environmental damage and misrepresented other consequences of the dam failure. *See In re* Vale S.A. Sec. Litig., No. 1:15-CV-9539-GHW, 2017 WL 1102666, at *25–30 (S.D.N.Y. Mar. 23, 2017) (raising issues of materiality and loss causation).

### A. SCIENTER AND CORPORATE AWARENESS

If what was concealed was a lack of preparedness for—or some heightened risk of—the disaster that came to pass, some person or persons in authority must have been aware of or ignored the propensity of what was said or omitted to mislead investors for there to be liability. This is because Rule 10b-5 liability requires scienter, meaning either knowledge or recklessness. Pleading and proving scienter is another heavy lift for the plaintiffs' lawyers, especially because courts tend to define recklessness not as a heightened form of negligence but rather as something closer to willful ignorance or conscious disregard.[177]

Disasters are often not easy to see coming until it is too late.[178] There are structural, psychological, and political (agency cost) reasons for this, which have been explored by many scholars in recent years, stimulated in particular by the global financial crisis effectively foreseen by almost no one.[179] The structural reasons involve how information and responsibility are diffused in large organizations—"siloed," to use a familiar term—so that the risk-related dots remain unconnected even as the situation turns dangerous.[180] The psychological reasons relate to the difficulty human beings have in recognizing change —the so-called conservatism bias.[181] That is all the more problematic when managers are overconfident or excessively optimistic,[182] or motivated to deny or resist information that threatens their preferred interpretation of what is happening. Internal politics can also distort information flow, where senders either bury key facts or put their own spin on them, either to make themselves look better or to cater to a superior who does not want to know the whole truth.[183]

This offers both opportunities and challenges for plaintiffs in disaster cases.[184] As a legal matter, they have to plead and prove *corporate* scienter, the standards

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177. That is the most common definition, effectively requiring that the defendant be aware that he doesn't know the truth yet speaks falsely as if he does. *See* COX ET AL., *supra* note 36, at 707–08. At the pleading stage, there is a statutory requirement that the facts presented give rise to a strong inference of scienter. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 323 (2007).

178. *See* LANGEVOORT, *supra* note 130, at 38–40 (discussing causes and effects of managerial overconfidence and over-optimism); Michael D. Watkins & Max H. Bazerman, *Predictable Surprises: The Disasters You Should Have Seen Coming*, 81 HARV. BUS. REV. 72, 76–77 (2003) (describing psychological vulnerabilities to business disasters exemplified by Shell's response to the Greenpeace protest).

179. *See, e.g.*, Biljana Adebambo et al., *Anticipating the 2007–2008 Financial Crisis: Who Knew What and When Did They Know It?*, 50 J. FIN. & QUANTITATIVE ANALYSIS 647, 666–67 (2015).

180. *See* Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 811–20 (2010).

181. *See* Watkins & Bazerman, *supra* note 178, at 76.

182. For a recent survey of the literature, see Ulrike Malmendier & Geoffrey Tate, *Behavioral CEOs: The Role of Managerial Overconfidence*, 29 J. ECON. PERSP. 37, 37–38 (2015). The connections between overconfidence and the etiology of corporate fraud are explored in LANGEVOORT, *supra* note 130, at 35–42.

183. *See* Watkins & Bazerman, *supra* note 178, at 77.

184. Disaster cases pose the hindsight bias problem, whereby our thinking about the likelihood that an event would occur as of some prior point in time is inevitably biased by knowing that it in fact did occur. This affects both materiality and scienter, to the extent that the factfinder either imagines

for which have puzzled the courts for decades. Being legal fictions, corporations cannot act knowingly except to the extent knowledge is attributed to them as a matter of law via their officers, directors, and agents. But not all the knowledge of corporate officials is attributed to the firm, especially if it is scattered piecemeal among many different persons. Courts want some more compelling connection between the knowledge and the misstatements,[185] which is straightforward enough if there is evidence the person(s) who spoke on the company's behalf knew enough about the truth so as to have acted with scienter. But that is not a necessity.[186] Courts seem to understand that too narrow a test generates an obvious incentive for executives to signal to subordinates that scienter-creating information is to be kept from them so as to reduce the risk of both personal and corporate liability. At the same time, an overly broad scope to attribution starts looking more like strict liability for the issuer, which generates its own perverse incentives.[187] Most courts are therefore willing to expand the zone of attribution moderately beyond complicit actors, and here the doctrinal fog thickens.[188] Many extend the list of those whose knowledge is attributable to include those who authorize the statement to be made even if they did not actually formulate it, or who furnish information necessary to its formulation.[189] The Sixth Circuit has recently taken this a step further, bringing onto the list anyone who reviewed the statement before or after its release and ratified, tolerated, or recklessly disregarded the falsity.[190] Other courts simply use status in the organization as the

erroneously that management *must* have known that something was amiss or overcorrects to absolve managers and the issuer for fear of imposing "liability by hindsight." Both aspects of this problem are discussed extensively in Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 773–825 (2004).

