

REVIVING RELIANCE

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This Article explores the misalignment between the disclosure requirements of the federal securities laws and the private causes of action available to investors to enforce those requirements.

Historically, federally mandated disclosures were designed to allow investors to set an appropriate price for publicly traded securities. Today's disclosures, however, also enable stockholders to participate in corporate governance and act as a check on managerial misbehavior. To enforce these requirements, investors' chief option is a claim under the general antifraud statute, section 10(b) of the Securities Exchange Act of 1934. But courts are deeply suspicious of investors' attempts to use the Act to hold corporations liable for false statements related to governance.

As this Article demonstrates, judicial skepticism can be traced to the functional elimination of the element of reliance from private investors' claims. Without the element of reliance, courts cannot discriminate between deception, which section 10(b) prohibits, and poor managerial decision-making, to which section 10(b) does not speak. Doctrines that courts developed to distinguish between the two now have the perverse effect of devaluing disclosures intended to facilitate shareholder participation in corporate governance. More troublingly, they enforce a normative viewpoint that shareholders do not, or should not, have interests beyond the short-term maximization of a firm's stock price. This interpretation of shareholder preferences undermines modern regulatory initiatives that employ shareholders as a restraining force on antisocial corporate conduct.

This Article proposes that courts adopt new interpretations of section 10(b) that reestablish the centrality of reliance. By doing so, courts can facilitate shareholders' participation in the corporate governance structure and reward investors who inhabit the role of corporate monitor.

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INTRODUCTION

The federal securities laws mandate that publicly traded businesses disclose material information to investors, and private litigation has long served as a critical mechanism for their enforcement. Today, however, the required disclosures have outgrown the private causes of action, making it easier for businesses to evade their legal responsibilities. Investors’ ability to monitor and influence corporate behavior suffers as a result.

For many years, federally mandated disclosures were designed primarily to enable investors to set appropriate prices for publically traded securities. Investors were provided with basic information about the corporation’s assets, revenues, liabilities, capital structure, and the like for the purpose of allowing them to price the securities they traded. In this manner, federal law

treated investors like consumers purchasing a corporate product, positioned as opposite and external to the corporate entity.

Over time, however, investors changed, and the purposes of disclosure changed with them. In the mid-twentieth century, most stock was held by individual retail investors. Today, by contrast, 66 percent of publicly traded stock is held by institutional investors such as mutual funds, pension funds, hedge funds, and insurance companies.¹ These investors often have a substantial stake in particular firms.² And unlike the dispersed, unsophisticated retail investors of days past, institutional investors have the expertise, the voting power, and the incentives to take a serious interest in the way that corporations are managed and to advocate for changes when they are dissatisfied with the current strategy. They no longer need to be treated as counterparties to the corporate entity—instead they are, or have the potential to be, participants in the corporate governance project.

Congress and federal regulators have responded to the shift. Though state law has traditionally afforded few rights to stockholders—a state of affairs that many have criticized for enabling managerial abuse³—federal law has gradually increased stockholder power. Among other things, Congress and the Securities and Exchange Commission (SEC) have enhanced stockholder voting rights, loosened restrictions on communications among stockholders, and granted stockholders greater access to the corporate proxy. As part of these efforts, regulators have expanded the types of information to be disclosed to stockholders. No longer is the focus solely on valuation. Today, many mandated disclosures concern the corporation's internal decision-making processes and governance structures in order to facilitate greater shareholder oversight.⁴ In this manner, federal law enables shareholders to protect themselves against unfaithful or incompetent managers and provides them with sufficient information to exercise a voice in corporate affairs. The federal regulatory scheme, in other words, has begun to enlist shareholders to serve as monitors of managerial behavior, and disclosure is one of its critical tools.

Unfortunately, even though private litigation remains a significant part of the regime for enforcing federal disclosure requirements, it has not adapted to the changes. Currently, there is no cause of action designed to enforce disclosures that are intended to assist shareholders' involvement in corporate governance. Instead, the only viable option is section 10(b) of the Securities

1. Marshall E. Blume & Donald B. Keim, Institutional Investors and Stock Market Liquidity: Trends and Relationships 7 (Aug. 21, 2012) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2147757 [<https://perma.cc/3FF4-WRTU>]; see also Shlomit Azgad-Tromer, *Corporations and the 99%: Team Production Revisited*, 21 *FORDHAM J. CORP. & FIN. L.* 163, 171–72 (2016) (reporting that in 1945, 93 percent of equity stock was held by individuals and that in 2014, the figure was closer to 36 percent).

2. For example, the Vanguard Group controls more than 5 percent of over 90 percent of the companies that make up the Standard & Poor's 500 index. Sarah Krouse et al., *Passive Funds Embrace Their New Power*, *WALL ST. J.*, Oct. 25, 2016, at A1.

3. See generally Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 *HARV. L. REV.* 833 (2005).

4. See *infra* Part I.

Exchange Act of 1934 (“Exchange Act”).⁵ Section 10(b) is a general antifraud statute, but it is narrowly aimed toward policing false statements in the context of valuation during a purchase or sale.⁶

Even with its limitations, section 10(b) could be utilized as a backdoor method for enforcing governance-related disclosures;⁷ however, over the years, courts have built up a series of doctrines which prevent precisely that.⁸ For example, the doctrine of puffery—treating certain types of disclosures as too vague to be material to investors—is often employed for the purpose of rejecting claims based on statements relating to corporate governance processes and quality.⁹ Additionally, section 10(b) damages are defined as the difference between a security’s purchase price and its true value at the time of purchase, disregarding how a continuing fraud may cause further damage over time precisely because it denies shareholders the opportunity to force an early course correction.¹⁰

Many of these doctrines can be traced to a particular development in section 10(b) jurisprudence: the functional elimination of the element of reliance.¹¹ Reliance is a typical element in fraud claims, where it provides the necessary causal connection between the defendant’s bad act and the plaintiff’s injury.¹² In the context of section 10(b), however, reliance has largely been replaced with the fraud-on-the-market doctrine.¹³ That doctrine requires that courts presume that false statements harm investors by distorting the market price of a security, even when particular investors did not personally know of, or make decisions based upon, the statement.¹⁴

By substituting a presumption of market disruption for individualized proof that false statements influenced investors, courts made it far easier for plaintiffs to bring claims and for claims to be aggregated into class actions.¹⁵ At the same time, the elimination of individualized reliance has made it more difficult to distinguish between deception, which section 10(b) prohibits, and poor managerial decision-making, to which section 10(b) does not speak.¹⁶ Courts developed alternative tools to draw a distinction between the two types of allegations, but those tools now have the perverse effect of devaluing disclosures intended to facilitate shareholder participation in corporate governance.¹⁷

Courts’ interpretations of section 10(b) not only draw obsolete distinctions between disclosure and governance, but, as this Article demonstrates, they

5. 15 U.S.C. § 78j (2012).

