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Donald C. Langevoort

Georgetown University Law Center, langevdc@law.georgetown.edu

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DISASTERS AND DISCLOSURES

*Donald C. Langevoort**

Corporate disasters happen with unnerving frequency. These can be 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 prime example, with loss of life, environmental damage across a multi-state expanse, and great consequential economic loss.¹ Many are legal compliance disasters: a massive fine or penalty imposed on the company after government authorities determine that the corporation surreptitiously had violated the law. Others may be on a smaller scale yet still painful, as with a defective product on which the company had pinned its hopes, or the departure of a key leader under questionable circumstances.

High-profile bad news events like these almost always produce high-stakes litigation.² Victims and their champions surface before, during, and after the damaging event becomes public. And if the company was publicly-traded, almost surely among these will be investors who own or owned the firm's securities. A defining characteristic of these kinds of

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. My thanks to Hillary Sale for helpful comments, and to Crystal Weeks, Dominique Rioux, Andrew Ko and Andrew Hopkins for excellent research assistance.

¹ See NATIONAL COMMISSION ON THE BP DEEPWATER HORIZON OIL SPILL AND OFFSHORE DRILLING, REPORT TO THE PRESIDENT—DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING, Jan. 2011, available at <https://www.gpo.gov/fdsys/pkg/GPO-OILCOMMISSION/pdf/GPO-ILCOMMISSION.pdf>; Russell Mills & Christopher Koliba, *The Challenge of Accountability in Complex Regulatory Networks: The Case of the Deepwater Horizon Oil Spill*, 9 Reg. & Gov. 77 (2015).

² 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 multiple domains (federal and state, public and private). This is part of a larger enterprise risk in the event of a crisis, with 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 (2014). 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); on the interaction of reputation, crisis and share prices, 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 Mgt. J. 2103 (2017).

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 naturally feel damaged and want 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 1933³ or the "fraud-on-the-market" theory for an implied private right of action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. The latter is more common, and thus the main subject of attention here.

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.⁴ To recover in the aftermath of a corporate disaster,⁵ purchaser-plaintiffs have to satisfy three main burdens of proof on the merits (while facing a multitude of potential defenses). One is to establish deception—one or more corporate statements that were materially false or misleading when made, which plausibly distorted the stock price to the investors' detriment. In disaster cases, these are usually claims that the company hid the risk of occurrence in the months, weeks or days before the blow-up. The next is to establish scienter, i.e., that these statements were intentionally false or made recklessly.⁶ Last is a set of showings related to causation, which involves connecting investor purchases class-wide to both the prior distortion and a subsequent loss in value of the stock after some corrective disclosure was made revealing the truth.⁷

³ Section 11 creates an express remedy for misrepresentations and omissions in registration statements filed in the course of a registered public offering. E.g., *Omnicare Inc. v. Laborers Dist. Council Pension Fund*, 135 S.Ct. 1318 (2015)(Section 11 suit involving a substantial compliance disaster)("Omnicare"). Public offerings are at best episodic in the corporate lifecycle and hence these cases are relatively less common than 10b-5 cases even though the '33 Act cause of action is more plaintiff-friendly.

⁴ See *Halliburton Co. v. Erica P. John Fund*, 134 S.Ct. 2398 (2014)("Halliburton II"). The underlying idea is that fraud in such markets harms all traders who assumed that the price was honestly and fairly set.

⁵ I make no effort to define "disaster," and indeed that word often is used loosely to describe any bad news serious enough to lower a company's stock price.

⁶ See *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007)(applying heightened pleading standard for scienter).

⁷ See *Halliburton II*, *supra* (presumption of reliance for all traders who relied on market integrity); *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005)(loss causation). Separately, plaintiffs must justify

Disaster-related fraud-on-the-market lawsuits can be controversial for any number of reasons. There may be doubts about the propriety of letting investors seek compensation alongside those more directly—sometimes horrifically—injured by the disaster, because shareholders may have been the intended beneficiaries of the risky business while the other victims were simply put in harm’s way. As in most all 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 out of the pockets of all current shareholders,⁸ even though they too are victims of the catastrophe. The class of plaintiffs seeking recovery under Rule 10b-5 is limited to those who can demonstrate that they purchased their shares after the deception began. Hence the feverish effort by the plaintiffs’ lawyers to identify false or misleading statements tied to the disaster as far back in time as possible, to maximize the size of the class and resulting recovery. Shareholders who bought afterwards have some chance of recovery. Shareholders who bought before are just double losers, suffering the share value loss from the disaster itself and from the additional costs associated with the litigation in which subsequent purchasers receive compensation.⁹

Legal scholars have generated an abundant literature examining each of the individual elements of the cause of action (and sub-elements, affirmative defenses, etc.) in an effort both to assess the soundness of prevailing doctrine and contribute to the on-going debate over whether such cases have positive net social value in terms of the compensation they offer or the deterrence they provide.¹⁰ Less attention, however, has been given to how all the different pieces mesh together.

the use of the class action device by demonstrating that common issues predominate, which is the primary function of the reliance presumption.

⁸ See William Bratton & Michael Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69 (2011).

⁹ See Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421 (1994).

¹⁰ Compare John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implications*, 106 Colum. L. Rev. 1534 (2006) with James Spindler, *We Have a Consensus on Fraud on the Market: But It’s Wrong*, 7 Harv. Bus. L. Rev. 67 (2017); see also James D. Cox & Randall Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Laws*, 6 Eur. Comp. & Fin. L. Rev. 164 (2009); note --- infra.

Disaster cases are mostly about distortions via the alleged concealment of risk factors prior to the crisis. In an ideal world, serious risk factors would naturally be subject to a duty to disclose, with scienter and materiality the only hard questions—there is no social value to justify deliberate concealment once those thresholds are met. Yet for a host of doctrinal, pragmatic and political reasons, there is no such duty. The SEC has imposed a set of requirements that *sometimes* forces risk disclosure, but does so neither consistently nor adequately, and with uneven enforcement. Courts in 10b-5 cases, in turn, have made duty mainly a matter of active rather than passive concealment and thus, literally, wordplay: there is no antifraud-based duty to disclose risks unless and until the issuer has said enough to put the particular kind of risk “in play.”¹¹ But when that is, and why, flummoxes them.

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 Fundao dam in November 2015. The dam (holding back toxic sludge from mining operations) was owned by a joint venture co-owned by two global companies with mines nearby, Vale and BHP Billiton. Both companies had securities traded in the U.S., and hence 10b-5 lawsuits were filed separately against each in the Southern District of New York for making statements touting their commitment to the safety of their projects while not revealing facts allegedly known to both indicating that Fundao was at risk. The public statements each made with respect to the respective companies’ commitment to safety and the environment were comparably soft and filled with marble-mouthed generalities. (Vale: “[w]e 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,” and “we seek nothing less than zero harm”; BHP Billiton: “[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 well-being, and to insist any work that is unsafe must be stopped.”) Yet the reactions of the two district judges, ruling just a few months apart, were palpably inconsistent on whether these

¹¹ For a relatively early expression of this, see *In re Craftmatic Sec. Litig.*, 890 F.2d 628, 640 (3d Cir. 1989)(duty to disclose unlawful marketing practice in light of affirmative statements touting marketing prowess). For more, see J. ROBERT BROWN JR., *THE REGULATION OF CORPORATE DISCLOSURE* sec. 10.03[D] (4th ed. 2017).

statements could mislead the reasonable investor. No said the judge in the Vale case, because the touting was ordinary puffery with no solid communicative content;¹² yes the judge said as to BHP because, while 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 allowing the inference that it was trying to deceive them.¹³ So who was right, and why? This 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, which are the two main contributions in what follows.¹⁴ But even if there is more thoughtfulness to the endeavor, it is fair to ask why wordplay should make so much of a difference as to duty in the first place, or whether instead our impoverished conception of duty deserves a more thorough makeover.

There are many pay-offs 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 good 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 imposes¹⁵ and negotiate the murky world of voluntary disclosure—whether and what to say in response to marketplace pressures (from the analysts, institutional investors, the media and other vocal stakeholders) to reveal more than the SEC forces about the risks the company faces. Research in financial economics is paying more attention to these complex interactions—essentially, the micro-structure of corporate communications—which are far more complicated than suggested by the simplifying assumptions about

¹² In re Vale S.A. Sec. Litig., Fed. Sec. L. Rep. (CCH) par. 99,658 (S.D.N.Y. 2017). 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.

¹³ In re BHP Billiton Ltd. Sec. Litig., 2017 WL 3822755 (S.D.N.Y. 2017) at *10. In footnote 3, the court distinguished the alleged misrepresentations in *Vale* as “significantly more specific” than the ones before it, but that is very hard to see much of a distinction from a side-by-side comparison of the disclosures in question.

¹⁴ For an effort along these same lines so as to enhance the potency of disclosure and corporate governance, see Ann M. Lipton, *Reviving Reliance*, 86 Fordham L. Rev. 91 (2017).

¹⁵ See Zahn Bozanic, *Securities Law Expertise and Corporate Disclosure*, Oct. 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2662096 (evidence that elite securities lawyers successfully help clients avoid disclosing what they don’t want to disclose).

near-perfect market efficiency that once dominated. Courts are a step behind, while lawyers seem to have found the doctrinal soft spots and how to exploit them. Language matters, presenting opportunities for obfuscation and gamesmanship.

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 of interpretation for how marketplace actors interpret what issuers say and don't say, whether in formal SEC disclosures, conference calls, press conferences and even executive tweets.¹⁶ They also offer a distinctive point of reference 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.¹⁷ Especially as more and more attention is paid to the environmental, regulatory and social risks corporations face, with fears of so many potential disasters in their future, 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: those created by the SEC, and those imposed by the courts mainly via the half-truth doctrine, from which comes so much of the gamesmanship. Part II then examines the especially problematic duty questions that arise when what is concealed was at the time under investigation from regulators or prosecutors, or was concealed unlawful behavior. Part III turns to duty once the crisis has become public, when the issuer has to narrate the disaster as it unfolds. Then we turn to ways in which duty affects other elements of the fraud 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 applies the foregoing to the burgeoning subject of sustainability disclosure, and Part VII concludes.

¹⁶ 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).

¹⁷ See generally Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 Harv. L. Rev. 1197 (1999).

I. DISASTERS AND DECEPTION

A. The Centrality of Duty

The law at work in determining whether there was deception in the course of some corporate disaster and if so when it began derives from a fundamental question: does (or should) the issuer have a duty to reveal material inside information that indicates that the disaster is looming, if not already in progress? In principle, at least, it is hard to see in theory why not, assuming that we wish for stock prices to be as accurate as possible.¹⁸ This category of 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.¹⁹ To be sure, the issuer that makes such disclosure will suffer (and hence its shareholders will, too), but 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, trumps that particular self-interest in hiding bad news.