185. *E.g.*, Silvercreek Mgmt., Inc. v. Citigroup, Inc., 248 F. Supp. 3d 428, 440 (S.D.N.Y. 2017) ("[I]t is not enough to *separately* allege misstatements by some individuals and knowledge belonging to some others where there is no strong inference that, in fact, there was a connection between the two."); *In re* Hertz Glob. Holdings, Inc. Sec. Litig., No. 13-7050, 2017 WL 1536223, at *23 (D.N.J. Apr. 27, 2017) ("[T]he pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter." (quoting Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 195 (2d Cir. 2008))).

186. *See Teamsters Local 445*, 531 F.3d at 195. A corporation can be liable under an agency law approach when the executive makes the misstatement within the scope of his or her actual or apparent authority. *See In re* ChinaCast Educ. Corp. Sec. Litig., 809 F.3d 471, 476 (9th Cir. 2015). In these kinds of cases, courts seem to assume that the speaker must have acted with scienter.

187. As Jennifer Arlen has pointed out in her studies of corporate criminal liability, automatic corporate liability discourages good internal compliance because such compliance increases the probability of discovering misconduct. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 836 (1994).

188. For a thorough assessment of the varying standards, see *In re Cognizant Technology Solutions Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 100,242, 2018 WL 3772675, at *31–34 (D.N.J. Aug. 8, 2018). For helpful information on this issue, see generally Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81. *See also* Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1229–30 (2003).

189. *E.g.*, Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004). Many courts indicate that the standard is less strict at the pleading stage than at trial. *See Teamsters Local 445*, 531 F.3d at 195.

190. *See In re* Omnicare, Inc. Sec. Litig., 769 F.3d 455, 476 (6th Cir. 2014); *see also* Doshi v. Gen. Cable Corp., 823 F.3d 1032, 1041 (6th Cir. 2016).

test.[191] There is particular controversy over whether to allow plaintiffs to plead that information must have been known to those sufficiently high up for attribution purposes simply because it was so important that it surely would have been known to them.[192] The law here is a mess that needs a thorough clean-up, in disaster cases and otherwise.

### B. AWARENESS, DUTY, AND COMPLIANCE CONTROLS

Whatever the particular attribution test applied, courts want to see enough evidence that the false or misleading statement could be fairly described as intentional at the disclosure level. That would not likely be so if the pre-disaster facts were bottled up somewhere in the firm and the senior management responsible for the disclosure was entirely unaware of them (much less so if no single person in the firm knew the troubling fact but could have made a diligent effort to gather all the facts diffused throughout the firm).

High-quality compliance systems are supposed to address these distortions. As to financial reporting specifically and disclosure generally, control systems are a legal requirement for public companies. More far-ranging controls as to legal and regulatory compliance are at least de facto necessary as well.[193] A substantial body of learning and best practices has emerged in the last decades about what constitute good controls. Not surprisingly, quite a few disaster cases contain allegations directed at breakdowns in internal compliance. Because the CEO and CFO have to certify their oversight and an absence of known material deficiencies regarding financial reporting controls, plaintiffs sometimes argue that an undisclosed control failure constituted fraud.[194] That could certainly be true in some cases, but these kinds of arguments have not had much success where the breakdown cannot be described with particularity, such that plaintiffs' argument seems to be that the later disaster event by itself proves that a breakdown had

191. *E.g.*, Thomas v. Shiloh Indus., Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,812, 2017 WL 2937620, at *3 (S.D.N.Y. 2017) ("In the closest approximation to a workable standard for determining corporate scienter, courts in this District have held that 'management level' employees can serve as proxies for the corporation . . . .").

192. This idea was developed by Judge Posner in *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704, 710 (7th Cir. 2008), on remand from the Supreme Court's decision in that case. This is effectively a presumption of knowledge from the nature of the information and the inherent implausibility of it *not* being widely known among senior managers. For some skepticism, see *Plumbers Local No. 1200 Pension Fund v. Washington Post Co.*, 930 F. Supp. 2d 222, 231 (D.D.C. 2013). Although useful in some kinds of disaster cases, this "collective scienter" pleading aid is not necessarily all that useful for the kinds of disasters that are outside the normal course of business. *See In re* Volkswagen Clean Diesel Mktg., Sales Practices Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,817, 2017 WL 3310179 (N.D. Cal. July 19, 2017) (refusing to employ a collective scienter approach, but finding other grounds for corporate scienter).

193. *E.g.*, Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2109 (2016).