6. *See infra* Part III.

7. *See infra* Part V.

8. *See infra* Part III.A–B.

9. *See infra* Part III.B.1.

10. *See infra* note 189 and accompanying text.

11. *See infra* Part III.

12. *See infra* Part III.

13. *See infra* Part III.

14. *See infra* notes 65–70 and accompanying text.

15. *See infra* notes 65–70 and accompanying text.

16. *See infra* notes 65–70 and accompanying text.

17. *See infra* Part III.

are often used to enforce courts' normative views of shareholder preferences.¹⁸ Specifically, courts frequently assume that shareholders are amoral, relatively short-term stakeholders with no interests beyond the maximization of the stock price of the firm at issue. But this portrait of shareholder preferences is factually inaccurate: shareholders frequently favor a longer-term view and have interests beyond their investment in a particular firm. More troublingly, it stands in opposition to the ethos of modern regulatory initiatives that employ shareholders as a restraining force on antisocial corporate conduct.¹⁹

This Article proposes that courts adopt new interpretations of section 10(b) that draw more workable distinctions between governance and deception and, crucially, reestablish the centrality of reliance. Though fraud on the market continues to have an important role, courts should distinguish between actual reliance claims and fraud-on-the-market claims in certain contexts. Doing so would encourage investors to inhabit the role of corporate monitor, ultimately benefitting other investors and society more broadly. Moreover, in today's deregulatory climate, the issue takes on a particular urgency: as government authorities retrench, the role of investors in constraining corporate behavior becomes especially critical.²⁰

At the same time, this Article recognizes that reinterpreting section 10(b) is only a partial fix, as the statute remains immutably focused on the transactional role of investors rather than the governing role. Today's investors often adopt passive strategies, purchasing and selling based on broad indices rather than individual company characteristics.²¹ These investors do take corporate disclosures into account, but at a different stage: when determining how to vote or engage with management. To fully empower these investors, then, enforcement mechanisms must be tailored to their role in the corporate structure.

Part I begins by describing the traditional division of labor between states and the federal government in the regulation of corporations. States are generally responsible for delineating the substantive rights of investors within the corporate structure and the duties owed by managers. Federal law has focused on disclosure, which is chiefly intended to allow investors to value securities in the context of trading. Next, Part II establishes that the purposes of federal disclosure requirements have expanded to encourage investors—particularly institutional investors—to participate in corporate

18. *See infra* Part III.

19. *See infra* Part IV.

20. Emily Chasan, *State Street Asks Boards to Disclose More on Climate Preparation*, BLOOMBERG (Jan. 26, 2017), <https://www.bloomberg.com/news/articles/2017-01-26/state-street-asks-boards-to-disclose-more-on-climate-preparation> [<https://perma.cc/MKH9-M5LW>]; Andrea Vittorio, *Shareholder Advocacy on Climate Change Won't Let Up*, BLOOMBERG BNA (Dec. 23, 2016), <https://www.bna.com/shareholder-advocacy-climate-n73014449052/> [<https://perma.cc/L725-LR66>] (reporting that investors will advocate for corporate action on climate change even if the federal government no longer prioritizes the issue).

21. Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks*, WALL ST. J. (Oct. 17, 2016), <https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749?mg=prod/accounts-wsj> [<https://perma.cc/EH59-HUZG>].

governance, with a view toward enabling them to act as monitors of management behavior.

Part III demonstrates how judicial interpretations of the private right of action under section 10(b) interfere with these disclosure requirements and devalue the role that investors occupy in the governance structure. Then, Part IV shows that these interpretations are not neutral but instead inscribe into doctrine a particular vision of shareholder values and priorities that is at odds with the evolving federal regulatory scheme. Finally, Part V proposes changes to harmonize judicial doctrine with the modern regulatory scheme.

I. FEDERAL DISCLOSURE REQUIREMENTS AND THE DIVISION BETWEEN STATE AND FEDERAL LAW

The relationships among corporations, their officers and directors, and their investors are subject to regulation at the state and federal levels.²² Corporations are created by state law, and state law defines the substantive terms of their existence; federal law, at least historically, has been primarily concerned with ensuring that investors receive sufficient information about the companies in which they invest. This Part describes the traditional division of regulatory labor between the states and the federal government and the purposes of the federal disclosure requirements.

A. *Disclosure Versus Substance: How States and the Federal Government Have Traditionally Allocated Responsibilities for Protecting Investors*

Corporations are generally chartered in the first instance by states, and state law, historically, has been responsible for regulating the legal requirements of the corporate form. Thus, state law determines how power is allocated between stockholders and managers and delineates the matters fit for stockholder action, the duties owed by managers to the corporation and its stockholders, and the mechanisms by which stockholders can enforce their rights.²³

Pursuant to this authority, states have chosen to grant most management powers to the corporate directors, with stockholder powers kept—at least as a formal matter—quite minimal.²⁴ In general, the remedy under state law for shareholders disenchanted with management is to sell their shares, commonly referred to as the “Wall Street Walk.”²⁵ Though state law grants shareholders

22. See generally Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449 (2001); James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116 (2017); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003).

23. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89–91 (1987).

24. In most states, there are significant barriers—if not outright prohibitions—on shareholders taking such actions as calling special meetings, initiating major transactions, or proposing director candidates. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 574 (2003).

25. See generally Anat R. Admati & Paul Pfleiderer, *The “Wall Street Walk” and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645 (2009).

certain rights to sue for corporate mismanagement that rises to the level of open self-dealing and willful illegality,²⁶ other types of managerial decisions are generally treated as within management's prerogative.²⁷ Moreover, high procedural barriers to shareholder claims make them impossible to bring in all but the most egregious circumstances.²⁸

Federal law, by contrast, has not historically been concerned with the duties of management vis-à-vis stockholders, or with stockholder governance rights. It has not regulated managerial behavior or the substantive quality of a particular investment. Instead, federal law has mostly concerned itself with disclosure of the details of corporate operations, so that investors—and, more generally, the market—understand the investment's character.²⁹

As a result, federal law requires public companies to make copious amounts of information available on a regular basis. For example, before issuing new securities, a company must file a registration statement containing a description of the business, audited financial statements, a statement of the risks of the investment, the intended uses of the capital raised, and other similar information.³⁰ Additionally, as long as the securities remain outstanding, the company must file annual reports with comprehensive details similar to those required in a registration statement and shorter quarterly reports containing updated financial information and management's explanations for changes in financial results.³¹ And when certain critical events occur, the company must issue an immediate update.³²

To be sure, the distinctions between federal regulation of disclosure and state regulation of substance have never been clean. Disclosure itself is a powerful governance mechanism, if for no other reason than that it deters fraud and mismanagement.³³ Moreover, disclosure requirements force corporate managers to attend to corporate operations in order to gather appropriate information, thus imposing a "quasi" duty of care.³⁴ Disclosure is also critical to giving shareholders a basis for exercising their state-conferred governance rights, such as their right to vote on corporate actions.³⁵

26. See, e.g., *Stone v. Ritter*, 911 A.2d 362, 370–71 (Del. 2006).

27. See, e.g., *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 130 (Del. Ch. 2009).

28. See James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 47–48 (2016); see also Thompson & Sale, *supra* note 22, at 865–66.