That is not to deny that there are real costs to take account of 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 speculative disclosure may be misinterpreted and lead to over-reaction by investors and other stakeholders. More subtly, there is often fear of the self-fulfilling prophecy: that disclosure of a possibility (e.g., a threatened government lawsuit) by itself makes the disaster more likely or weakens the company's ability to prevent it. All this is part of the balancing the SEC is supposed to do. This article is not the place to attempt a cost-benefit analysis or formulate ideal disclosure policy for disaster-related risks generally, though we will certainly look more closely at the challenges that arise over the course of the disaster timeline. My sense, for what it is worth, is that the SEC has fallen short of the optimal in its policies

¹⁸ E.g., Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 Wisc. L. Rev. 297; Thompson & Sale, *supra*, at 530-31.

¹⁹ See Edmund Kitch, *The Theory and Practice of Securities Disclosure*, 61 Brook. L. Rev. 763 (1995).

relating to risk disclosure,²⁰ and that this failing has had an unfortunately spillover effect on fraud litigation.

The courts play a backup role here, with a more limited mandate of imposing disclosure duties only to the extent that nondisclosure constitutes fraud. As courts have formulated Rule 10b-5's "duty to disclose," the concealed truth must be of course be material, i.e., of importance to a reasonable investor.²¹ But that is only the starting point, much as many plaintiffs and their lawyers wish otherwise. There is no liability simply because investors would consider the secret important and like to know it.²² There must also be a duty to speak. While there are a number of duty theories, by far the most important is the half-truth doctrine—once the issuer speaks, it must tell both the literal truth *and* the whole truth, not omitting any hidden facts necessary to make what is said not misleading.²³ This potent textual coupling is found in the text of the most important express antifraud provisions under the securities laws, as well as in Rule 10b-5. In its recent *Omnicare* decision,²⁴ the Supreme Court had something to say about finding half-truths in statements of opinion (there in the context of a compliance failure), which is relevant to all disaster cases.²⁵

²⁰ See Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 Wash. U.L.Q. 753 (1997).

²¹ These same challenges arise in the assessment of materiality. See *Matrixx Initiatives Inc. v. Siricusano*, 563 U.S. 27 (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.

²² 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 rulings: *Chiarella v. United States*, 445 U.S. 222 (1980), an insider trading case, and *Basic Inc. v. Levinson*, 485 U.S. 224 n. 17 (1988), a materiality decision. As a result of the indirect way the law of duty formed, there is no overarching theory, which has led to a very "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 (2004). On the duty to disclose prior to those two Supreme Court decisions, see Jeffrey Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 Geo. L.J. 935 (1979).

²³ As courts often point out, this is not actually a disclosure obligation since the fraud is in what was said, not 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). The other forms of duty include fiduciary obligation, and the duties to update and correct. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 722-26 (8th ed. 2017); note -- *infra*. Though these could be raised in disaster cases, they tend not to be.

²⁴ *Omnicare* was a Section 11 case brought pursuant to the Securities Act (see note --- *supra*) but most courts since have applied its reasoning to fraud-on-the-market litigation under Rule 10b-5 as well.

²⁵ Hillary Sale and I have recently explored both the discourse and corporate governance implications of *Omnicare*, the substance of which need not be repeated Hillary A. Sale & Donald C. Langevoort, "We

The half-truth doctrine forces judges to assess claim of hidden risks by reference to whether what was undisclosed rendered what was said incomplete, thereby crossing the dividing line from passive to active concealment. In the Deepwater Horizon securities lawsuit, for example, the main pre-explosion storyline put forth by 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 subjected to the same procedures.²⁶ In the Fundao 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.²⁷ Any careful reader of judicial decisions in this area involving defendants' pre-trial 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 plaintiff's claims about hidden risks are otherwise true.

This task is taken on by judges with surprising confidence, even though that question is really quite difficult given how many different kinds of investors interact in our financial markets and the varying mixes of information to which they have access.²⁸ These seem like mixed questions of law and fact of the sort commonly left to fact-finders at trial, which is exactly what the plaintiffs' attorneys want to have happen.²⁹ And indeed that is what judges do say when rejecting motions to dismiss. Yet

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 for Failure to Comply with the Law*, 68 SMU L. Rev. 715 (2015).

²⁶ See *In re BP P.L.C. Sec. Litig.*, 922 F. Supp.2d 600 (S.D. Tex. 2013). There were also post-explosion disclosure issues, discussed *infra*. 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 (9th Cir. 2014).

²⁷ See pp. ---- *supra*.

²⁸ For just a sampling of this literature, see David Hoffman, *The "Duty" to be a Rational Shareholder*, 90 Minn. L. Rev. 537 (2006); Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. Rev. 461 (2015); Charles Korsmo, *The Audience for Corporate Disclosure*, 102 Iowa L. Rev. 1581 (2017). Some courts describe this as a materiality inquiry, but that isn't right. 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 what is a material fact. See note --- *supra*.

²⁹ It is well understood in both the case law and academic commentary that fraud-on-the-market trials almost never occur, because the high-stakes case will be settled beforehand. Hence the stepped up pre-trial judicial role on these fact-like questions mainly helps 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.

at least as often, it seems, judges take them on as their own to decide. This stepped-up judicial role on questions of how reasonable investors think has been noted by a number of legal scholars, some of whom express doubt about whether such judges are usurping the fact-finding prerogative of juries.³⁰

Here, I want put both motivation and procedural legitimacy to the side and dig more deeply 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 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.³¹ It is, because the speaker was signaling a willingness to be helpful and cooperative, and instead being just the opposite. Our question, essentially, is whether corporate executives should be held to a similarly cooperative signal when communicating with investors, or to something different.

Certain patterns of argument are typical in these cases. Defendants commonly claim that whatever was said, no matter how upbeat, was too general, speculative or vague to be anything more than “puffery,” so that it was neither material nor misleading no matter what was not being said.³² The reasonable investor, they say, knows enough not to rely on

³⁰ How courts make such decisions as a matter of law is unclear. One influential article claims that judges are largely disinterested in these kinds of cases, and employ simple (and often empirically doubtful) heuristics. Stephen Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everyone Else Does—Boundedly): Rules of Thumb in Securities Law Opinions*, 51 Emory L.J. 83 (2002); see also Hillary A. Sale, *Judging Heuristics*, 35 U.C. Davis L. Rev. 903 (2002). Or perhaps politics are at work, so that business friendliness is the real driver behind the rate of aggressive dismissals. *Id.* I have argued that judges are inclined 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. See Donald C. Langevoort, *Review Essay: Are Judges Motivated to Create “Good” Securities Fraud Doctrine?*, 51 Emory L.J. 309 (2002).

³¹ See PAUL GRICE, *STUDIES IN THE WAY OF WORDS*, ch. 2 (1989). For a sampling of the literature putting implicature to use in business settings, see Robert Bloomfield, *A Pragmatic Approach to More Efficient Corporate Disclosure*, 26 Acct. Horizons 357 (2012); Langevoort & Gulati, *supra*; Peter Tiersma, *The Language of Silence*, 48 Rutgers L. Rev. 1 (1995).

³² See *City of Pontiac Ret. System 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”). For a good recent discussion of cases going both ways, see Lipton, *supra*, at 112-16.

statements devoid of hard facts or concrete representations, and can read between the lines well enough to know what is not being said and hence tread carefully, not assume that they've been told all that is important. Soft language, in other words, doesn't matter at all. This is often bolstered by the argument that the securities laws are not meant to force corporations to accuse themselves of wrongdoing or mismanagement. This becomes the contested territory that judges have to work their way through.

There are countless examples of this battling: the Deepwater Horizon and Fundao dam cases have already been noted, and there are so many others plucked out of recent headline news (Volkswagen,³³ Wells Fargo,³⁴ etc.). For our purposes, an especially intriguing example involves a lesser kind of disaster: the Hewlett-Packard corporate governance scandal, wherein its highly-regarded CEO was forced out after allegations of sexual harassment and a cover-up. Were statements he and others made touting HP's improved code of conduct—a response to an earlier corporate governance disaster at the company—misleading for failure to disclose his apparent disregard of it? The Ninth Circuit said no,³⁵ but why not? The opinion offers a jumble of reasons, none particular incisive. The remainder of this part seeks a better way of answering the question.

B. “Voluntary” Disclosures

We start the search by looking at the legal context surrounding the disclosure and asking whether it voluntary or required pursuant to SEC rule. Presumably, investor assumptions and expectations change when they receive a message voluntarily offered as compared to one made under the compulsion of a disclosure regime meant for their benefit. Because the SEC is the disclosure standard-setter, it might seem logical to start with the latter. But for reasons that will become clear, most disaster disclosure issues arise out of voluntary disclosures, where the judicial

³³ In re Volkswagen (Clean Diesel) Sec. Litig., Fed. Sec. L. Rep. (CCH) par. 99,817 (N.D. Cal., July 19, 2017).

³⁴ In re Wells Fargo & Co., Fed. Sec. L. Rep. (CCH) par. 99,900 (N.D. Cal., Oct. 4, 2017).

³⁵ See Retail, Hotel & Dep't Store Local 338 Pension Fund v. Hewlett Packard Co., 845 F.3d 1268 (9th Cir. 2017).

responses focus entirely on whether what was said was misleading or not. 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. Securities analysts take the lead here to lobby on behalf of institutional clients and (on the sell-side) the public investors who read their reports, seeking access to management insights via both conference calls and private audiences with management within limits set by the SEC.³⁶ Pressure to disclose comes from other sources as well—the financial media, stock exchanges, regulators, social and investor activists, and the like. In the aggregate, these are the uncomfortable demands of publicness.³⁷

Managers have discretion in whether and how to respond. They may be hesitant, under advice from their own lawyers, to make disclosures that might create inflated expectations and generate future litigation. And certainly they would prefer not, all other things being equal, to reveal their failures and troublesome risks. But they cannot ignore the financial market pressures, either. A large literature in financial economics has studied voluntary disclosure choices and found considerable variance in practice depending as to whom management mainly caters.³⁸ Where a company's investor base is transient (i.e., made up of active traders), failure to develop a reputation for real-time candor will result in a depressed stock price, which management may well prefer to avoid. Voluntary disclosure will be fairly robust as a result, as long as the rewards to candor outweigh the costs. In contrast, short-run voluntary

³⁶ See Lawrence D. Brown et al., *Inside the Black Box of "Sell Side" Financial Analysts*, 53 J. Acct. Res. 1 (2015); Lawrence D. Brown et al., *The Activities of Buy-Side Analysts and the Determinants of their Stock Recommendations*, 62 J. Acct. & Econ. 139 (2016). The SEC's Regulation FD bars selective disclosure to analysts, in order to force issuers into public disclosure of any material nonpublic information they want to disclose at all.

³⁷ See note --- supra.