194. On the effects of a deliberately false assessment as part of the certification process, see *In re Bofi Holdings, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 99,727, 2017 WL 2257980 (S.D. Cal. May 23, 2017).

occurred.[195] On the other hand, highlighting a controls system can put the issue of adequacy in play, as where a company that handles toxic materials "discussed [its] pollution abatement equipment and its provision of monitoring environmental teams on duty 24 hours a day," which the court found enough to potentially trigger a duty to disclose because what was said "gave comfort to investors that reasonably effective steps were being taken to comply with applicable environmental regulations."[196] These are just variations on the issues discussed earlier.

A well-pleaded allegation of a known control deficiency in advance of a crisis can also help with scienter. Precisely because of the complex organizational nature of information flow, there can and should be some meaningful way to ascribe recklessness to the system itself for a failure to come to know, beyond whether those who did know were senior enough. After all, corporations are distinct persons in the eyes of the law whose securities law liability is ordinarily seen as primary, not merely derivative through respondeat superior.[197] And the duty to disclose arising from the half-truth doctrine, when compliance matters are put in play, reasonably speaks to the corporate state of mind *as a system*.[198] My impression is that a meaningful form of scienter can (and should) be available without the practical and doctrinal tangles associated with attributing constructive knowledge to any one individual. It would not be unreasonable nor inconsistent with the heightened pleading standard to allow plaintiffs in their complaints to make a circumstantial case that the control failure that produced the absence of high-level knowledge was not readily explainable, except by recklessness in the design or implementation of the control system. Consider a case where a parent company suffered financially as a result of disastrous wrongdoing at a large, recently acquired subsidiary. Plaintiffs are able to show that the parent's internal control system was deliberately compromised because the subsidiary's powerful CEO

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195. *E.g.*, *In re* Braskem S.A. Sec. Litig., 246 F. Supp. 3d 731, 757–58 (S.D.N.Y. 2017) (citing cases where plaintiffs have been unsuccessful without particularity). Even if this hurdle is jumped, plaintiffs must show that the breakdown was related to financial reporting, see *In re PetroChina Co. Sec. Litig.*, 120 F. Supp. 3d 340, 359–60 (S.D.N.Y. 2015), and—eventually—that the breakdown had a sufficiently tight causal connection to the disaster event.

196. Meyer v. JinkoSolar Holdings Co., 761 F.3d 245, 251 (2d Cir. 2014); *see also In re Bofi Holdings*, Fed. Sec. L. Rep. (CCH) ¶ 99,727; City of Brockton Ret. Sys. v. Avon Prods., Inc., Fed. Sec. L. Rep. (CCH) ¶ 98,197, 2014 WL 4832321 (S.D.N.Y. Sept. 29, 2014); *In re* Scottish Re Grp. Sec. Litig., 524 F. Supp. 2d 370, 398 (S.D.N.Y. 2007). Assessing internal controls is difficult, and would be especially so for plaintiffs at the time they file a complaint, preceding any discovery—the main point at which scienter assessments are made in fraud-on-the-market cases. There can be some aid from the fact that external auditors are required to assess and report regarding material weaknesses in financial reporting controls at larger issuers. Further, the larger the disaster, the more likely it is that government agencies or the financial media will have done their own investigations on which plaintiffs can free-ride for evidence of recklessness.

197. For a criticism of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), on the basis that it employs an unrealistic view of the nature and limits of corporate personhood, see generally Donald C. Langevoort, *Lies Without Liars?* Janus Capital *and Conservative Securities Jurisprudence*, 90 WASH. U. L. REV. 933 (2013).

198. *See generally* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579 (2018) (suggesting that systems theory provides the best framework for understanding corporations).

would "go ballistic" at intrusions into his domains, thereby leading to a struggle to get acceptable information. In exactly this kind of case, however, the court stumbled on the meaning and nature of attribution as to the subsidiary's CEO, and dismissed the case.[199] But putting that attribution issue aside, the compliance failure itself should have been treated as an allegation of corporate recklessness sufficient at the pleading stage.