29. See, e.g., Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 pmbl. ("An Act [t]o provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . .").

30. 17 C.F.R. § 239.11 (2016).

31. *Id.* §§ 249.308a, 249.310.

32. *Id.* § 249.308.

33. AA Sommer Jr., *Therapeutic Disclosure*, 4 SEC. REG. J. 263, 265 (1976) ("Very simply put, if every instance of adultery had to be disclosed, there would probably be less adultery.").

34. Hillary A. Sale & Donald C. Langevoort, "*We Believe*": *Omnicare, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763, 788 (2016); Thompson & Sale, *supra* note 22, at 874, 877–78; see also Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 614–16 (2003).

35. Park, *supra* note 22, at 155–56.

Even when used solely to value a security, disclosure still facilitates the most important governance right in the shareholders' arsenal: the right to buy and sell, i.e., the right of entry and exit.³⁶ By setting market prices, investors send important signals to managers about the quality of their management, which in turn acts as a potent disciplinary mechanism.³⁷

Additionally, certain aspects of federal law are specifically directed toward stockholders' exercise of the franchise. When the company holds a shareholder vote,³⁸ federal law requires an extensive description of the matters to be voted on, including directors' qualifications, approaches to corporate governance, and standards for compensating executives.³⁹ Federal law also contains certain requirements regarding proxy voting, including the requirement that shareholders be granted access to the corporate proxy for particular subjects.⁴⁰

That said, the hallmark of federal regulation has been its emphasis on disclosure to enable proper valuation, rather than as a tool to impose governance standards on managers. State law has been left to attend to the substantive role of stockholders within the corporate structure.⁴¹ Even federal regulation of stockholder voting has been geared toward facilitating the rights conferred under state law.⁴² As the SEC once explained, "Although disclosure requirements may have some indirect effect on corporate conduct, the Commission may not require disclosure solely for this purpose."⁴³

B. Private Enforcement Is Oriented Toward Disclosure for Purposes of Valuation

To enforce its disclosure requirements, federal law relies on the Justice Department, SEC, and private plaintiffs. These entities are permitted to bring criminal and civil actions for disclosure violations under a patchwork of statutes, which require degrees of fault that range from strict liability to

36. See Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 516 (2000).

37. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 688–89 (2010). In addition to imposing disclosure obligations, federal law has directly interfered in corporate governance in other ways. For example, federal law has long governed proxy voting—a core aspect of governance. See Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REG. 26, 26 (2003); Roe, *supra* note 34, at 598. Federal law has also imposed governance standards via regulation of listing requirements for stock exchanges. See 17 C.F.R. §§ 240.10A-3, 240.10C-1(b)(1).

38. Shareholder votes occur annually to elect directors and additional special votes are held to decide upon imperative matters. See, e.g., DEL. CODE ANN. tit. 8, § 211 (2009).

39. 17 C.F.R. § 240.14a-101.

40. *Id.* § 240.14a-8.

41. See, e.g., 15 U.S.C. § 78b (2012) (recognizing the importance of setting appropriate prices for securities); Securities Exchange Act of 1934, Pub. L. No 73-291, 48 Stat. 881 pmbl.

42. See Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 894 (1994).

43. Notice of Commission Conclusions and Rulemaking Proposals, Securities Act Release No. 5627, Exchange Act Release No. 11,733, 8 SEC Docket 33, 41, 45 (Oct. 29, 1975).

willful or intentional misconduct.⁴⁴ Though this ad hoc system of enforcement has been the frequent target of both scholarly and political ire,⁴⁵ Congress and the SEC have repeatedly stated that they rely on both public and private enforcement efforts to compensate investors and ensure compliance with the law.⁴⁶ The SEC, for example, has admitted that it does not have the resources to police the entire securities industry.⁴⁷ Instead, it relies on private plaintiffs to provide assistance,⁴⁸ which may become even more necessary if—as appears possible—the SEC’s system of administrative adjudication is found to be unconstitutional by the U.S. Supreme Court.⁴⁹ Thus, for the past several decades, the securities regulation architecture has

44. See 15 U.S.C. §§ 77k–l, 77q, 78i–j, 78r; 17 C.F.R. § 240.14a-9. See generally Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511 (2011).

45. See generally James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115 (2012) (describing proposals to centralize enforcement).

46. See, e.g., H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.) (“[P]rivate lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.”); Brief for the United States as Amicus Curiae Supporting Petitioners at 1, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (No. 06-484) (“Meritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions . . .”).

47. *The Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities of the S. Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. 41 (1997) (statement of Arthur Levitt, Chairman, SEC) (“Private actions are an especially important supplement to the Commission’s enforcement program today because of the phenomenal growth of the securities industry during a time when the Commission’s staff and budget levels have remained relatively constant.”).

48. See *id.*; *Securities Investor Protection Act of 1991: Hearing on S. 1533 Before the Subcomm. on Securities of the S. Comm. of the Banking, Hous., and Urban Affairs*, 102d Cong. 15–16 (1992) (statement of Richard C. Breeden, Chairman, SEC) (“Because the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets.”); Luis A. Aguilar, Comm’r, SEC, *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections*, Address at the North American Securities Administrators Association Annual NASAA/SEC 19(d) Conference (Apr. 16, 2013) (“It is unrealistic to expect that state regulators or the SEC will have the resources to police all securities frauds or go after every fraudster. Investors should have the ability to protect themselves.”); see also Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 101 (2008) (“Despite the SEC’s status as a highly regarded institution, both limited resources and agency capture hinder optimal enforcement.”); Langevoort, *supra* note 22, at 476 (“Enforcement personnel are spread thin not only among investigations and actions involving managerial accountability, but numerous other matters, such as the conduct of the securities industry and its associated persons. The numbers are only part of the story. SEC enforcement lawyers are underpaid, leading to high rates of turnover. This high rate of turnover, in turn, means a loss of experience and expertise, a large burden given the resources and talent typically on the other side of an important enforcement matter. The consequence is far fewer investigations and enforcement actions than optimal, and a pressure to settle rather than take a case through an expensive trial . . .”).