³⁸ E.g., Douglas Skinner, *Why Firms Voluntarily Disclose Bad News?*, 32 J. Acct. Res. 38 (1994). In law, an important debate emerged in the 1980s about whether mandatory disclosure was necessary in light of the pressures and incentives for voluntary disclosure, and if so, how and why—one that continues today. See Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 722 (1984); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998); Merritt Fox, *Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335 (1999). For a more recent assessment by financial economists, see Luca Enriques & Sergio Gilota, *Disclosure and Financial Regulation*, in NIAMH MOLONEY ET AL., EDS., *THE OXFORD HANDBOOK OF FINANCIAL REGULATION* (2015).

disclosure incentives diminish in potency when the investor base is less focused on liquidity or management is more indifferent to stock price pressures.

These are purely financial incentives. But as society has become more sensitive to private sector risk-taking in the face of environmental and other “sustainability” threats, worries about looming disasters become of general political interest, too. Climate change palpably triggers such short and long-term concerns, as do matters of safety, cybersecurity, human rights, etc. Hence there is considerable pressure on companies to address these issues on a regular basis for a broader audience, increasingly in elaborate written reports. The content of these sustainability reports will often be directly at issue in disaster-related securities fraud claims. The growing interest in “ESG” (environmental, social and governance) disclosure is at least partly non-financial—prodding companies toward greater social responsibility for its own sake—but the distinction is fuzzy.³⁹ Companies indifferent to sustainability may lag financially, and more and more long-term investors report being interested in how management addresses these diffuse sorts of risks and handles stresses when they occur.⁴⁰ In other words, there is a large group of people interested in sustainability disclosure for diverse reasons that are impossible to separate.

This multi-sourced public angst—which management probably sees as both unreasonable and excessive—naturally tempts those who speak on the issuer’s behalf to try to manage impressions so as to reduce the pressures. Voluntary disclosures tend to accentuate the positive, though the optimism may be tempered by lawyer-driven warnings about forward-looking uncertainty. And that takes us back to fraud-on-the-market litigation. After a disaster happens, plaintiffs’ counsel will comb through everything said earlier in an upbeat fashion to identify what possibly may have had the propensity to mislead investors, all of which

³⁹ See Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. Corp. L. 647 (2016).

⁴⁰ See Chitru S. Fernando et al., *Corporate Environmental Policy and Shareholder Value: Following the Smart Money*, J. Fin. & Quant. Analysis (forthcoming, 2017). There is evidence of a separating equilibrium as between long-term patient investors and short-term traders, with the demand for sustainability disclosures being from the former and not the latter. See Laura Starks et al., *Corporate ESG Profiles and Investor Horizons*, Oct. 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049943. In turn, the level of voluntary ESG disclosure is higher in firms that attract more of the former to their shareholder base.

(with the accompanying scienter allegations) becomes the core of their fraud-on-the-market lawsuit. Plaintiffs search for blatant lies if possible, but more likely half-truths. Complaints usually offer scores of individual statements said to have deceived, which courts will have to evaluate one-by-one in response to defendants' inevitable motion to dismiss. How they do this is worth more careful attention.

1. Language Matters, Even in Efficient Markets

Probably the most common explanation courts give for a skeptical approach to whether a reasonable investor would be misled by any kind of soft pre-disaster language is that investors are savvy lot, steely-eyed and not easily tricked. Of course judges do understand that many retail investors are not particularly sophisticated, but at least in fraud-on-the-market cases, they generally work on the assumption that the smart money drives securities prices, thus justifying heightened rigor. This is the assumption, for example, behind the puffery doctrine noted earlier, whereby courts routinely dismiss fraud claims based on general statements of optimism, no matter how ugly the concealed truth really might be.⁴¹ Puffery is the label courts most often use in disaster cases when dismissing cases on duty grounds, essentially saying that since investors are unlikely to any attention to what was said in the first place, they could not have been misled by what was omitted. The same thing happens in treatments of forward-looking statements like the “bespeaks caution” doctrine (dismissing claims where investors are warned about future uncertainties)⁴² or the notion that projections or estimates are not actionable unless characterized as reasonably certain to occur.

While many of these holdings simply accord with common sense, aggressively invoking the imaginary mindset of the sophisticated investor to decide these cases has two problems. One is that it proves way too much. A thoroughly savvy, skeptical investor would never draw *any*

⁴¹ E.g., David Hoffman, *The Best Puffery Article Ever*, 91 Iowa L. Rev. 1395 (2006); Stefan Padfield, *Is Puffery Material to Investors?, Maybe We Should Ask Them*, 10 U. Pa. J. Bus. & Emp. L. 339, 354 (2008); Cox, *supra*.

⁴² E.g., Donald C. Langevoort, *Disclosures that “Bespeak Caution,”* 49 Bus. Law. 481 (2004).

inference beyond what explicitly was said, if that, and would assume instead that any hedged or limited statement was an effort to avoid revealing anything 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 has to have some room for credulity.⁴³ But once we concede that, it is hard to know when to stop.

The other problem is an empirical one. In looking at 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, assumptions about market efficiency supported a reflexive stance in fraud-on-the-market cases. 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 reflect the fundamental value of the issuer's shares. The mechanisms of market efficiency involve, for the most part, the influence of professionally informed investors (active institutional investors), who pay for the best-available analysis and advice.⁴⁴ For some time, sociologists and organizational behavior scholars have believed that companies often successfully use sleights of hand to mislead investors,⁴⁵ to which the dismissive response from financial economists (if they paid attention to the work at all) was that such credulousness could not possibly survive the rigors of market discipline. Courts might thus be excused for assuming that these professionals are always the aforementioned utility maximizers, thoroughly immune to puffery or cheap talk.⁴⁶

Today, however, there is greater inclination to accept that market imperfections are persistent. Though well-oiled markets surely remain the best available source of valuation even with these imperfections,

⁴³ One could take this 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 economist's famous "lemons problem"). The law of fraud is an entitlement that invites and protects reliance in the face of doubts about credibility, thereby lowering transaction costs.

⁴⁴ The classic article on the subject is Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984); more recently, see Ronald Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 Va. L. Rev. 313 (2014).

⁴⁵ E.g., James Westphal & Edward Zajac, *The Symbolic Management of Stockholders: Corporate Governance Reforms and Shareholder Reactions*, 43 Admin. Sci.Q. 127 (1998).

⁴⁶ On the tendency of earlier courts to invoke unrealistically demanding views of market efficiency in fraud-on-the-market cases, see Langevoort, *Basic at Twenty*, *supra*.

market efficiency is viewed more as an idealized goal than descriptive reality, largely because of high information costs.⁴⁷ Even professional investors have limited resources and capacity for attention,⁴⁸ and use short-cuts to optimize their valuation models, not try to perfect them. 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.⁴⁹ This subject has received considerable scholarly attention in both law and finance, and made its way into the arguments before the Supreme Court in 2014 on whether the fraud-on-the-market presumption of reliance was still viable. (In *Halliburton II*, the Court said it was.⁵⁰)

That more realistic approach, however, doesn't by itself prove that wordplay matters. Highly relevant but less familiar to lawyers, however, 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 via machine learning that looks for clues in how they 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 like the latest earnings per share.⁵¹ 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.⁵²

One important message of this work is that ordinary language indeed matters more than we had thought. Of course, the empirical findings give

⁴⁷ 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).

⁴⁸ See David Hirshleifer et al., *Driven to Distraction: Extraneous Events and Underreaction to Earnings News*, 64 J. Fin. 2289 (2009).

⁴⁹ Andrew Lo, *Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis*, 7 J. Inv. Consult. 21 (2005).

⁵⁰ *Halliburton Co. v. Erica P. John Fund*, 134 S.Ct. 2389 (2014). The Court explicitly said that imperfect efficiency is not inconsistent with the reasons for the presumption of reliance in well-organized markets.

⁵¹ 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).

⁵² E.g., Gerard Hoberg & Craig Lewis, *Do Fraudulent Firms Produce Abnormal Disclosure?*, 43 J. Corp. Fin. 58 (2017); see also Xuan Huang et al., *Tone Management*, 89 Acct. Rev. 1083 (2014); David Larcker & A. Zarolyurina, *Detecting Deceptive Discussions in Conference Calls*, 50 J. Acct. Res. 495 (2012); Jonathan Rogers et al., *Disclosure Tone and Shareholder Litigation*, 86 Acct. Rev. 2155 (2011).

sophisticated investors new arbitrage opportunities to erode these effects,⁵³ and so this work has become of substantial interest as an algorithmic tool.⁵⁴ On the other hand, it also demonstrates that the market *is* susceptible to language-based impression management. Wording, syntax, hyperbole, euphemisms,⁵⁵ tone etc. influence investors and prices, though how much and for how long will vary. There is evidence that market prices underreact to the reality revealed by such cues, so that the price effects of deception continue over time.⁵⁶

A plausible explanation for this, taking us back to our discussion of implicature, is that sophisticated investors use management credibility as a common 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. (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 as well.⁵⁷) When credibility is high based on prior experience, even general optimism can be influential when it responds to some matter on 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

⁵³ There is substantial evidence, for example, at sophisticated analysts pick up on tone “tips and tells.” See Marina Druz et al., *Reading Managerial Tone: How Analysts and the Market Respond to Conference Calls* (NBER working paper, Jan. 2016). Presumably this arbitrage will improve pricing in light of what the cues reveal, though one wonders whether managers, too, will change their language in response.

⁵⁴ Recent advances in algorithmic trading apply syntax and tone assessments to various forms of news releases to trigger high-speed trades. For an expression of concern about this kind of trading, see Yesha Yadav, *How Algorithmic Trading Undermines Efficiency in Financial Markets*, 68 Vand. L. Rev. 1607 (2015). Not surprisingly, the SEC is interested in the work as well as a tool for the early identification of fraud risk.

⁵⁵ See Kate Suslava, “Stiff Business Headwinds and Uncharted Economic Waters:” *The Use of Euphemisms in Earnings Conference Calls*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2876819 (July 17, 2017).

⁵⁶ See Joshua Lee, *Can Investors Detect Managers’ Lack of Spontaneity?: Adherence to Predetermined Scripts During Earnings Conference Calls*, 91 Acct. Rev. 229 (2016); see also Huang et al., *supra*, uncovering strong evidence that tone misinforms market actors.

⁵⁷ See pp. --- *infra*.

spend, if not waste, their reputational capital in order to avoid blame. 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).⁵⁸

Hiding behind euphemisms, puffery or what might be technically true but nonetheless misleading can be especially pernicious. Ample evidence shows that people 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. Thus “individuals may deceive both more frequently and more effectively by paltering than using lies of commission or omission.”⁵⁹ If language does matter, courts should be especially alert for such temptations, particularly when disaster threatens, and certainly not assume them away.