## V. CAUSATION AND DAMAGES

### A. FROM DUTY TO CAUSATION

We now move on to the final cluster of disaster-related issues on which plaintiffs must sustain the burden of proof and persuasion: reliance,[200] loss causation, and actual loss (damages). At first glance, it may appear that these issues are thoroughly disconnected from the duty to disclose issues we have been examining and should be relatively easy to deal with. By definition, a disaster brings with it an immediate and dramatic price decline upon disclosure of the truth. That would seem to satisfy the standard of loss causation commanding that plaintiffs demonstrate some proximate link between the fraud and the loss, so that the fraud-on-the-market claim does not become a de facto insurance scheme compensating for price declines caused by other unrelated factors (for example, extraneous market movements or supervening events).[201] However, as any law student who has finished first-year torts would understand, this is a financial markets version of the *Palsgraf* problem, which is all about duty.[202]

To illustrate: after surviving significant motion practice trying to dismiss plaintiffs' "pre-spill" claims in the *BP* litigation, the plaintiffs failed at the class certification stage because of a causation and damages problems.[203] The case presents a

199. For a case on essentially these facts that could well have been decided on this basis—but was not—see *Doshi v. General Cable Corp.*, 823 F.3d 1032, 1041–42 (6th Cir. 2016). The court drew a distinction between attribution of knowledge and attribution of scienter, and found the former present but the latter lacking. *Id.* This is not a common distinction to draw; most courts simply equate knowledge and scienter, without looking for separate evidence as to the motivations behind the misrepresentation or omission. COX ET AL., *supra* note 36, at 707 (citing AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202 (2d Cir. 2000), and SEC v. Falstaff Brewing Co., 629 F.2d 62, 76 (D.C. Cir. 1980)).

200. Reliance is a class-wide inquiry invoking the presumption endorsed in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) and *Halliburton II*, 134 S. Ct. 2398, 2414 (2014). For a discussion of lingering questions about what has to be demonstrated and by whom, see Sale & Thompson, *supra* note 4, at 546–50.

201. *See* Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 816–17 (2009). As Fisch shows, loss causation takes on more work than it is able to handle, which has led to immense judicial confusion about what is necessary to be demonstrated, by whom, and why. *Id.* at 821.

202. *Palsgraf v. Long Island R.R. Co.,* 248 N.Y. 339 (1928), of course, was about negligence liability, not intentional torts. *Id.* at 341. Its relevance, however, has been recognized in fraud cases. *See AUSA Life Ins. Co.*, 206 F.3d at 210, 217; *see also* Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC, 797 F.3d 160, 183–85 (2d Cir. 2015) (Calabresi, J.).

203. Ludlow v. BP, P.L.C., 800 F.3d 674, 689–91 (5th Cir. 2015); *see* Lipton, *supra* note 25, at 119–20.

conundrum. As we have seen, so many fraud cases like *BP* are concealment allegations. In other words, had the defendants told the truth about the risks, the market price would have been lower than what investors paid during the class period.[204] That would seem to lead to an out-of-pocket damage measure that would give each investor the dollars per share representing the difference between the actual purchase price and the hypothetical "true" price. Empirically, however, that is hard to construct. As a result, plaintiffs tend to turn to the later stock price drop as approximating their real damages, which they adjust if there are demonstrably extraneous or supervening events to be subtracted.

The problem in the *BP* case, according to both the district court and the Fifth Circuit, was that what was misrepresented was risk, whereas what the plaintiffs were asking for was a measure based on the historical certainty that the disaster did occur (the actual stock price drop). To give what the plaintiffs asked, the judges thought, would overcompensate them vis-à-vis the price distortion theory on which their claim rested.[205] In response, the plaintiffs said that surely certain investors, upon knowing the truth about disaster preparedness at BP, would not have bought at all but instead put their money elsewhere.[206] To that, the judges said that there was no way of knowing who or how many of the class members would fit in this category, and that this open question meant that the plaintiffs' theory and proof as to damages was not common to the entire class.[207] Hence, class certification failed.[208]

The judges may be right in their assessment, although loss causation was probably not the correct label for their reasoning. Proximate cause—the foreseeable materialization of precisely the risk that had been misrepresented—did exist. But the very nature of the fraud-on-the-market lawsuit is about price distortion, so that a strict out-of-pocket measure would seem to be the necessary corollary for those who want its reliance-absolving grace bestowed upon them. The mystery is why so many courts have indicated a willingness to instead offer a rescission-based remedy in these kinds of cases. That is a story for another time and place.[209]

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204. There is another interesting duty issue embedded in this, which has received relatively little attention from courts or commentators. In situations where the issuer would have been entitled to conceal the truth, the measure of distortion should be the difference between the price at the time of the fraud and the price that would have prevailed had the issuer taken that option, which may be small or nonexistent. To assume truth-telling as the counterfactual takes duty beyond what courts have said in Rule 10b-5 cases. *See* Donald C. Langevoort, *Compared to What? Econometric Evidence and the Counterfactual Difficulty*, 35 J. CORP. L. 183, 187 (2009).

205. *Ludlow*, 800 F.3d at 690 (such a measure would overcompensate investors who would have traded at a different price).

206. *Id.*

207. *Id.* at 690–91.

208. *Id.*

209.