49. There is currently a dispute about whether the appointment of SEC administrative judges (and constraints on their removal) violates Article II. See *Bandimere v. SEC*, 844 F.3d 1168, 1183 (10th Cir. 2016). It has been suggested that the Supreme Court may invalidate the current structure. See, e.g., Carmen Germaine, *Gorsuch Could Tip Scales Against SEC’s Admin Court*, LAW360 (Feb. 2, 2017), <https://www.law360.com/articles/887745/gorsuch-could-tip-scales-against-sec-s-admin-court> [https://perma.cc/28W4-P28G].

been designed with the expectation that private plaintiffs will prove a “necessary supplement to Commission action.”⁵⁰ And, in fact, some have endorsed the decentralized enforcement model that currently prevails: entrepreneurial plaintiffs may be more willing to invest in complex cases and expand the boundaries of the law than their public counterparts.⁵¹

The most significant cause of action available to private investors arises under section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.⁵² Section 10(b) broadly prohibits any “manipulative or deceptive” conduct “in connection with the purchase or sale” of a security⁵³ and, as relevant here, Rule 10b-5(b) prohibits false statements, or misleading omissions, “in connection with the purchase or sale of any security.”⁵⁴ The statute and rule, then, are oriented toward fraud that influences transactions, namely, buying and selling, and not the quality of corporate governance.

Investors who wish to bring claims under section 10(b) and Rule 10b-5(b) must prove: (1) the existence of a misstatement (2) that is material to investors (3) made intentionally or recklessly (4) on which investors relied (5) that caused economic losses and (6) caused damages.⁵⁵ In recognition of the distinct spheres of federal and state corporate regulation, the Supreme Court held in *Santa Fe Industries, Inc. v. Green*⁵⁶ that section 10(b) does not extend to claims based solely on violations of fiduciary duty, such as negligent, reckless, or disloyal behavior; instead, such matters are regulated by state law.⁵⁷ Thus, in keeping with the federal emphasis on disclosure and valuation, section 10(b) is only available for claims based on *deceptive* conduct. By now, it has become something of a cliché for courts to declare that section 10(b) is unavailable merely to challenge mismanagement.⁵⁸

That section 10(b) is not in the first instance designed to address governance deficiencies is hardly a surprise; indeed, one of the earliest Supreme Court cases on the subject, *Blue Chip Stamps v. Manor Drug Stores*,⁵⁹ limited private section 10(b) claims to plaintiffs who either bought or sold a security, rather than to plaintiffs who merely held a security.⁶⁰ *Blue Chip* was not intended to thwart governance claims so much as frivolous

50. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

51. *See* Park, *supra* note 22, at 127–28, 160; *see also* Burch, *supra* note 48, at 75, 81–82.

52. There are a few other significant causes of action available to investors for false corporate statements, but all are limited in particular ways. For example, Rule 14a-9 is applicable only to false proxies and has very tight causation requirements for plaintiffs seeking damages. *See infra* note 122 and accompanying text. Section 11 only applies when a corporation issues new securities and is nearly impossible to use for stock issued after the initial public offering. *See* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 432 (2000).

53. 15 U.S.C. § 78j(b) (2012).

54. 17 C.F.R. § 240.10b-5 (2016).

55. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

56. 430 U.S. 462 (1977).

57. *Id.* at 474.

58. *See, e.g., In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 537 (3d Cir. 1999).

59. 421 U.S. 723 (1975).

60. *Id.* at 754–55.

ones,⁶¹ but it orients section 10(b) toward investors in their capacity as consumers of a corporate product—corporate securities—rather than as participants in the enterprise.⁶²

The remaining elements of a section 10(b) cause of action continue in this vein, focusing on the process of price setting. Materiality is defined in terms of information that “would have . . . significantly altered the ‘total mix’ of information” for the purpose of investment decisions.⁶³ Damages are usually defined to mean the difference between the price investors paid for the security and its true value at the time of purchase.⁶⁴ All of these elements, then, treat disclosures as relevant solely for the purpose of allowing investors to value a security when directly engaged in buying or selling. Even the reliance element of section 10(b) has largely been transformed into an inquiry into proper valuation, via courts’ adoption of the fraud-on-the-market doctrine.

Decades ago, courts recognized that section 10(b) claims based on open market frauds—public statements that influence the price of securities in organized markets—are uniquely difficult to bring. They are extremely expensive to litigate relative to the size of most investments, and establishing reliance on false information in this context presents special challenges. Most investors rely on a variety of information sources, including statements issued directly by the corporation as well as recommendations from analysts and associates (who themselves may have relied on corporate-issued information), news stories, and other types of data. Indexed investors may not rely on corporate-specific information at all.⁶⁵

In response, courts developed the fraud-on-the-market doctrine, which eliminates the need to examine reliance on an investor-by-investor basis.⁶⁶ The doctrine affords plaintiffs in a section 10(b) action the benefit of two presumptions: first, that any material information—including false information—introduced into an “open and developed market” influences stock prices,⁶⁷ and second, that investors who transact in such a market “rely” on stock prices when they purchase at the market price.⁶⁸ Together, the two presumptions become a syllogism: investors who rely on prices that have been distorted by fraud have, indirectly, relied on the fraud itself.⁶⁹

61. *Id.* at 739.

62. See Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741–44 (2012).

63. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

64. *Ludlow v. BP, P.L.C.*, 800 F.3d 674, 682 n.30 (5th Cir. 2015).

65. Jill E. Fisch, *The Trouble with Basic: Price Distortion after Halliburton*, 90 WASH. U. L. REV. 895, 916 (2013).

66. See generally *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014); *Basic*, 485 U.S. 224.

67. *Basic*, 485 U.S. at 244 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986)).

68. *Halliburton*, 134 S. Ct. at 2411.

69. *Basic*, 485 U.S. at 241–42.

The doctrine thus kills two birds with one stone. First, it eases the burden on plaintiffs attempting to prove reliance.⁷⁰ Second, because reliance is decided based on market characteristics rather than investor characteristics, it facilitates the use of the class actions, which mitigates the expenses associated with individual claims.⁷¹ Today, most section 10(b) claims involving open-market fraud are brought using the fraud-on-the-market doctrine.⁷² Thus, the element of reliance is no longer an inquiry into the actual preferences of defrauded investors but is instead an inquiry into the market-wide impact of corporate statements on the pricing of securities.

The existence of the fraud-on-the-market doctrine represents a trade-off between the goals of compensation and deterrence. The two are somewhat at odds: deterrence is best achieved via the high damages available through collective action, but the risks and coordination problems inherent in such actions encourage settlements that result in little investor compensation.⁷³ To achieve truly compensatory damages, then, shareholders must file individual lawsuits that have little deterrent effect; meanwhile, the complexity and expenses of such actions make them difficult to pursue in the first place. In light of these trade-offs, our legal system has largely favored deterrence with almost all actions proceeding on a class basis.⁷⁴ As a result, questions regarding the proper interpretation of section 10(b) similarly tend to arise in the class action context.

In recent years, however, the purposes of federal mandatory disclosure have changed. These changes have placed increasing pressures on an enforcement regime that was designed for a different era.

70. *Halliburton*, 134 S. Ct. at 2408 (noting that under the fraud-on-the-market theory, investors are entitled to a rebuttable presumption of reliance and are not required to show direct reliance on an individual basis).

71. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 818 (2009).

72. Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1303 (2008).

73. See Cox & Thomas, *supra* note 28, at 65.

74. State law might, in some situations, provide a remedy for deceived investors as well. However, the Securities Litigation Uniform Standards Act of 1998 would bar investors from bringing claims collectively, or even coordinating individual claims with a pending class action, which may be necessary for investors to litigate effectively. See Benjamin P. Edwards, *Disaggregated Classes*, 9 VA. L. & BUS. REV. 305, 327–30 (2015). Additionally, it is not clear that all states would provide a remedy for open market frauds where the investors are not in privity with the defendants and did not receive direct communications from them. Cf. *In re Bear Stearns Cos. Secs., Derivative, & ERISA Litig.*, 995 F. Supp. 2d 291, 313 (S.D.N.Y. 2014) (noting that under New York common law, liability of an auditor is limited to “the persons or class of persons’ to whom the auditor intends to communicate its representations” (quoting *Ultramares Corp. v. Touche*, 174 N.E. 441, 446–47 (N.Y. 1931))). Finally, states tend to take their cues from federal law when crafting their own investor protections. Delaware, for example, has imported the federal definition of materiality into its own law. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985). State common law may borrow loss causation standards from federal law as well. See, e.g., *Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC*, 797 F.3d 160, 186–87 (2d Cir. 2015); *King County v. IKB Deutsche Industriebank AG*, 708 F. Supp. 2d 334, 338 n.25 (S.D.N.Y. 2010); *Basis Pac-Rim Opportunity Fund (Master) v. TCW Asset Mgmt. Co.*, 48 N.Y.S.3d 654, 656 (App. Div. 2017).

II. DISCLOSURE'S EVOLUTION: FROM VALUATION TO GOVERNANCE

Despite shareholders' limited powers under state law, federal law has gradually increased shareholders' ability to influence corporate behavior and encouraged shareholders to flex their newly invigorated muscles.

Federal disclosure standards have long been geared toward informing investors of the character of the security—which in more modern terms refers to facilitating price accuracy—with the additional goal of detecting and preventing fraud and embezzlement.⁷⁵ For many years, critics of the dual regime for regulating corporations insisted that managers have too much power vis-à-vis shareholders and use this power to extract economic rents to the shareholders' detriment.⁷⁶ Some argued that increasing shareholder power will cause management to be more responsive to shareholder desires, which ultimately will result in more loyal managers and better-run, more profitable companies.⁷⁷ Federal law has responded to this criticism by developing new rules aimed at enhancing shareholder power within the corporate structure.

These initiatives take a two-pronged approach. First, federal law has directly expanded shareholder governance powers in publicly traded companies. Though buying and selling necessarily remains one of the most powerful weapons in the shareholder arsenal, the SEC has also taken steps to increase shareholder power by deregulating communications among shareholders regarding proxy voting,⁷⁸ imposing limitations on the authority of brokers to vote stock in the absence of shareholder instructions,⁷⁹ requiring that corporations “unbundle” proposals to allow for separate shareholder votes,⁸⁰ and loosening restrictions on shareholders' ability to use corporate proxies to affect director elections.⁸¹ Federal law has also required nonbinding “say on pay” votes requiring shareholder approval of executive pay packages.⁸² These measures have greatly enhanced shareholders' ability to influence corporate behavior.

75. See *supra* Part I.B; see also Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 773 (1995); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1060 (1995).

76. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 61 (2004); Bebchuk, *supra* note 3, at 898; Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1911 (2013).

77. See Bebchuk, *supra* note 3, at 855–56.

78. See generally John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411 (2005).

79. N.Y.S.E. RULES r. 452.

80. See 17 C.F.R. § 240.14a-4(a)(3), (b)(1) (2016).

81. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,707 (Sept. 16, 2010).

82. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951(b)(2), 124 Stat. 1376, 1900 (2010).

Second, shareholders' new governance powers are complemented by expanded federal disclosure requirements. These disclosures are intended less to assist with the proper valuation of securities than to encourage investors to police the quality of corporate decision-making.⁸³ For example, one of the most controversial aspects of corporate governance concerns executive compensation, and volumes have been written weighing in on optimal compensation designs.⁸⁴ Though the responsibility for designing pay packages rests with corporate directors, the SEC has gradually expanded disclosure requirements pertaining to executive compensation, with pages of instruction dedicated to "providing specific categories of compensation and exact formulations for the charts in which management must present the information."⁸⁵ The SEC thus openly encourages investors to evaluate directors' decision-making processes and, if necessary, apply pressure to alter them.

The global financial crisis heightened concerns that corporate compensation was poorly calibrated to align managerial incentives with shareholder desires. Commentators argued that compensation structures were designed to reward short-term risk-taking at the expense of the long-term health of the enterprise.⁸⁶ In response, federal statutes and regulations imposed new requirements that companies disclose the relationship between compensation policies and corporate risk-taking⁸⁷ and the relationship between compensation and corporate performance,⁸⁸ and identify the ratio between the compensation of the CEO and the compensation of the median employee.⁸⁹ Once again, these disclosures are facially not intended to assist with valuation, but rather aim to provide specific information that shareholders can use as a lever to influence corporate behavior.⁹⁰ As Hillary Sale describes it, "The regulations have been growing steadily and are not solely about disclosure. Instead, the regulations are about the power of disclosure to force substance."⁹¹

83. J. Robert Brown, Jr., *Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 CATH. U. L. REV. 45, 65 (2007); Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359, 389 (2016); Park, *supra* note 22, at 136 ("[D]isclosure is increasingly used as a method for influencing corporate affairs.").

84. See generally BEBCHUK & FRIED, *supra* note 76; David Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW 232 (Claire A. Hill & Brett H. McDonnell eds., 2012); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021 (1999).

85. Thompson & Sale, *supra* note 22, at 875 (footnote omitted).

86. See, e.g., Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1047 (2012).

87. Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,335 (Dec. 23, 2009).

88. 15 U.S.C. § 78n(1) (2012).

89. *Id.* § 78l.

90. See Hillary A. Sale, *The New "Public" Corporation*, 74 L. & CONTEMP. PROBS. 137, 143–44 (2011).

91. *Id.* at 144.

Federal law also contains a host of other disclosure requirements that give shareholders insight into the processes by which decisions are made, and thus a foothold into influencing those processes. For example, public corporations must disclose costs associated with environmental compliance,⁹² board diversity and independence,⁹³ managerial oversight of internal information flow,⁹⁴ their reasons for not separating the chairperson and CEO roles,⁹⁵ and any codes of ethics governing corporate managers, including waivers of those codes.⁹⁶ The SEC also requires companies to disclose how often the board of directors meets and identify any directors who attend fewer than 75 percent of those meetings.⁹⁷ By requiring that this information be disclosed, federal law not only gives investors a window into corporate operations, which they may use when they exercise their governance powers, but also makes particular issues more salient, thus encouraging greater shareholder attention. When combined with the long-standing requirements that corporations disclose any known trends that could impact operations⁹⁸ and the risks associated with their securities (including legal risks),⁹⁹ the collective weight of required federal disclosures becomes a significant starting point for shareholder engagement.