2. Normative Guidance

We’ve now seen that there are problems in simply assuming away the influence of soft language, particularly in world where credibility matters. But none of this tells courts what to do instead. To me, the essential starting point is to acknowledge that the goal in fraud-on-the-market cases is not about predicting how investors respond to words. Rather, the remedy is an entitlement given to investors in order to facilitate reliance even where it might be palpably risky given asymmetric information and the arms-length nature of the bargain. 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.”⁶⁰ The Supreme Court in both *Basic* and *Halliburton II* affords investors a presumption of reliance on the integrity of the prevailing market price (i.e., that it is undistorted by fraud) not because smart

⁵⁸ See Jessen L. Hobson et al., *Analyzing Speech to Detect Financial Misreporting*, 50 J. Acct. Res. 349 (2012).

⁵⁹ Todd Rogers et al., *Artful Paltering: The Risks and Rewards of Using Truthful Statements to Mislead Others*, 112 J. Pers. & Soc. Psych. 456 (2016).

⁶⁰ See Langevoort, *Basic at Twenty*, *supra*.

investors naively assume management integrity, but because offering it stimulates socially valuable investment in the face of risk.⁶¹

We can see this normative turn in other Supreme Court decisions as well. In the *Virginia Bankshares* case,⁶² the defense claimed that smart investors never rely on statements of opinion by boards of directors, especially when the board was chosen by the interested party to a transaction, a controlling shareholder. But they certainly have a right to, said the Court, given the board's superior access to information and the norms of fiduciary responsibility. And more recently in *Omnicare*,⁶³ the argument was made that statements of opinion surely convey nothing to the cautious investor beyond the honesty of the underlying belief, if that. But the Court rejected the argument and opened the door for plaintiffs to draw inferences from what was said that go beyond the strict textual confines of the words used, thereby weakening what had been a powerful defense tactic embraced by many lower courts.⁶⁴

So predicting simply what savvy investors do or don't believe isn't really the right approach in the first place, even if it is knowable. But what is, beyond saying that the focus should be on facilitating reliance of the sort that merits encouragement and protection, including some degree of reliance on credibility? *Omnicare* offers a useful starting point, but ultimately reduces the inquiry to a factual question on propensity to mislead on which, it assumes, lower courts have ample experience and expertise. Its exegesis was thus fairly limited in terms of guidance for future cases (or even the one at hand), and can be read as either encouraging, restrictive or both in terms of the scope of the half-truth doctrine as applied to statements of opinion.⁶⁵

⁶¹ See also Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711 (2006).

⁶² *Virginia Bankshares Inc. v. Sandberg*, 501 U.S. 1083 (1991).

⁶³ *Omnicare Inc. v. Laborers Dist. Council Pension Fund*, 135 S.Ct. 1318 (2015).

⁶⁴ E.g., *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 112 (2d Cir. 2011)(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).

⁶⁵ 135 S.Ct. at 1332 (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 invited to think more expansively. For surveys of *Omnicare* and its aftermath, see Robert A. Van Kirk & John S. Williams, *The Supreme Court's Decision in Omnicare: The View from Two Years Out*, 49 Sec. Reg. & L. Rep. (Bloomberg) 1264 (Aug. 7, 2017); Sale & Langevoort, *supra*, at 779-80.

Based on all the foregoing, there are some useful first principles from which to derive an approach to interpretation in disaster 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. 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 cause 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 shouldn’t expect to be told what is already readily findable.⁶⁶ Or, as the Court stressed in *Omnicare*, the careful use of words like “in our opinion” naturally send a cautionary note that distinguishes such a message from one that is totally unqualified.

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.⁶⁷ Such words signal that they derive from a particularly rigorous process of information-elicitation, and thus convey more than a top of the head opinion.⁶⁸ An executive tweet would probably be the opposite, conveying informality. That doesn’t mean it comes without implications; just that the implications suggest some less rigor from which to draw extended inferences.

⁶⁶ For a case where finding the facts might have been possible but too difficult, in the court’s opinion, see *In re Massey Energy Co., Sec. Litig.*, 883 F. Supp.2d 597, 618-19 (S.D.W. Va. 2012).

⁶⁷ *Omnicare*, 135 S.Ct. at 1330.

⁶⁸ 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. Sale & Langevoort, *supra*, at 782.

Attention to context and background norms sounds obvious in setting principles of inference, but a careful review of the case law shows how often courts operate differently.⁶⁹ As noted earlier, quite a few commentators have taken courts to task for their approach to the puffery defense. And indeed, many courts act as if there is a dictionary of words and phrases that everyone understands lack communicative content. But that is questionable, 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.⁷⁰ So, too, with half-truths. The worse the news is that is unrevealed, the less fair it is to opportunistically use literal truth as a means to conceal, especially if the matter has already sparked investor interest.⁷¹

This connects to 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.⁷² But if the apparent motivation for what is said, however soft, was to respond to a matter of palpable interest to investors but hide a harsher truth, the case for deception strengthens. Those courts that find an issue to be in play by reference to how many time the issuer repeated the soft assurances are right to do so.⁷³ The same with evidence showing high levels of investor interest in a matter (i.e., oil rig safety). These

⁶⁹ 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.

⁷⁰ See *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 745 (7th Cir. 1997).

⁷¹ I explored the connections among puffery, contextualism and half-truth in Langevoort, *Half-Truths*, supra. More recently, see Cox, supra; Sale & Langevoort, supra, at 779; Lipton, supra, at 140-41.

⁷² For a good discussion of the case law here, with an acknowledgement that the general principle may give way in a particular context, see *In re Braskem S.A. Sec. Litig.*, 246 F. Supp.3d 731, 754-57 (S.D.N.Y. 2017).

⁷³ 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 they did not fully apply to BP’s non-wholly owned assets. *In re BP P.L.C. Sec. Litig.*, 922 F. Supp.2 600, 623 (S.D. Tex. 2013). See also *In re BHP Billiton Ltd. Sec. Litig.*, 2017 WL 3822755 (S.D.N.Y. 2017) at *10 (stressing commitment “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).

principles of inference in particular lead me to the impression that the Ninth Circuit was wrong to dismiss the claims in the Hewlett-Packard case, described earlier.⁷⁴ While corporate ethics statements might be deemed trivial to sophisticated investors in the abstract, the context to the case seemed to be HP's ability to emerge from its earlier governance scandal, for which the strong leadership of its CEO, Mark Hurd, was crucial. I see HP's statements as a deliberate effort to assuage investor unease and identify strength and integrity as strong points.⁷⁵ If so, and 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 quite consequential. As another court of appeals put it better in addressing this same kind of issue, 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 are clearly designed to distinguish the company from other specified companies in the same industry."⁷⁶

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 those courts that find a duty seem to recognize is that when the disclosure is unprompted and apparently quite voluntary, investors should be able to infer that the issuer is motivated by a genuine desire to reveal, and hence are entitled to draw broader inferences consistent with what is said explicitly, especially if the issuer keeps insistently repeating a message for emphasis. On the other hand, when an issuer makes a statement that reflects that it does not really want to speak but is under pressure or compulsion to do so, the investor should be more hesitant to draw strong inferences regarding things unsaid. This, as we will see shortly, arises especially with respect to legal compliance.

C. Reporting Obligations and Line-item Disclosures

⁷⁴ See note --- supra.

⁷⁵ The court acknowledges that Hurd led a charge to change perceptions of HP's integrity and conduct norms after the earlier scandal, and says that it would have been a closer case had the sexual scandal been more closely related to the prior governance scandal. 845 F.3d at 1278.

⁷⁶ *Indiana Public Ret. System v. SAIC Inc.*, 818 F.3d 85, 97-98 (2d Cir. 2016).

As noted, courts today are insistent that broad disclosure duties are for the SEC or Congress to formulate, not for the courts to invent.⁷⁷ Thus, in search of 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 via periodic filings that are (almost) instantly made available on the internet. Buttressing this is the Commission's own half-truth rule, forcing issuers to add further material information necessary to make the responses complete.

This route has many obstacles. Reg S-K is extensive and dense, enough so that both Congress and the SEC are currently seeking to prune it.⁷⁸ Yet what is striking about these line-item requirements is how much potentially material information is *not* subject to any disclosure obligation. Many have pointed out how poorly the current mandatory disclosure regime speaks to issues relating to the modern corporation, especially as to opportunities and risk relating to intellectual property and human capital.⁷⁹ What they have done operate mainly with a short to medium term horizon, even though many long-term investors and sustainability proponents want and need a longer outlook.⁸⁰ The SEC long adhered to a

⁷⁷ See *Gallagher v. Abbott Laboratories Inc.*, 269 F.3d 806 (7th Cir 2001) (“judges 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 the Securities Exchange Act, Rule 12b-20. There are two other fraud-based exceptions. The so-called “duty to correct” holds that if the issuer previously made a misstatement but in good faith so that no liability follows, it nonetheless has a duty to correct it when the truth is discovered. See *id.* The “duty to update” is accepted by some courts but not others. See *id.*; *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1996). It holds that an issuer must update an earlier statement that no longer is accurate even though it was 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, i.e., was “still alive” in the marketplace. Though potentially powerful, 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*, 2916 WL 362312 (S.D. Tex., Jan. 29, 2016). As a result, duty to update cases are less frequent today. But see *Finnerty v. Stiefel Laboratories Inc.*, 756 F.3d 1310 (11th Cir. 2014); *In re Facebook IPO Litig.*, 986 F. Supp.2d 428 (S.D.N.Y. 2013).

⁷⁸ See Release No. 33-10064, April 13, 2016, at 204-10; Roberta Karmel, *Disclosure Reform—The SEC is Riding Off in Two Directions at Once*, 71 *Bus. Law.* 781 (2016).

⁷⁹ See Baruch Lev, *Evaluating Sustainable Competitive Advantage*, 29 *J. App. Corp. Fin.* 70 (2017).

⁸⁰ Other major countries around the world (in the European Union and Australia, most notably) have more expansive corporate disclosure requirements. See Dale Oesterle, *The Inexorable March Toward a Continuous Disclosure Obligation for Publicly-Traded Companies: Are We There Yet?*, 20 *Cardozo L. Rev.* 135 (1998).

policy limiting disclosure to historical, backwards-looking, facts, not forward-looking information even though that is the more value-relevant to investors; the effects of this are still felt today. Another purported explanation is clarity: giving issuers and their lawyers more definition in what disclosure is required, to avoid even more overload. But deeper than these is an uneasy recognition of the need for corporate secrecy on many matters, especially forward-looking ones, lest the company be hampered in its ability to compete, or not invest in strategies or products whose value would disappear if the information was publicly available to competitors and others. Unfortunately, the effect of a duty limited to line item instructions is to offer this zone of secrecy whether or not 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 in their effort to find actionable omissions.⁸¹ One, found in the instructions to the 10-K and 10-Q, seems particularly promising: companies have to identify the most significant risk factors they face, updated on a quarterly basis.⁸² But this has turned out to be disappointing as an early warning device for a handful of reasons. First, and most importantly, it requires identification, but not assessment—that is, describing kinds of risk, but not explicitly requiring discussion of either probability that they will come to pass or impact on the company if they do. The disclosures can easily devolve to 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.⁸³ 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

⁸¹ 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. See Item 407(h) of Regulation S-K.