> The measure of recovery in a Rule 10b-5 action always has been confusing. Not coincidentally, it always has been an afterthought in Rule 10b-5 caselaw. Litigants seeking to establish the existence and then the elements of a private cause of action under Rule 10b-5 were

Importantly, however, not every investor needs that grace. Today, more and more investors limit their purchases to companies that meet some threshold social or environmental responsibility or otherwise pay close attention to environmental performance.[210]And these are not usually the price-takers assumed in fraud-on-the-market theory but active investors making customized investment decisions.[211] These become ideal "opt-out" plaintiffs willing to forego the presumption of reliance in return for the ability to gain the advantages—including an effort at rescission—that come from showing that their investment in the company's stock would not have occurred at all but for the falsity.[212] It is not hard to imagine socially responsible investors, in particular, adjusting their strategies and procedures to bolster this potential. Where actual reliance can be shown, there are many possibilities for improving the deterrence value of disaster-related private securities litigation.[213]

### B. CREDIBILITY AND GAMESMANSHIP

In the aftermath of corrective disclosure in light of some disaster, the observable stock price drop often seems excessive in relation to the fundamental value of the news that has just been revealed. A common assumption is that this additional drop reflects the loss of credibility from revealing the extent to which management showed itself willing and able to dissemble, leading to the inference that other aspects of corporate performance and prospects may also be unreliable—"collateral damage" from the corrective news. One prominent study estimates that as much as sixty-six percent of a stock price decline in the aftermath of fraud is reputational.[214] So here we find another subtle connection between duty and causation.

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> content to leave the measure of recovery to be resolved another day. In almost all cases "another day" never came as cases settled without the need to precisely define the measure of recovery. In those cases where the courts have been forced to state a measure, they have provided a bewildering mix of standards, often using the same terms, but frequently giving them radically different interpretations and doing little to resolve the inconsistencies. For those cases that made it to the end, judges seemed more partial to providing rough justice than to establishing a clean theoretical formula for recovery.

Koch v. Koch Indus., Inc., 6 F. Supp. 2d 1192, 1201 n.6 (D. Kan. 1998) (quoting Robert B. Thompson, *"Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5*, 51 BUS. LAW 1177, 1179 (1996)).

210. Fernando et al., *supra* note 58, at 2024, 2027 (explaining that "investors scrutinize corporate environmental policies more closely than they do other corporate actions that have social implications" and "unconstrained institutional investors are not indifferent to environmental performance"); *see also supra* notes 44–45.

211. *See* Fernando et al., *supra* note 58, at 2027.

212. *See* David H. Webber, *Shareholder Litigation Without Class Actions*, 57 ARIZ. L. REV. 201, 239–40 (2015) (describing conversations with two heads of portfolio-monitoring companies about their experiences with corporate clients deciding whether to opt-out of a class action). The BP litigation had a substantial opt-out component.

213. This is the heart of Ann Lipton's proposal to revive reliance in mismanagement cases by redesigning the puffery doctrine, rethinking loss causation, affording "holder" claims, and even creating a cause of action to facilitate greater shareholder governance. Lipton, *supra* note 25, at 140–46.

214. *See* Jonathan Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 600 (2008). This may oversimplify, since there are so many different

There is a lively academic debate over whether the class of investors suing in a fraud-on-the-market class action should be able to recover for some or all of this collateral damage.[215] Such damage certainly is a foreseeable consequence of the revelation, so that if this is simply a loss causation problem addressable by reference to the "materialization of the risk" standard used by many courts,[216] the case for recovery seems almost self-evident. On the other hand, if we focus on the time of the purchase or sale, opponents argue that there is no distinctive deception about credibility independent of the fraud itself. Without that, class members have not been fraudulently misled about management's credibility—preexisting credibility has simply been abused in the course of the fraud.[217] They are in no different position from the longer-term investor who has held the stock for years, who suffers precisely the same collateral damage but has no right to recover.

Because of the widespread judicial confusion about causation and damages, this argument is particularly hard to resolve. As noted above, I am averse to anything but a strict out-of-pocket measure of damages in fraud-on-the-market cases, as well as to obsessing on corrective disclosure. If fraud on the market is about remedying distortion, then the amount of distortion at the time of the fraud has to be the only appropriate measure of damages, which might seem to undercut the argument for including collateral harm. But this approach actually offers an appealing middle-ground solution.

My earlier discussion of credibility as a variable, and its potential to facilitate fraudulent impression management, suggests that the prevailing level of trust in management's candor operates as a multiplier. Take two issuers with different

ways news relating to a disaster and its aftermath may cause a stock price to drop. For instance, the news may indicate a greater likelihood of more intrusive regulation going forward, and thus a drag on profits. Research in the aftermath of the Deepwater Horizon catastrophe shows that other drilling companies suffered significant stock price drops, presumably because of factors common to everyone engaged in that newly riskier business. *See generally* Frank Heflin & Dana Wallace, *The BP Oil Spill: Shareholder Wealth Effects and Environmental Disclosures*, 44 J. BUS. FIN. & ACCT. 337 (2017). The decline affected firms with lower quality environmental disclosure more than those who had been more forthcoming. *Id.* at 340.