To be sure, there have been signals that the current Congress may rollback some of the recent changes to the federal scheme.¹⁰⁰ As of this writing, however, the regulatory framework remains intact, and therefore represents the current direction of federal policy.

Moreover, this new regime has not ended with federally imposed disclosure requirements. The more power shareholders gain, the more information they themselves demand from their companies, further enhancing their ability to participate in governance. Thus, shareholders have forced corporations to disclose more information about political spending,¹⁰¹ sustainability,¹⁰² and similar issues.¹⁰³ Investors have particularly

92. 17 C.F.R. § 229.101(h)(4)(x1) (2016).

93. *Id.* § 229.407(b)(3)(vi); *see also* Andrea Vittorio, *Board Diversity Advocates Aren't Giving up on Disclosures*, BLOOMBERG BNA (Mar. 6, 2017), <https://www.bna.com/board-diversity-advocates-n57982084793/> [<https://perma.cc/TS48-YFFA>] (describing efforts to increase diversity disclosures).

94. 17 C.F.R. § 240.13a-14.

95. *Id.* § 229.407.

96. *Id.* § 229.406.

97. *Id.* § 229.407(2)(d).

98. *Id.* § 229.303.

99. *Id.* § 229.503.

100. *See* Gretchen Morgenson, *Meet the Legislation Designed to Stifle Shareholders*, N.Y. TIMES (June 16, 2017), <https://www.nytimes.com/2017/06/16/business/wells-fargo-clawback-fair-choice-act-shareholders.html> [<https://perma.cc/MCC4-HWMS>].

101. *See generally* Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. 262 (2016).

102. Justin Morton, *Investors Seek More Measures of Chemicals and Pesticide Use*, BLOOMBERG BNA: CORPORATE GOVERNANCE, Nov. 17, 2016, at 1; PricewaterhouseCoopers, *Investors, Corporates, and ESG: Bridging the Gap*, GOVERNANCE INSIGHTS, Oct. 2016, at 3.

103. *See, e.g.*, SPENCERSTUART, SPENCER STUART BOARD INDEX: A PERSPECTIVE ON U.S. BOARDS 3 (2016) (describing how boards are disclosing more about governance in response to investor demand); Laura Colby, *Goldman, BNY Mellon Bow to Investor Pressure on Gender Pay*, BLOOMBERG BNA (Mar. 23, 2017), <https://www.bloomberg.com/news/articles/2017-03->

encouraged corporations to make greater disclosures about—and devote greater attention to—risks associated with climate change.¹⁰⁴ Collectively, these types of disclosures are known as “Environmental, Social, Governance” (ESG) disclosures. Evidence suggests that investors increasingly seek out investment opportunities based on companies’ ESG disclosures,¹⁰⁵ and companies in turn encourage investors to evaluate their performance along these dimensions.¹⁰⁶

In sum, federal law has undergone a significant shift. Even as newer regulations take the *form* of disclosure requirements, they are transparently designed to grant shareholders a greater voice in the conduct of corporate operations. That power has snowballed, allowing shareholders to claim even more voice via disclosure.

Critical to these efforts has been the rise of the institutional shareholder.¹⁰⁷ It has long been recognized that dispersed, rationally passive retail stockholders cannot be expected to exert serious pressure on management. These shareholders suffer from difficult collective action problems and lack both the expertise and the incentives to educate themselves on corporate governance issues.¹⁰⁸ In recent decades, however, stock ownership has become concentrated among a relatively small group of large institutional investors.¹⁰⁹ For these investors, merely selling their stock to express

23/goldman-bny-mellon-bow-to-investor-pressure-on-gender-pay-gap [https://perma.cc/ZZD5-59X9]; Ross Kerber, *Exclusive: BlackRock Vows New Pressure on Climate, Board Diversity*, REUTERS (Mar. 13, 2017), <http://www.reuters.com/article/us-blackrock-climate-exclusive-idUSKBN16K0CR> [https://perma.cc/VS96-4Z6C] (“BlackRock Inc, which wields outsized clout as the world’s largest asset manager, planned on Monday to put new pressure on companies to explain themselves on issues including how climate change could affect their business as well as boardroom diversity.”); Jena McGregor, *A Surprising Number of Investors Voted for a Gender Pay Gap Measure at eBay*, WASH. POST (Apr. 28, 2016), https://www.washingtonpost.com/news/on-leadership/wp/2016/04/28/a-surprising-number-of-investors-voted-for-a-gender-pay-gap-measure-at-ebay/?utm_term=.c1816805f2aa [https://perma.cc/H8FP-4NDD].

104. See generally Kerber, *supra* note 103; Vittorio, *supra* note 20; Giovanna Michelon et al., *No Pressure, No Diamonds: The Role of Shareholder Activism on CSR Transparency* (May 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2817276 [https://perma.cc/3EMP-798B].

105. CFA INSTITUTE, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) SURVEY 5 (2015); Azgad-Tromer, *supra* note 1, at 185; PricewaterhouseCoopers, *supra* note 102, at 2; Justin Baer, *State Street Offers New Tool to Gauge Environmental, Other Social Risks*, WALL ST. J. (Mar. 26, 2017), <https://www.wsj.com/articles/state-street-offers-new-tool-to-gauge-environmental-other-social-risks-1490532564> [https://perma.cc/DC7Z-3TBZ]; Randall Smith, *Investors Sharpen Focus on Social and Environmental Risks to Stocks*, N.Y. TIMES (Dec. 14, 2016), <https://www.nytimes.com/2016/12/14/business/dealbook/investors-social-environmental-corporate-governance.html> [https://perma.cc/3EUM-RWQB].

106. See Steve Burkholder, *‘Integrated Reporting’ Attracts More Companies World-Wide*, BLOOMBERG BNA, Mar. 14, 2017, at 1.