⁸² The ’34 Act filing instructions cross-reference Item 503(c) of Regulation S-K, which involves risk disclosures in public offerings.

⁸³ See A.C. Pritchard & Karen Nelson, *Carrot or Stick? The Shift from Voluntary to Mandatory Disclosure of Risk Factors*, 13 J. Emp. Leg. Studies 266 (2016); Ole-Kristian Hope et al., *The Benefits of Specific Risk Factor Disclosures*, 21 Rev. Acct’g Studies 1005 (2016). In addition, the SEC staff comments on a filing may draw attention to deficiencies and force the issuer to be more forthcoming.

worry about that particular subject had risen. These sophisticated investors can then follow up with questions to the company or do further research. But the identification itself is little more than a potential conversation starter, by itself 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 as many as ninety days.

Of more help is Item 303 of Reg S-K: management’s discussion and analysis (the MD&A). In the eyes of the SEC, this 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.⁸⁴ The Commission staff has highlighted the MD&A as quite relevant to disclosure of environmental risks,⁸⁵ for example, as well as cybersecurity and other hot button topics.⁸⁶ As mentioned earlier, an emerging body of empirical work using machine learning shows that the MD&A can be important not only for what the issuer reveals explicitly (again, especially changes from period to period) but how it “speaks.”⁸⁷ 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 evidence that the obfuscation works.

The MD&A, however, is less than entirely reliable as an early warning device.⁸⁸ It has built-in limits, most importantly that the events, trends and uncertainties have to be “known” to management and “reasonably likely” to occur.⁸⁹ Precisely what level of probability makes

⁸⁴ See Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (2003).

⁸⁵ See Commission Guidance Regarding Disclosure Relating to Climate Change, SEC Release No. 33-9106 (Feb. 8, 2010).

⁸⁶ SEC Div. of Corporation Finance, Disclosure Guidance Topic No. 2 (Oct. 13, 2011). The SEC is elevating the importance of cybersecurity, both as to disclosure and threats to customer and employee data privacy. See *SEC May Refresh Cybersecurity Disclosure Guidance*, 49 Sec. Reg. & L. Rep. (Bloomberg) 1809 (Nov. 20, 2017).

⁸⁷ See pp. --- infra.

⁸⁸ See Stephen Brown & Jennifer Wu Tucker, *Large Sample Evidence on Firm’s Year-to-Year MD&A Modifications*, 49 J. Acct. Res. 309 (2011).

⁸⁹ See Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of “May,”* 48 Vill. L. Rev. 1245 (2003)(describing scuttled plans to alter the “reasonably likely” standard). In the Fudao 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.*, 2017 WL 3822755 (S.D.N.Y. 2017).

something reasonably likely has been debated for decades, without closure, but surely leaves room for management to determine that something, however worrisome, hasn't 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 on enforcement intensity.⁹⁰ The SEC does indeed stress MD&A compliance in comment letters and public statements, but enforcement seems somewhat muted. Cases tend to be settled on cease and desist-type terms, without large sanctions. SEC officials have long complained about the quality of MD&A disclosures. That takes us back to our main subject here, the fraud-on-the-market action, which can put a much larger price-tag on issuer non-compliance.

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, on which the Supreme Court granted certiorari in early 2017 but then withdrew the grant at the request of the parties when the case was settled.⁹¹ That is, does the MD&A mandate establish a duty to disclose, the breach of which creates a 10b-5 violation assuming that plaintiffs satisfy all the other elements of the cause of action, including materiality and scienter? The negative view is that SEC line-items create no independent private right of action, but instead are left entirely to SEC enforcement. While that is certainly true, it misses the point. To me, the answer to the duty question is fairly easy.⁹² Surely a blatant lie in the MD&A would be

⁹⁰ 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 (2005). For an illustration of enforcement failure undermining the intentions for creating the disclosure in the first place, see Usha Rodrigues & Michael Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 Va. L. Rev. 1 (2010).

⁹¹ On the apparent split, compare, for example, *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 103 (2d Cir. 2015)(does create a duty) with *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 454, 465 (9th Cir. 2014)(does not). The Supreme Court's grant of certiorari was in *Indiana Pub. Ret. System v. SAIC Inc.*, 818 F.3d 85 (2d Cir. 2016), cert. granted sub nom. *Leidos Inc. v. Indiana Pub. Ret. System*, 137 S.Ct. 1395 (2017). For an argument that the impression of a circuit split is largely illusory, see Matthew Turk & Karen Woody, *The Leidos Mixup and the Misunderstood Duty to Disclose in Securities Law*, July 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2996555.

⁹² See Langevoort & Gulati, *supra*, at 1680-81. But see Linda Griggs et al., *When Rules Collide: Leidos, the Supreme Court and the Risk to the MD&A*, 49 Sec. Reg. & L. Rep. (Bloomberg) 1511 (Sept. 25, 2017).

actionable fraud—no court has even 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: the Rule also prohibits misstatements and omissions necessary to make what was said not misleading. So the question comes down to whether intentionally failing to disclose something called for by Item 303 would mislead a reasonable investor. Assume that an issuer deliberately omits from the MD&A a serious known risk for fear that its revelation would damage the company near-term. Other risks, trends and uncertainties are fully discussed. 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 “omission of a material fact necessary to make statements made not misleading”? Ordinarily, yes. As courts have stressed, SEC rule-making is authoritative on what public companies have to disclose and investors are the intended beneficiaries of the mandate. It follows that investors should be entitled to assume compliance unless on notice otherwise. The duty element would thus be satisfied.⁹³

Without such a rule, there would be a severe enforcement gap with respect the MD&A, one that could severely reduce its efficacy as an early warning device. But even if the Court does what it should, enforcement intensity as to Item 303 is at best moderate, 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 needed dose of deterrence to SEC enforcement,⁹⁴ so that those worried about corporate candor with respect to disaster risk should pay close attention to future battling about the duty issue.

⁹³ Id. This would be different if the issuer made clear that it was not responding fully and completely, but that, of course, would not set well with the SEC.

⁹⁴ For discussions of the deterrence value of fraud-on-the-market cases, see, e.g., Cox & Thomas, *supra*; 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 (2016); see also Dain C. Donelson et al., *The Role of D&O Insurance in Securities Fraud Class Action Settlements*, 58 J. L. & Econ. 747 (2015)(positive role of merits in influencing settlements).

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 1996 that is much put to use in disaster litigation. The so-called safe harbor for forward-looking information declares on its face that such information is not fraud for purposes of private securities litigation if either made without actual fraudulent intent or accompanied by “meaningful cautionary language” that warns investors of the risk that the forward-looking information may not come to pass as predicted. This was a codification of a judge-made “bespeaks caution” doctrine, albeit without the nuance some courts had brought to application of that principle.⁹⁵ When the issuer speaks to the future in addressing risks or lack thereof, the invitation is to add a disclaimer drawing investors’ attention to risk factors—usually, the same risk factors already set forth in the 10-K or Q as per the line-item instructions discussed above—that could affect the likelihood of whatever future circumstance the issuer is addressing. If this works, the risk of liability disappears.⁹⁶ The potency of the safe harbor is obvious in pre-crisis disaster cases because 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 were to make a statement that its assessment of a catastrophic failure at a power plant was that it was highly unlikely. In fact, there is private evidence of internal doubts about the accuracy of the risk assessment. That would be false and misleading. And it would be none the 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 simply states that the bad event is possible. What is important is management’s determination that the event is highly

⁹⁵ See Langevoort, *Bespeaks Caution*, supra.

⁹⁶ See Nelson & Pritchard, supra; Ann Morales Olazabal, *False Forward Looking Information and the PSLRA’s Safe Harbor*, 86 Ind. L.J. 596 (2011).

unlikely, assuming that it has a reputation for credibility.⁹⁷ Otherwise, the warning is just noise.⁹⁸

But because the protection is a statutory command, absurdity doesn't matter. At best, the statutory safe harbor is a trade-off: effective immunization of forward-looking information from liability in order to encourage honest 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.⁹⁹

There is some good news, however, in the contextualism that many courts bring to the two interpretive questions that often come up in deciding whether the safe harbor protects some alleged falsity. One is whether the issuer is truly speaking to the future or instead—fully or partially—addressing the present, which eliminates the statutory protection entirely.¹⁰⁰ This is an exercise in implicature, because there are many statements that appear forward-looking on their face but also 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 eagerness some courts demonstrate to consider whether the cautionary language itself might be misleading, for suggesting that the predicted risk is merely possible when management knows privately that it is actually coming to pass.¹⁰¹ So

⁹⁷ See Jonathan L. Rogers & Phillip C. Stocken, *Credibility of Management Forecasts*, 80 *Acct. Rev.* 1233 (2005).

⁹⁸ 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*, Sept. 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2573333.

⁹⁹ 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'g Res.* 297 (2001)(more disclosure but diminished accuracy).

¹⁰⁰ See Wendy Gerwick Couture, *Mixed Statements: The Safe Harbor's Rocky Shore*, 39 *Sec. Reg. L.J.* 257 (2011). On the distinction between present and forward-looking information when the two are bundled, see *In re Quality Systems Inc. Sec. Litig.*, 865 F.3d 1130 (9th Cir. 2017)(no protection for the non-forward looking parts of the bundle).

¹⁰¹ E.g., *Slayton v. American Express Co.*, 604 F.3d 758, 770 (2d Cir. 2010); *Arkansas Pub. Emp. Ret. System v. Harman Int'l Indus. Inc.*, 791 F.3d 90 (D.C. Cir. 2015). In *Loritz v. Exide Technologies Inc.*, Fed. Sec. L. Rep. (CCH) par. 98,142 (C.D. Cal. 2014), the court observed that a warning that the corporation could not be sure that it "has been, or will be at all times, in complete compliance with all environmental requirements" was not meaningful enough when it knew of significant environmental exposure.

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, there may be allegations made by plaintiffs that the issuer concealed the occurrence of some governmental investigation that was triggered by suspicion that something was wrong, or a routine inspection finding something amiss. These are particularly common, of course, with respect to compliance disasters. Such governmental inquiries are 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 undisclosed investigation as a fraudulently concealed risk.

There is a substantial body of case law on the materiality of unpublicized government investigations, which turns on the probability that the case will turn serious in terms of its implications for the issuer and the magnitude of the impact (in terms of fines, loss of business, disqualifications, etc.) if it does.¹⁰² These are hardly easy calculations, but one can imagine 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 at all.

¹⁰² See David Stuart & David Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 *Bus. Law.* 973 (2009); see also Jonathan N. Eisenberg, *Are Public Companies Required to Disclose Government Investigations?*, available at <https://corpgov.law.harvard.edu/2015/07/22/are-public-companies-required-to-disclose-government-investigations/> (July 22, 2015). The “probability-magnitude” test was endorsed by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988); see generally *COX ET AL.*, *supra*, at 628-31.