215. For discussions, compare Bradford Cornell & James C. Rutten, *Collateral Damage and Securities Litigation*, 2009 UTAH L. REV. 717, 741 (arguing collateral damage should not be recoverable), and Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of* Dura Pharmaceuticals, Inc. v. Broudo, 63 BUS. LAW. 163, 179–85 (2007) (same), with Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169, 173–75 (2009) (arguing collateral damage should be recoverable), and Lipton, *supra* note 25, at 119, 122 (same). Cornell and Rutten tie their argument to the point extensively discussed (and critiqued) above: the absence of a per se duty to disclose wrongdoing or mismanagement. Cornell & Rutten, *supra*, at 738–41.

216. *E.g.*, Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005). For a good explanation of this idea, see Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation and Loss Causation: Toward a Corporate Finance–Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1442–43 (2004).

217. Black, *supra* note 215, at 177–79, rightly notes that executive certification requirements imposed by the Sarbanes–Oxley Act do create an independent duty for senior managers to attest both to the accuracy of the financial disclosures and the adequacy of internal controls, subject to a knowledge qualifier. Such certifications can be important in imposing liability, especially the liability of the officers in question, in 10–Ks and 10–Qs, but not necessarily outside those reports. The role of a control failure on issuer liability is discussed *supra* at text accompanying notes 193–99.

marketplace assessments of credibility: company *A*'s management is viewed as truthful, whereas company *B* has lost investor trust. If we imagine both companies making similar factual announcements of hard-to-verify information, the price inflation for *A* will be higher than for *B*. If what is represented is thus untrue, the price distortion will be larger for *A*. If so, then there is a portion of the price distortion at the time of the fraud that does reflect credibility, not just information, and the loss when the truth comes out is not just collateral damage. Once again, reliance on the integrity of the market price—and on the processes that underlie price formation—is an entitlement granted to encourage socially valuable risk-taking by investors.

## VI. DISASTERS AND SUSTAINABILITY DISCLOSURE

As noted above, there has been a rapidly growing effort through both public and private channels to increase the amount and quality of corporate disclosure relating to matters of environmental and social responsibility, under the heading of sustainability or ESG disclosures.[218] Proponents for more disclosure see disasters great and small looming in the foreseeable future and want to give investors and other stakeholders early warning as to which companies are sensitive to—and better prepared for—these risks and which are not. The goal for some is to produce useful financial information, whereas others want to use disclosure mainly to pressure companies into more sensitivity and preparedness. Not surprisingly, mandated sustainability disclosure is highly controversial. It has had more traction in Europe than in the United States,[219] where regulatory efforts are apparently now on a politically induced hiatus. In the United States, business interests have made a concerted effort to limit the SEC's mandate to matters of financial materiality, but that is just part of the resistance. In the current political climate, for example, one can imagine the ideological consequences associated with imposing a rule that issuers address the specific impacts of climate change with so many climate change deniers in our government.

As we have already seen, the supposedly clean separation between the financial and the non-financial is an illusion.[220] Even if we stick closely to financial materiality, there is ample research tying environmental, social, and similar aspects of corporate behavior to stock market valuations and firm profitability.[221] Serious

218. For one argument for such an effort see Ho, *supra* note 57, at 650–51 (arguing for the exercise of shareholder to promote firm management, mitigation and disclosure of ESG risks). In its 2016 Disclosure Reform release, the SEC requested comment on sustainability disclosure, which generated a large number of responses from both advocates and critics. See *supra* note 107.

219. On the various approaches taken globally, see Williams & Conley, *supra* note 109, at 550.

220. *See* Williams, *supra* note 29, at 1284 (explaining the difficulty in drawing the distinction). And as to the investors whose interests extend to sustainability mainly on ethical grounds, it is far from clear how or why these concerns should be banished entirely from the realm of securities regulation. *See generally id.*

221. *See, e.g.*, Allen Ferrell et al., *Socially Responsible Firms*, 122 J. FIN. ECON. 585 (2016) (finding that well-governed firms that suffer less from agency problems engage more in corporate social responsibility).

sustainability risks are priced. The hard question is what specific disclosure mandates would add value in a cost-efficient manner, taking into account the many positive externalities associated with accurate disclosure along with the inevitable costs.[222] That is the motivation behind the various nongovernment organization efforts to fill the void via voluntary disclosure frameworks that avoid (directly, at least) both the rigidity of formal administrative rulemaking and political battles for agenda control. In the United States, an effort by the private Sustainability Accounting Standards Board (SASB) is well underway to craft disclosure standards for domestic companies tightly coupled to financial materiality.[223] Companies are invited to opt in, thereby creating expectations about what they will reveal regarding sustainability metrics and controlling how they will reveal it. This approach has a number of virtues: the system has to be appealing enough to issuers to generate a critical mass of adherents, while presumably also satisfying key investor stakeholder groups, thereby gaining flexibility and cost–benefit discipline that the SEC itself might find politically difficult to obtain.