107. See generally Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

108. See generally *id.*

109. See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 573 (2006); Vipal Monga & David Benoit, *Companies Forgot About Mom-and-Pop Investors . . . Until Now*, WALL ST. J. (July 19, 2016), <https://www.wsj.com/articles/companies-forgot-about-mom-and-pop-investors-until-now-1468920601> [https://perma.cc/QR7W-2ZN6]; see also Jan Fichtner et al., *Hidden Power of the Big Three?*

disapproval of management is not always an option.¹¹⁰ Holdings may be so large that divestment would drive prices down, causing the shareholder to incur substantial losses.¹¹¹ Indexed investors cannot sell at all in response to bad management.¹¹² Thus, in many instances, direct policing of corporate management has become a preferable alternative, or at least a supplement, to the Wall Street Walk. The large stakes held or controlled by these institutions strengthen both their incentives to monitor corporate management and their leverage when doing so.¹¹³ Monitoring costs have also been reduced by proxy advisory services, like Institutional Shareholder Services and Glass Lewis, which provide recommendations to institutions as to how to vote their shares.¹¹⁴

The new federal initiatives take advantage of these developments, and the expanded disclosures and governance powers granted to shareholders assume an audience of investors capable of assimilating and making use of the new information. Federal law has even encouraged greater institutional participation in governance by articulating fiduciary duties of institutional investors to vote their shares and requiring disclosure of mutual fund votes.¹¹⁵

The experiment has panned out: institutional shareholders have become much more likely to engage directly with management and advocate for changes in governance.¹¹⁶ They may sponsor shareholder proposals

Passive Index Funds, Re-Concentration of Corporate Ownership and New Financial Risk, 19 BUS. & POL. 298, 299–300 (2017).

110. J. Robert Brown, Jr., *The SEC, Corporate Governance and Shareholder Access to the Board Room*, 2008 UTAH L. REV. 1339, 1355.

111. Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 916 (2011).

112. See David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157, 160 (2012).

113. See, e.g., John Authers, *Passive Investors Are Good Corporate Stewards*, FIN. TIMES (Jan. 19, 2016), <https://www.ft.com/content/c4e7a4f6-be8a-11e5-846f-79b0e3d20eaf> [<https://perma.cc/QJG5-2D3H>].

114. Notably, these advisory services are the intellectual descendants of shareholder advisory services that were proposed in the 1930s, specifically with a view toward advancing the general public interest. See Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1531, 1544 (2006).

115. 17 C.F.R. § 275.206(4)–(6) (2016); Christopher M. Bruner, *Center-Left Politics and Corporate Governance: What Is the “Progressive” Agenda?* 25 (Wash. & Lee Sch. of Law, Working Paper No. 2017-4, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2917253 [<https://perma.cc/WX5F-SU9H>] (describing federal regulations that require pension plans to “engage in strong-form activism”). Federal regulators have also made clear that pension funds may take the ESG factors into account without violating their fiduciary duties. Interpretative Bulletin Relating to the Fiduciary Duty Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65,135, 65,135–36 (Oct. 26, 2015).

116. See, e.g., Reena Aggarwal et al., *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 52 J. FIN. 2309, 2311 (2015); Ian Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 114 (2016); Ying Duan & Yawen Jiao, *The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds’ Proxy Voting and Trading Behavior*, 51 J. FIN. & QUANTITATIVE ANALYSIS 489, 491–92 (2016); Morgan et al., *supra* note 111, at 927; Jeff Green & Emily Chasan, *Investors Push Corporate Boards to Add Women, People of Color*, BLOOMBERG (Mar. 2, 2017), <https://www.bloomberg.com/news/articles/2017-03-02/shareholders-target-pale-male-and->

designed to prompt management to adopt various reforms or support dissident candidates for director slots. On a more basic level, though, institutions have begun addressing management through “soft” forms of engagement—discussions, counseling sessions, and negotiation—none of which necessarily ends in divestiture or a proxy contest.¹¹⁷ When matters are addressed through shareholder votes, the proposals are typically precatory; they operate as suggestions to management, rather than commands. Even when they fail, significant minority support can prompt management to adopt voluntary reform.¹¹⁸ Under pressure from shareholders, many companies have adopted new standards that directors be elected with a majority—rather than the traditional plurality—of shareholder votes, but these standards are likewise often nonbinding; they represent a form of communication rather than direct control.¹¹⁹ The SEC has strongly encouraged these types of dialogues between institutional investors and corporate boards.¹²⁰

The difficulty with disclosure as a governance mechanism, however, is that the federal enforcement apparatus continues to view the matter solely through the lens of valuation. As the substance-disclosure line is eroded and the role

stale-corporate-boards [https://perma.cc/A7XA-RDSZ]; Kerber, *supra* note 103; Joann S. Lublin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J. (Mar. 7, 2017), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863 [https://perma.cc/WS2Y-RGZK]; Alexandra Stevenson & Leslie Picker, *A Rare Corner of Finance Where Women Dominate*, N.Y. TIMES (Jan. 16, 2017), https://www.nytimes.com/2017/01/16/business/dealbook/women-corporate-governance-shareholders.html [https://perma.cc/7DGU-49MK]; Ian Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism 1* (Nat'l Bureau of Econ. Research, Working Paper No. 22707, 2016), http://www.nber.org/papers/w22707.pdf [https://perma.cc/6B9A-588F].

117. See generally Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821; Fichtner et al., *supra* note 109; Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle in the Bebchuk-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385 (2016); Steven Davidoff Solomon, *A New Strategy for Shareholder Activism: Engagement*, N.Y. TIMES (Nov. 29, 2016), https://www.nytimes.com/2016/11/29/business/dealbook/a-new-strategy-for-shareholder-activism-engagement.html?_r=0 [https://perma.cc/9QNC-ZHF5].

118. Palmiter, *supra* note 42, at 917.

119. Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 909–10.

120. See George S. Georgiev, *Shareholder vs. Investor Primacy in Federal Corporate Governance*, 62 UCLA L. REV. DISCOURSE 71, 75 (2014), http://www.uclalawreview.org/pdf/discourse/62-4.pdf [https://perma.cc/T95Q-SR92]. Tellingly, the shift in investor composition has not gone unnoticed at the state level where direct regulation of management conduct typically occurs. Delaware (which takes the lead in the formation of corporate law) has concluded that otherwise negligent or disloyal managerial action can be cleansed by a shareholder vote upon disclosure of all material facts, making disclosure—rather than substantive evaluation of managerial behavior—the fulcrum on which fiduciary duties turn. Thus, like federal law, states increasingly expect investors, enabled by management disclosures, to take an active role in protecting their own interests. See, e.g., *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 308 (Del. 2015); *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 444 (Del. Ch. 2002) (recognizing the “increased activism of institutional investors and the greater information flows available to them”); J. Travis Laster, *Changing Attitudes: The Stark Results of Thirty Years of Evolution in Delaware M&A Litigation*, in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION (forthcoming 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2982603 [https://perma.cc/M8JQ-N66M].

of the shareholder is placed in flux, section 10(b) doctrine has become increasingly out of step with federal policy and, worse, actively undermines it by denying shareholders the role in the corporate governance structure that federal law is attempting to encourage. The danger is particularly acute due to the federal system's reliance on private enforcement as a mechanism for enforcement and deterrence.¹²¹

III. JUDICIAL IMPEDIMENTS TO ENFORCEMENT OF THE NEW DISCLOSURE REGIME

The shift in the purposes of federal disclosure presents new challenges to enforcement. Section 10(b), with its emphasis on disclosure for purposes of valuation, is not crafted to address disclosure violations whose most immediate effect is to diminish shareholders' ability to discipline corporate managers. It still could play that role, however, if not for overly cramped judicial interpretations of the statute that were designed for an earlier era.