But again, there is no per se duty to disclose an investigation even if deemed material, though my impression is that many practitioners say that they nonetheless urge clients disclose voluntarily. 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 our earlier discussion. But there is more specific line-item to consider. Item 103 requires a brief description of any material pending non-routine legal proceedings against the issuer or one of its subsidiaries. To this is added, somewhat ominously, similar disclosure as to “any such proceeding known to be contemplated by government authorities.” Beyond these familiar line-items, there are some particularized enhancements to the disclosure duty with respect to proceedings involving allegations of environmental law violations, which was part of an understanding reached between the SEC and environmental activists back in the 1970s. Of more recent vintage, there are special rules on the disclosure of both pending and resolved enforcement actions taken by the Federal Mine Safety and Health Review Commission against mining companies that are ’34 Act registrants. 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 this data was already known to mine safety regulators and discoverable (albeit with considerable effort) on-line.¹⁰³ It is a pointed reminder that the benefits from public company disclosure are not simply from making the issuer’s stock price more accurate, and often as much about influencing behavior as generating information.

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 disclosure pointing out the inevitable risks highly regulated companies face with respect to legal compliance.¹⁰⁴ To be sure, as many courts have said, the mere fact of an investigation triggers none of the line items. But once government

¹⁰³ See Hans Christensen et al., *The Real Effects of Mandatory Non-Financial Disclosures in Financial Statements*, 64 J. Acct. & Econ. 284 (2017).

¹⁰⁴ This reluctance is sometimes justified by reference to the regulatory agency’s own policy (e.g., at the SEC) of treating its enforcement investigations as confidential.

enforcers indicate that an action is likely, that would seem to at least satisfy Item 103's "known to be contemplated" language. Curiously, courts have found their way to saying that that phrase requires disclosure only of actions "substantially certain to occur."¹⁰⁵ To an issuer busily trying to persuade the government not to act or to impose only minor sanctions, this truncates the duty considerably. The MD&A and risk factor disclosure have not fared that well as triggers for a duty to reveal investigations, either.

Once again, half-truth once again seems to be the doctrine of choice for resolving these cases, especially when what plaintiffs want revealed is not just the fact of the investigation but an assessment of its seriousness as of the time of the disclosure. This implicates the background norm set forth earlier about matters of special sensitivity, and may be a place where the presumption of cooperativeness in drawing inferences is less justifiable. Legal risk is something on which companies cannot speak in depth without revealing too much of its hand in the on-going negotiations with regulators. While 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, with 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—enthusiastically welcomed by the defense bar and their clients—have rejected omission claims arising out of undisclosed, or minimally disclosed, investigations.¹⁰⁶

Issuers and their lawyers often 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

¹⁰⁵ E.g., *Richman v. Goldman Sachs*, 868 F. Supp.2d 261, 275 (S.D.N.Y. 2012); *In re Lion's Gate Ent. Corp. Sec. Litig.*, 165 F. Supp.3d 1 (S.D.N.Y. 2016).

¹⁰⁶ See *Lion's Gate*, *supra.*; see also *Lubbers v. Flagstar Bancorp. Inc.*, 162 F. Supp.3d 571 (E.D. Mich. 2016); *In re Investment Technology Group Sec. Litig.* 2017 WL 1498055 (S.D.N.Y., April 26, 2017).

our view,” “we expect,” or similar equivocations, invoking a legacy from the pre-*Omnicare* days when courts reflexively protected statements of opinion absent evidence of deliberate deceit. Invoking the norm of fair play referred to 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 threat was indeterminate at the time, and maybe even still.¹⁰⁷

B. Illegality

Almost by definition, compliance-related corporate catastrophes are produced by an investigation that, eventually at least, uncovers evidence of some kind of pre-existing illegality on which the government brings charges. In that case, plaintiffs can point not only to the concealed investigation but the hidden fact of the underlying wrongdoing itself as a possible fraud. If the argument succeeds,¹⁰⁸ this locates the scheme to defraud further back in time, enlarging the plaintiff class. But here, too, courts are often quick to say that silence—whether about illegality or anything else—is not fraudulent without showing that a duty was breached.¹⁰⁹

These are particularly hard cases for plaintiffs when 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. They thus impose a high level of particularized pleading in support of the illegality. But legal disaster cases are usually ones where the government has already done the heavy lifting on the illegality of what transpired, and the issuer may be precluded from denying the wrongdoing after a plea or non-prosecution deal. That

¹⁰⁷ The most notable case here is *Menaldi v. Och-Ziff Cap. Mgt. Group LLC*, 164 F. Supp.3d 568 (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 Sec. Litig.*, 544 F. Supp.2d 346, 353 (S.D.N.Y. 2008).

¹⁰⁸ For an overview of possibilities, see Alison B. Miller, *Note, Navigating the Disclosure Dilemma: Corporate Illegality and the Federal Securities Laws*, 102 *Geo. L.J.* 1647 (2014).

¹⁰⁹ See *Roeder v. Alpha Indus.*, 814 F.2d 22 (1st Cir 1987).

obviously strengthens plaintiffs' claim. Even then, however, many judges seem reluctant to make liability turn on the company's failure to disclose its own wrongdoing.¹¹⁰ They often cite case law saying that the securities disclosure is not "a rite of confession,"¹¹¹ nor meant to force self-incrimination.¹¹²

Most courts understand that corporations cannot lie about compliance, nor (as the Supreme Court specifically addressed in *Omnicare*) make affirmative statements about law-abidingness that may literally be true but misleading because of what wasn't said. But even here, many courts still seem skeptical.¹¹³ Take a situation where a pattern of bribery enabled a significant (i.e., material) amount of revenues 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: "the 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."¹¹⁴ 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.¹¹⁵ For better or worse, it usually takes more to cross the line, as with repeated touting of a commitment to compliance in the face of a pervasive criminal scheme¹¹⁶ or where the issuer puts its competitive success at issue without

¹¹⁰ For good discussions, see the *Menaldi* case, *supra*, and *In re Braskem S.A. Sec. Litig.*, 246 F. Supp.3d 731 (S.D.N.Y. 2017).

¹¹¹ *City of Pontiac Ret. System v. UBS AG*, 752 F.3d 173, 183-84 (2d Cir. 2014).

¹¹² *Id.*; see also *United States v. Mathews*, 787 F.2d 38, 49 (2d Cir. 1986).

¹¹³ *Menaldi v. Och-Ziff Cap. Mgt. Group LLC*, 164 F. Supp.3d 568 (S.D.N.Y. 2016)(finding the statements about transparency and risk management commitments too vague). See also *id.*, 2017 WL 4386902 (S.D.N.Y., Sept. 29, 2017)(same). For a thorough discussion of how *Omnicare* affects the law here, see *In re BioScrip Sec. Litig.*, 95 F. Supp.3d 711, 728-31 (S.D.N.Y. 2015)(finding statements to be potentially misleading).

¹¹⁴ *In re Marsh & McLennan Sec. Litig.*, 501 F. Supp.2d 452, 470 (S.D.N.Y. 2006).

¹¹⁵ *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969); *United States v. Ebberts*, 458 F.3d 110 (2d Cir. 2006).

¹¹⁶ See *Meyer v. Jinksolar Holdings Co.*, 761 F.3d 245 (2d Cir. 2014)(finding potential for deception in description of compliance program if there was a known failure to prevent on-going pollution problems. The bigger the hidden wrongdoing, moreover, the more likely it seems that a court will find enough evidence of deception. See, e.g., *In re Volkswagen Clean Diesel Sec. Litig.*, Fed. Sec. L. Rep. (CCH) par. 99,817 (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 risk factor disclosures were misleading because they omitted "the massive defeat device scheme."

revealing that a material reason for the apparent success was the wrongdoing.¹¹⁷ In other words, something close to an well-crafted scheme to defraud.¹¹⁸

No doubt there are reasons for the courts' hesitancy, even if corporations have no Fifth Amendment right against self-incrimination. Some reasons are better than others. 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.

A better reason for the heightened sensitivity here has to do with the inherent subjectivity of law. Relatively few legal 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, with insiders probably often believing that they would (or at least should) prevail at trial but unwilling to bear the costs and risks. The disclosure obligation, moreover, comes at an earlier

¹¹⁷ See *In re Van der Moolen Holding NV Sec. Litig.*, 405 F. Supp.2d 388, 400-01(S.D.N.Y. 2005)(illegal trading revenues); *In re Braskem S.A. Sec. Litig.*, 246 F. Supp.3d 751, 760-61 (S.D.N.Y. 2017)(statements about pricing for a particular product misleading for failure to disclose bribes). For a case finding the potential for deception in both generalized stress on a commitment to safety and reliance on a particular metric that it tried to game even if the numbers might have been technically accurate, see *In re Massey Energy Co. Sec. Litig.*, 883 F. Supp.2d 597 (S.D.W.V. 2012).

¹¹⁸ See Lipton, *supra*, 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”), citing cases in accord with this approach, including *Strougo v. Barclays PLC*, 312 F.R.D. 307, 319 (S.D.N.Y. 2016). See also *In re Countrywide Financial Sec. Litig.*, 588 F. Supp.2d 1132, 1153-54(C.D. Cal. 2008). At some point in cases like this, resort to “scheme liability” instead of the more common half-truth approach seems plausible. E.g., *West Virginia Pipe Trades Health & Welfare Fund v Medtronic Inc.*, 845 F.3d 384 (8th Cir. 2016)(allowing case involving pay-offs to 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.

point in time, at which there is no concession of liability. As with government investigations, disclosure isn't 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 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. Investors should not liberally draw inferences inconsistent with that desire, in other words, but instead understand that the issuer is trying to manage a potentially risky situation without prejudicing its defense.¹¹⁹ This is the 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.¹²⁰ If both material and genuinely the subject of deception, concealment claims about such matters deserve the courts' careful attention.

III. NARRATING THE DISASTER

A disaster often becomes public when announced by the corporation, while other times the news comes first from some other source (e.g., government prosecutors, financial media) or is so publicly visible that it needs no announcement. In any event, the company is now in crisis and someone—or a team—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 like to flow from it. They know full well that millions (or billions) of dollars in liability risk other consequences may depend on whether they are sufficiently candid yet desperately not wanting to add to the conflagration or upset their superiors by getting 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

¹¹⁹ See Langevoort, *Half-Truths*, *supra*.

¹²⁰ 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 (2001).

Horizon case, for example, the judge determined that the company's 1000 barrel per day 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 for failure to reveal higher estimates generated by other internal or external methodologies.¹²¹ 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.¹²²

Obviously, 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 project a sense of confidence and control, assuring others that the company and its management are on top of the situation.¹²³ The truth may be otherwise, of course, which makes this phase so crucial in any fraud-on-the-market lawsuit. Behind the scenes often lurk palpable uncertainty, fears about blame, and the challenges of getting an unruly high-level team "on the same page" under severe time pressure. 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 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 generally 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.