My interest here is about disaster-related litigation, particularly class actions. The discussion connected to this is about whether—and if so, how much—fear of litigation "chills" voluntary sustainability disclosure. This question is of interest to sustainability proponents in two conflicting respects. If there is such a chill, then the case for mandatory disclosure is more compelling. On the other hand, if governmental sustainability mandates are either unlikely for political reasons or unwise as a matter of policy, the litigation threat might stand in the way of improved disclosure via a SASB-like process. This is a familiar conundrum. Issuer adherence to mandatory disclosure standards varies based on the potency of public and private enforcement threats together with the perceived proprietary and reputational costs and benefits of either law-abidingness or defection.[224] Voluntary disclosure involves a different calculus because silence is a legitimate option. For decades, now, there has been a working assumption that the threat of investor litigation leads issuers to a less-than-optimal disclosure policy, fearing the consequences if they make statements or projections that turn out badly. That disserves investors to the extent that what would have been disclosed was valuable. This was the impetus behind the safe harbor for forward-looking information discussed earlier.[225]

The litigation risks associated with sustainability disclosure can easily be overestimated, especially if the risks being discussed are likely to emerge, if at all,

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222. *See* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1947 (2013) (explaining that disclosure produces positive externalities to the firm's suppliers, customers, employees, and rivals). On the cost-benefit assessments of externalities as they relate to the agency's "core mission," see Yoon-Ho Alex Lee, *Beyond Agency Core Mission*, 68 ADMIN. L. REV. 551, 569–93 (2016).

223. The SASB efforts in this direction are described in its comment letter to the SEC on disclosure reform. Letter from Jean Rogers, Ph.D., P.E., CEO and Founder of SASB, to Brent J. Fields, Secretary, U.S. Sec. & Exch. Comm'n (July 1, 2016), https://www.sec.gov/comments/s7-06-16/s70616-25.pdf.

224. *See generally* Karpoff et al., *supra* note 214 (reviewing SEC enforcement actions for financial misrepresentation).

225. *See supra* Section I.D.

only in the medium- to long-term. Materiality naturally diminishes the longer the time horizon grows: the probability of any given future is less and the magnitude of the impact less, if only because it has to be discounted to present value.[226] The most serious fraud-on-the-market litigation risk is the disaster that occurs relatively soon after the disclosures. Loss causation issues also come into play here because of the difficulties in connecting specific disclosures to stock price losses far into the future. So does scienter become relevant, insofar as knowing or reckless disregard is harder to show in times of mind-numbing normalcy rather than palpable foreboding.

But near-term disasters are not impossible, and of course as time goes by in a continuous disclosure environment, what was far off gradually becomes less so. The remaining questions, not surprisingly, take us back to duty. We have seen ample defendant-friendly caselaw, especially in treating aspirational statements relating to the issuer's commitment to safety, security, and sustainability as puffery. But there are many other cases finding potentially actionable fraud in other soft statements, especially when repeated or made in response to heightened investor interest. In both the Deepwater Horizon and Massey Energy litigation, the plaintiffs pointed to the issuers' voluntary sustainability reports as sources of actionable deception.[227] As investor interest in this area grows, issuers cannot be confident that the law will favor them when disaster ensues. It might, but it is a gamble that depends on how the judge they draw reacts to the particular wordplay.

Could these same liability fears undermine SASB's efforts to gain traction? Any voluntary statement within the approved frameworks would, of course, still be tested under Rule 10b-5. This raises the question of whether an issuer's voluntary commitment to privately-adopted disclosure standards creates a reasonable expectation for investors that what is said will be fully responsive to those standards.[228] My sense is yes: if a duty to disclose can be derived from an SEC line item, as I think it is and should be, then a comparable duty should derive from a contractual commitment to privately promulgated standards as well. In other settings, it is clear enough that following industry standards, even when they have

226. There is ample evidence that stock analysts focus on the near term because the longer term is so much harder to predict and value with confidence. *See* LANGEVOORT, *supra* note 130, at 105–07.