¹²¹ In re BP P.L.C. Sec. Litig., 2016 WL 3090779 (S.D. Tex. 2016). The court was clearly 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.* at *13.

¹²² The court said that it arguably "doubled down" on its original 1000 bpd figure. *Id.* at *14. Later on the BP official expanded the range to somewhere between 1000 and 5000. The court suggested that it should have stress the tentativeness of all the estimations rather than anchoring on a single point estimate, which then became difficult to let go of.

¹²³ E.g., Anastasya Zavyalova et al., *Managing the Message: The Effect of Firm Actions and Industry Spillovers on Media Coverage Following Wrongdoing*, 55 Acad. Mgt. J. 1079 (2012).

The law here is largely the same as what we have already covered. While there may be SEC filings required in the midst of the crisis, they are not likely to play as large a role. Indeed, most lawyers will advise delaying the filing of a 10-K or Q if the situation is too fluid and uncertain to draft something in which everyone is confident.¹²⁴ 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 goes into a filing accompanying a public offering (or any other SEC filing). The company is reacting to a bad event, under great pressure, and cannot be held to quite the same heightened expectations as to candor or completeness. The reasonable investor presumably understands that the truth is hard to extract from a crisis situation, so that inferences should not too liberally be drawn one way or the other from things deliberately not said or affirmatively avoided. That said, at this stage we have may well have hyper-materiality—exceptionally intense trading and investor interest in what the company and others have to say, so that there must be a baseline of candor and completeness on which reliance is invited. Courts are walking another fine line, and as in *BP*, the decisions here tend to reject narrations that are overly self-protective.¹²⁵

IV. KNOWLEDGE AND INTENTIONALITY

A. Scierter 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

¹²⁴ See SEC Rule 12b-25.

¹²⁵ The Fundao dam cases also had a narration aspect to them, 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.*, 2017 WL 1102666 (S.D.N.Y., March 23, 2017)(raising issues of materiality and loss causation)

in authority must have been aware of or ignored the propensity of what was said or omitted to mislead investors. This is because Rule 10b-5 liability requires scienter—i.e., knowledge or recklessness. Pleading and proving this is often heavy lifting for the plaintiffs’ lawyers, especially because courts tend to see recklessness not as a heightened form of negligence but rather something closer to willful ignorance or conscious disregard.¹²⁶

Disasters are often not easy to see coming until it is too late.¹²⁷ 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.¹²⁸ The structural reasons involve how information and responsibility are diffused in large organizations—“siloeed,” to use a familiar term—so that the risk-related dots remain unconnected even as the situation turns dangerous.¹²⁹ The psychological reasons relate to the difficulty human beings have in recognizing change—the so-called conservatism bias.¹³⁰ That is all the more problematic when managers (or corporate cultures) are overconfident or excessively optimistic,¹³¹ 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 doesn’t want to know the whole truth.¹³²

¹²⁶ 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*, at 707-08. At the pleading stage, there is a statutory requirement that the facts presented give rise to a strong inference of scienter. *Id.* at 708-18.

¹²⁷ See Michael D. Watkins & Max H. Bazerman, *Predictable Surprises: The Disasters You Should Have Seen Coming*, Harv. Bus. Rev., March 2003, at 72; LANGEVOORT, *SELLING HOPE*, *supra*, ch. 2.

¹²⁸ See Biljana Adebambo et al., *Anticipating the 2007-2008 Financial Crisis: Who Knew What and When Did They Know It?*, 50 J. Fin. & Quant. Analysis 647 (2015).

¹²⁹ See Geoffrey Miller & Gerald Rosenfeld, *Intellectual Hazards: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 Harv. J. L. & Pub. Pol’y 807 (2010).

¹³⁰ See Watkins & Bazerman, *supra*, at 76.

¹³¹ For a recent survey of the literature, see Ulrike Malmendier & Geoffrey Tate, *Behavioral CEOs: The Role of Managerial Overconfidence*, 29 J. Econ. Perspectives 37 (2015). The connections between overconfidence and the etiology of corporate fraud are explored in Langevoort, *SELLING HOPE*, *supra*, at 35-42.

¹³² See Watkins & Bazerman, *supra*, at 77.

This offers both opportunities and challenges for plaintiffs in disaster cases.¹³³ As a legal matter, they have to plead and prove *corporate* scienter, the standards 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,¹³⁴ 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, especially at the pleading stage.¹³⁵ Courts seem to understand that besides just making things excessively hard for plaintiffs, too a narrow 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, on the other hand, starts looking more like strict liability for the issuer, which generates its own perverse incentives.¹³⁶ Most courts are willing to expand the zone of attribution beyond complicit

¹³³ Disaster cases pose the hindsight bias problem, derived from psychological research (and folk wisdom) that 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 fact-finder either imagines 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 G. Mitu Gulati et al., *Fraud by Hindsight*, 98 Nw. U. L. Rev. 773 (2004)

¹³⁴ E.g., *In re Hertz Global Holdings Inc. Sec. Litig.*, 2017 WL 1536223 at *23 (D.N.J. 2017)(“the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter”); *Silvercreek Mgt Inc. v. Citigroup Inc.*, 2017 WL 1207836 at *6 (S.D.N.Y. 2017)(“it 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”).

¹³⁵ See *Teamsters Local 445 Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008). 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.

¹³⁶ 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.

actors only moderately, and here the doctrinal fog thickens.¹³⁷ 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.¹³⁸ The Sixth Circuit has recently taken this a step further, bringing onto the list any who reviewed the statement before or after its release and ratified, tolerated or recklessly disregarded the falsity.¹³⁹ Other courts simply use status in the organization as the test.¹⁴⁰ 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.¹⁴¹

B. Awareness and Compliance Controls

Whatever the particular attribution test applied, courts seem to want to see enough evidence that the false or misleading statement could fairly be described as intentional at the disclosure level. That would not likely be so if the facts were bottled up somewhere in the firm and the senior management responsible for the disclosure was entirely unaware of them

¹³⁷ This issue is explored thoroughly in Patricia S. Abril & Ann Morales Olazabal, *The Locus of Corporate Scierter*, 2006 Colum. Bus. L. Rev. 81. See also Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. Cinn. L. Rev. 1187, 1229-30 (2003).

¹³⁸ E.g., *Southland Sec. Corp. v. INSpire Ins. Sols. Inc.*, 365 F.3d 353, 366 (5th Cir. 2004). Many courts indicate that at the pleading stage, the standard is less strict than at trial. *Teamsters Local 445 Pension Fund v. Dynex Cap. Inc.*, 531 F.3d 190, 195 (2d Cir. 2008).

¹³⁹ *In re Omnicare Inc. Sec. Litig.*, 769 F.3d 455, 476 (6th Cir. 2014); see also *Doshi v. General Cable Corp.*, 823 F.3d 1032 (6th Cir. 2016).

¹⁴⁰ E.g., *Thomas v. Shiloh Industries*, 2017 WL 2937620 (S.D.N.Y. 2017) (“In the closest approximation to a workable standard for determining corporate scierter, courts in this District have held that ‘management-level’ employees can serve as proxies for the corporation. . . .”)

¹⁴¹ This idea was developed by Judge Posner in *Makor Issues & Rights v. Tellabs*, 513 F.3d 702, 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 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 scierter” 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” Marketing Sales Practices Sec. Litig.*, Fed. Sec. L. Rep. (CCH) par. 99,817 (N.D. Cal. 2017)(refusing to employ collective scierter approach, but finding other grounds for corporate scierter).

(much less if no single person in the firm knew the troubling fact but could have had a diligent effort been made to gather all the facts diffused throughout the firm).

High-quality compliance systems are supposed to address this. 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 a de facto necessity as well.¹⁴² 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 of breakdowns in internal compliance controls. Because the CEO and CFO have to certify their oversight and an absence of known material deficiencies regarding financial reporting, plaintiffs sometimes argue that an undisclosed control failure constituted fraud. 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 so that plaintiffs' argument seems to be that the later disaster event by itself proves that a breakdown had occurred.¹⁴³ 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."¹⁴⁴ These are just variations on the issues discussed earlier.

¹⁴² E.g., Sean J. Griffith, *Corporate Governance in an Age of Compliance*, 57 Wm. & Mary L. Rev. 2075 (2016).

¹⁴³ E.g., *In re Braskem S.A. Sec. Litig.*, 246 F. Supp.3d 731, 757-58 (S.D.N.Y. 2017)(citing cases). 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, 360 (S.D.N.Y. 2015)) and—eventually—that the breakdown had a sufficiently tight causal connection to the disaster event.

¹⁴⁴ *Meyer v. Jinksolar Holdings Co.*, 761 F.3d 245, 251(2d Cir. 2014); see also *In re City of Brockton Ret. System v. Avon Products Inc.*, 2014 WL 4832321 (S.D.N.Y., Sept. 29, 2014); *In re Scottish Re Group Sec. Litig.*, 524 F. Supp.2d 370, 398 (S.D.N.Y. 2007). To be sure, 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 scierter 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. And 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.

Could a well-plead allegation of a known control deficiency in advance of a crisis also help with scienter? Precisely because of the complex organizational nature of information flow, there can and should be some meaningful way of ascribing recklessness to *the system itself* for a failure to come to know, beyond whether those who did know were high enough up. After all, corporations are distinct persons in the eyes of the law whose securities law liability is generally seen as primary, not merely derivative via respondeat superior.¹⁴⁵ My impression is that a meaningful form of scienter can (and should) be available without the practical and doctrinal tangles associated with finding individual knowledge to attribute. It would not be unreasonable or 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 major, recently-acquired subsidiary. Plaintiffs are able to show that the parent’s internal control system was deliberately compromised with respect to the sub, because the sub’s powerful CEO would “go ballistic” at intrusions, thereby leading to a struggle to get acceptable information. In just such a case, the court stumbled on the meaning and nature of attribution as to the sub’s CEO, and dismissed the case. But putting that attribution issue aside, the compliance failure itself should have been treated as an allegation of corporate recklessness that suffices at the pleading stage.¹⁴⁶

V. CAUSATION AND DAMAGES

¹⁴⁵ See Donald C. Langevoort, *Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence*, 90 Wash. U. L. Rev. 933 (2013), criticizing the Supreme Court’s decision in *Janus Capital Group Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), for employing an unrealistic view of the nature and limits of corporate personhood.

¹⁴⁶ 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 (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. 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. See *COX ET AL.*, *supra*, at 707.

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,¹⁴⁷ loss causation and actual loss (damages). At first glance, it would appear that these are disconnected from the duty to disclose issues we've been examining, and should be relative 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, which is a command 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 by compensating for price declines caused by other unrelated factors (e.g., extraneous market movements or supervening events).¹⁴⁸ But as any law student who has finished first-year torts would see, this is a financial markets version of the *Palsgraf* problem, which is all about duty.¹⁴⁹

To illustrate: after surviving so much motion practice trying to dismiss plaintiffs' "pre-spill" claims in the *BP* litigation, they failed at the class certification stage because of a causation/damages problem.¹⁵⁰ The case illustrates a conundrum. So many fraud cases like *BP* are, as we have seen, 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.¹⁵¹ That would seem to lead

¹⁴⁷ Reliance is a class-wide inquiry invoking the presumption endorsed in *Basic* and *Halliburton II*. See notes --- supra. On lingering questions of what has to be demonstrated and by whom, see Sale & Thompson, supra, at 546-50.

¹⁴⁸ See Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 Iowa L. Rev. 811 (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.

¹⁴⁹ *Palsgraf*, of course, was about negligence liability, not intentional torts. Its relevance, however, has been recognized in fraud cases. See *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000).

¹⁵⁰ *Ludlow v. BP P.L.C.*, 800 F.3d 674 (5th Cir. 2015); see Lipton, supra, at 119-20.

¹⁵¹ Actually, there is another interesting duty issue embedded in this, which has received relatively little attention from courts or commentators. In those 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 non-existent. To assume truth-telling as the counterfactual takes duty beyond what courts have said in 10b-5 cases. See Donald C. Langevoort, *Econometric Evidence and the Counterfactual Difficulty*, 35 J. Corp. L. 183 (2009).

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, according to both the district court and the Fifth Circuit, was that what was misrepresented was risk whereas plaintiffs were asking for a measure based on the historical certainty that the disaster did occur (the actual stock price drop). That, the judges thought, would overcompensate them vis-à-vis the price distortion theory on which their claim rested. In response, 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. 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 plaintiffs’ theory and proof as to damages was not common to the entire class. Hence, class certification failed.

The judges may be right in their assessment, though loss causation was probably not the correct label for their reasoning. There was clearly proximate cause: the foreseeable materialization of precisely the risk that had been misrepresented. 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 offer a rescission-based remedy instead in these kinds of cases. That is a story for another time and place.¹⁵²

¹⁵² 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 case law. Litigants seeking to establish the existence and then the elements of a private cause of action under Rule 10b–5 were 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.” Robert B. Thompson, “*Simplicity and Certainty*” in *The Measure of Recovery under Rule 10b–5*, 51 Bus. Law 1177, 1179 (1996), quoted in *Koch v. Koch Indus., Inc.*, 6 F. Supp. 2d 1192, 1202 n.6 (D. Kan. 1998).

Importantly, however, not every investor needs that grace. Today, more and more investors limit their purchases to companies that meet some threshold of social or environmental responsibility or otherwise pay close attention to environmental performance.¹⁵³ And these are not usually the price-takers assumed in fraud-on-the-market theory but active investors making customized investment decisions. 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.¹⁵⁴ 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 private securities litigation.¹⁵⁵

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 66% of a stock price decline in the aftermath of fraud is reputational.¹⁵⁶ So here we find another subtle connection between duty and causation.

¹⁵³ Chitru S. Fernando et al., *Corporate Environmental Policy and Shareholder Value: Following the Smart Money*, J. Fin. & Quant. Analysis (forthcoming, 2017); note --- supra.

¹⁵⁴ See David Webber, *Shareholder Litigation without Class Actions*, 57 Ariz. L. Rev. 201 (2015). The BP litigation had a substantial opt-out component.

¹⁵⁵ 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 for to facilitate greater shareholder governance. Lipton, supra, at 139-46.

¹⁵⁶ See Jonathan Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. Fin. & Quant. Analysis 581 (2008). This may oversimplify, since there are so many 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

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.¹⁵⁷ It 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,¹⁵⁸ 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—pre-existing credibility has simply been abused in the course of the fraud.¹⁵⁹ 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 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

of more intrusive regulation going forward, and thus a drag on profits. Research in the aftermath of the Deepwater Horizon catastrophe show that other drilling companies suffered significant stock price drops, presumably because of factors common to everyone engaged in that newly more risky business. See 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.

¹⁵⁷ For discussions, compare Bradford Cornell & James C. Rutten, *Collateral Damage and Securities Litigation*, 2009 Utah L. Rev. 717 and Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals v. Broudo*, 63 Bus. Law. 163, 179-85 (2007)(collateral damage should not be recoverable) with Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. Corp. L. 169 (2009); Lipton, *supra*, at 122 (should be recoverable). Cornell and Rutten, *supra*, tie their argument to the point discussed (and critiqued) extensively above: the absence of a per se duty to disclose wrongdoing or mismanagement. 209 Utah L. Rev. at 738-41.

¹⁵⁸ E.g., *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005). For a good explanation of this idea, see Jay Eisenhofer et al., *Securities Fraud, Stock Price Valuation and Loss Causation: Toward a Corporate Finance Theory of Loss Causation*, 59 Bus. Law. 1419, 1442 (2004).

¹⁵⁹ Black, *supra*, 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 Qs, but not necessarily outside those reports. The role of a control failure on issuer liability is discussed *infra*.

collateral harm. But this approach actually offers an appealing middle-ground solution. Our earlier discussion of credibility as a variable (and its potential to facilitate impression management) suggests that the prevailing level of trust in management's candor operates as a *multiplier*. Take two issuers with different marketplace assessments of credibility: company A's management is viewed as truthful, while 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. So if what is represented is 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

There has been a 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” disclosures.¹⁶⁰ 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 prepared for these risks and which are not. The goal for some is to produce useful information, while others simply 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 U.S., where regulatory efforts are apparently now on a politically-induced hiatus. In the U.S., 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

¹⁶⁰ See Ho, *supra*. In its 2016 Disclosure Reform release, the SEC requested comment on sustainability disclosure, generating a large number of responses from both advocates and critics.

can imagine the ideological consequences associated with imposing a rule that issuers address the specific impacts of climate change among an audience that includes so many climate change deniers.

As we have already seen, the supposedly clean separation between the financial and the non-financial is an illusion.¹⁶¹ 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.¹⁶² Sustainability risks are priced. The hard question is what specific disclosures 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.¹⁶³ That is the motivation behind the various non-government organization efforts to fill the void via voluntary disclosure frameworks that avoid (directly, at least) both the rigidity of formal administrative rule-making and political battles for agenda control. In the U.S., the Sustainability Accounting Standards Board (SASB) is well underway in an effort to craft disclosure standards for domestic companies tightly coupled to financial materiality.¹⁶⁴ Companies could opt-in, thereby creating expectations about what and how they will reveal regarding sustainability metrics. 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 difficult to find.

Our 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 is of interest to sustainability proponents in two conflicting respects. If there is such a chill, then the case for mandatory disclosure might seem more compelling. On the other hand, if governmental sustainability

¹⁶¹ 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 Williams, *supra*.

¹⁶² See Allen Ferrell et al., *Socially Responsible Firms*, 122 J. Fin. Econ. 585 (2015).

¹⁶³ See Urska Velikonja, *The Cost of Securities Fraud*, 54 Wm. & Mary L. Rev. 1887 (2013). On the cost-benefit assessments of externalities as they relate to the agency’s “core mission,” see Alex Lee, *Beyond Agency Core Mission*, 68 Admin. L. Rev. 551 (2016).

¹⁶⁴ The SASB efforts in this direction are described in its comment letter to the SEC on disclosure reform, dated July 1, 2016, available at <https://www.sec.gov/comments/s7-06-16/s70616-25.pdf>.

mandates are either unlikely for political reasons or unwise as a matter of policy, the litigation threat might stand in the way of optimal disclosure via a SASB-like process. This is a well-known 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.¹⁶⁵ 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, although the statutory product was overdone.

The litigation risks associated with sustainability disclosure can easily be over-estimated, especially if the risks being discussed are likely to emerge, if at all, 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.¹⁶⁶ The only serious litigation risk is the disaster that occurs relatively soon after the disclosures. Loss causation issues also come into play here, because of the difficulties connecting specific disclosures to stock price losses far into the future. So does scienter, in that 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 case law, especially in treating as puffery aspirational statements as to the issuer's commitment to safety, security and sustainability. But our main takeaway was that these cases are not all that well thought through as a normative matter, and counter-balanced by many other cases finding potentially actionable fraud in other soft statements, especially when repeated or

¹⁶⁵ See Karpoff et al., *supra*.

¹⁶⁶ 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, *SELLING HOPE*, at 105-07.

made in response to heightened investor interest. In both the Deepwater Horizon and Massey Energy litigation, plaintiffs pointed to the issuers' voluntary sustainability reports as sources of actionable deception.¹⁶⁷ As investor interest in this area grows, issuers can't be very confident that the law will favor them when disaster ensues. It might, but it's 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 the standards creates a reasonable expectation for investors that what is said will be fully responsive to those standards.¹⁶⁸ My sense is that the answer should be symmetric, so that if a duty to disclose derives from an SEC line-item, as I think it is and should be, it should 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 some regulatory imprimatur, cannot protect statements that otherwise have the propensity to mislead.¹⁶⁹

So compliance with SASB-like standards is 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 remains. On the other hand, some lessening of that threat comes from standardization: using a common rubric with other similarly-situated issuers reduces the risk that comes from being unique in what is said. Presumably, SASB could aid this by explicitly setting boundaries for reasonable investor expectations. In

¹⁶⁷ See *In re BP P.L.C. Sec. Litig.*, 922 F. Supp.2d 600, 613 (S.D. Tex. 2013)(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)(Corporate Social Responsibility Report contained possible omissions). The statutory safe harbor for forward-looking information offers a cautionary lesson about even the most aggressive protections when judges sense deceit. See pp. --- supra.

¹⁶⁸ 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 note --- supra.

¹⁶⁹ See *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969)(adherence to generally accepted accounting principles does not eliminate possibility that financial statements were nonetheless misleading); *United States v. Ebbers*, 458 F.3d 110 (2d Cir. 2006)(same).

outreach and guidance to the investor community, in other words, it 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. A reasonable, moderate statement of what investors should and shouldn’t expect, however, might help assuage issuer fears enough to stimulate participation in the voluntary regime notwithstanding residual fears, so long as they see good market driven reasons to do so as well. Adherence to the letter and spirit of high-quality voluntary sustainability disclosure is more likely to lessen the litigation risk than increase it.

VII. CONCLUSION

Our inquiry into the etiology of corporate disasters sheds light on what is emerging as a major 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. Via either gamesmanship or stone-cold silence, corporations can hide too much risk and wrongdoing. In other words, 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 Section 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 their right or responsibility to optimize the disclosure system or its remedies—that is for Congress and the

SEC.¹⁷⁰ 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 shouldn't be outcome-determinative, but are. The effort to promote stock price integrity deserves better than this.¹⁷¹ 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.

¹⁷⁰ Prior to the late 1970s, the courts were more open to a partnership role in duty-creation (see Bauman, *supra*), which probably led the SEC to pay less attention to the design of the disclosure system as a whole than it should have. Reg S-K and its doctrinal limitations are the legacy of that era.

¹⁷¹ Paying more attention to scheme liability may be a way forward. See note – *supra*. 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.