227. *See In re* BP P.L.C. Sec. Litig., 922 F. Supp. 2d 600, 613 (S.D. Tex. 2013) (finding a corporate statement in a sustainability report may have been misleading but scienter not adequately alleged because authorship of sustainability report not clear); *In re* Massey Energy Co. Sec. Litig., 883 F. Supp. 2d 597, 615 (S.D.W. Va. 2012) (finding Corporate Social Responsibility Report contained possible omissions); *see also In re* Cognizant Tech. Sols. Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 100,242, 2018 WL 3772675, at *19–21 (D.N.J. Aug. 8, 2018). Plaintiffs also had preliminary success in a high profile non-disaster case against Exxon Mobil for misrepresenting or omitting various facts relating to the carbon control risks in a sustainability-like report on its risk management efforts. *See* Ramirez v. Exxon Mobil Corp., 334 F. Supp. 3d 832, 839-40 (N.D. Tex. 2018). The statutory safe harbor for forward-looking information offers a cautionary lesson about even the most aggressive protections when judges sense deceit. *See supra* Section I.D.

228. This is similar to the issue of whether the MD&A creates a duty in Rule 10b-5 cases, on which the Supreme Court had been expected to rule. *See supra* note 124.

some regulatory imprimatur, cannot protect statements that otherwise have the propensity to mislead.[229]

If so, then compliance with SASB-like standards would be a proper "duty" subject for fraud-on-the-market litigation. And materiality as applied under Rule 10b-5 is explicitly the baseline for its sustainability standards, so that element fits as well. The combination of duty and materiality, in turn, means that some litigation threat will be present. On the other hand, some lessening of that threat comes from using a common rubric with other similarly situated issuers. This reduces the risk that comes from being unique in what is said. Presumably, SASB could aid this to some extent by explicitly setting boundaries for reasonable investor expectations. In other words, in outreach and guidance to the investor community, SASB could emphasize that the standards have been crafted carefully to balance investor demand for sustainability disclosure and peer comparability against the costs and risks associated with providing such information, so that adherence is not meant to put in play anything beyond the natural or explicit confines of the standards. Too much protectionism, of course, will backfire by turning the disclosure into unreliable cheap talk. However, a reasonable, moderate statement of what investors should and should not expect might help assuage issuer fears enough to stimulate participation in the voluntary regime notwithstanding residual fears, so long as investors see good market-driven reasons to do so. Issuers, in turn, would be wise to preface their voluntary standards-based disclosure with a statement that nothing therein is meant to create an expectation of disclosures outside the four corners of the chosen framework. All this should mean that adherence to the letter and spirit of high-quality voluntary sustainability disclosure is more likely to lessen the litigation risk than increase it.

## CONCLUSION

Our inquiry into disclosures and disasters sheds light on what is emerging as a significant issue in corporate disclosure theory and practice. By this point it should be clear that the securities laws—and the fraud-on-the-market lawsuit in particular—are not as effective as they could or should be at forcing either disclosure about, or managerial attention to, the emergent risks leading up to a corporate disaster. Through either gamesmanship or stone-cold silence, corporations can hide too much risk and wrongdoing. There is something deeply unsatisfying about making potentially massive fraud-on-the-market liability turn on the wordplay underlying such small distinctions.

So we are back to the point at which we started Part I: if an issuer has engaged in financially material wrongdoing but kept it hidden, the market has been deceived (and the stock price distorted) regardless of whether artful paltering about the issue crossed some fine line. Today, however, courts disavow that it is

229. *See* United States v. Simon, 425 F.2d 796, 808 (2d Cir. 1969) (finding that adhering to generally accepted accounting principles does not eliminate possibility that financial statements were nonetheless misleading); *see also* United States v. Ebbers, 458 F.3d 110, 125–26 (2d Cir. 2006) (same).

their right or responsibility to optimize the disclosure system or its remedies; that is for Congress and the SEC.[230] Politics being what it is, the status quo will probably be with us for the foreseeable future, so that courts will continue to struggle and disagree about what to do in individual cases by asking and answering questions that should not be outcome-determinative, but are. The effort to promote stock price integrity deserves better than this, even without a thorough makeover.[231] Ultimately, how courts decide disaster cases says much about what norms of candor companies have to follow in an increasingly complex and risky world, and whether investors and others can depend on insiders not to hide the dark clouds that are starting to appear on the internal radar screens when everything still seems sunny to those outside.

230. Prior to the late 1970s, the courts were more open to a partnership role in duty creation, see Bauman, *supra* note 35, which probably led the SEC to pay less attention to the design of the disclosure system as a whole than it should have. Regulation S–K and its doctrinal limitations are the legacy of that era.

231. Paying more attention to scheme liability may be a way forward. *See supra* note 167. But courts have been skeptical of scheme claims as backdoor ways of expanding the category of persons liable for fraud, a skepticism that has its own collateral damage to the extent it also truncates fresh approaches to duty.