A. Federal Law Contains No Cause of Action Designed to Enforce Governance-Related Disclosures

The federal trend toward requiring companies to open their governance processes to shareholder participation is relatively new; as a result, there exists no private cause of action specifically designed to allow shareholders to enforce their rights. The closest thing to a "governance" claim under federal law arises under Rule 14a-9, promulgated under section 14(a) of the Exchange Act.¹²² That rule prohibits false statements in corporate proxy materials and thus explicitly recognizes deception in a manner that injures shareholders' governance rights as an actionable harm.¹²³ However, Rule 14a-9 does not address corporate statements made outside the proxy context that may influence voting decisions, nor does it acknowledge or protect any of the other forms of shareholder engagement, beyond simply casting a vote, that have come to dominate the landscape.

Additionally, at least when it comes to damages claims, Rule 14a-9 has been interpreted to require very tight causation requirements between the vote and the injury alleged by stockholders. Under these standards, plaintiffs must show that a shareholder vote was necessary to complete the particular challenged transaction.¹²⁴ It is not sufficient, for example, to show that shareholders were misled into supporting a director who then made poor governance choices.¹²⁵ As a result, Rule 14a-9 may not permit claims associated with precatory votes, or votes that—while failing to win a majority—still gain the support of an influential minority, both of which are

121. *See supra* Part I.B.

122. 17 C.F.R. § 240.14a-9 (2016).

123. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 377 (1970).

124. Plaintiffs must show that a shareholder vote was necessary to complete the particular challenged transaction. *See Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1105–08 (1991).

125. *See Gen. Elec. Co. v. Cathcart*, 980 F.2d 927, 933 (3d Cir. 1992).

key mechanisms for shareholder participation today. Thus, Rule 14a-9 has limited utility for protecting shareholders' ability to participate in corporate decision-making, leaving section 10(b) to fill the vacuum.

B. Section 10(b) as an Alternative Option

Though not structured with this aim in mind, section 10(b) *can* be used to enhance shareholder participation rights by punishing false or misleading statements relating to corporate governance mechanisms. When a corporation misleads investors on a subject regarding its internal processes—for example, by falsely claiming to have adopted compliance policies or risk mitigation strategies—that statement is actionable under section 10(b). As one court put it, “[T]he mere fact that the conduct in question arguably constitutes mismanagement will not preclude a claim under the federal securities laws if the defendant made a statement of material fact wholly inconsistent with known existing mismanagement.”¹²⁶ The threat of damages for such statements can deter corporations from issuing false statements in the first place. Once full disclosure has been made—for example, the admission of flawed risk management—shareholders are now in a position to pressure the company to correct its policies. Indeed, many scholars have championed section 10(b) as a deterrent mechanism to ensure the quality of corporate governance.¹²⁷

The chief obstacle to utilizing section 10(b) in this manner, however, is judicial resistance. As described above, section 10(b) claims must be rooted in *deceptive* conduct—a mere failure to govern properly is not sufficient.¹²⁸ However, the fraud-on-the-market doctrine, which functionally eliminates the element of reliance, threatens to make any kind of undisclosed problem actionable under section 10(b). This leaves courts unable to distinguish cases involving true deception of investors from attacks on the quality of governance itself.

Typically, a fraud-on-the-market claim begins when bad news is released about a public company. The news might explicitly admit that prior statements were false—such as a restatement of previously released financial results—but more commonly, it represents a negative legal or business development, such as a drop in sales, a product defect, or a regulatory investigation. The job of the plaintiffs' attorney is then to identify statements upon which investors may *plausibly* have relied and that are *arguably* rendered false by the newly disclosed problems. The plaintiff-investor does not even need to have relied on particular statements, as would be required for an ordinary fraud claim, because whether one investor did or did not personally rely on a statement is not the issue. The issue is whether the market as a whole was fooled. Indeed, no single investor is, or should be,

126. *Portannese v. Donna Karan Int'l, Inc.*, No. 97-CV-2011 CBA, 1998 WL 637547, at *10 (E.D.N.Y. Aug. 14, 1998).

127. *See, e.g., Cox & Thomas, supra note 28; Merritt B. Fox, Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 325–30; Thompson & Sale, *supra note 22*.

128. *See supra notes 53–58 and accompanying text*.

capable of identifying all of the statements that may have influenced the market.¹²⁹ Courts entertaining fraud-on-the-market claims have gone so far as to *exclude* evidence as to whether particular investors relied on particular statements, recognizing that any single investor's experience is beside the point.¹³⁰

Given the extensive disclosure requirements imposed on public corporations, many of which directly concern the quality of governance, risk management systems, and business trends, it is likely that if there was an undisclosed problem known to the company at the time (as required by section 10(b)'s scienter element),¹³¹ plaintiffs' attorneys would be able to identify *some* public statement that was arguably false at the time it was issued.¹³² And because fraud-on-the-market does not require investors to prove that they relied on the statement, there is a chance that there will always be a potential section 10(b) claim based on any unfavorable information that was known to management and kept secret for any length of time. As a result, it is the substantive conduct, rather than the ostensibly false statement, that becomes the center of gravity for many section 10(b) claims.¹³³

To be sure, from a normative perspective, this is not necessarily a bad thing. The federal securities laws contain extensive disclosure requirements precisely to prevent companies from concealing problems from the market for prolonged periods. One might reasonably argue, then, that such concealment should be actionable. To do so, however, is to elide the distinction between governance and disclosure that has historically characterized the separate spheres of federal and state law.¹³⁴

Courts addressing section 10(b) claims are thus tasked with discriminating between disclosure claims and governance claims without reference to the most obvious distinguishing factor: the presence of a deceived investor. Instead, they have crafted a series of alternative inquiries that cabin section

129. Ann M. Lipton, *Slouching Towards Monell: The Disappearance of Vicarious Liability Under Section 10(b)*, 92 WASH. U. L. REV. 1261, 1263 (2015).

130. See *In re ICN/Viratek Sec. Litig.*, No. 87 Civ. 4296, 1996 WL 34448146, at *4 (S.D.N.Y. July 15, 1996) ("The defendants would like to subpoena six members of a class the members of which number in the thousands. If I were to allow them to do so, and if the class representatives testified that they did *not* find defendants' allegedly fraudulent statements material, then it would be reasonable for the Class to request that I allow it to subpoena six class representatives of its own by way of rebuttal, who would likely testify that they *did* find the defendants' allegedly fraudulent statements material. The larger the number of actual investors to testify at trial and the lengthier the 'mini-trial' on actual investors' reliance, the more the jury would understandably be distracted from the 'reasonable investor' standard of materiality.").

131. See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

132. Langevoort, *supra* note 22, at 451, 460; Lipton, *supra* note 129, at 1293–94. Theoretically, concepts of loss causation and damages might serve as another gating item: if the misstatements themselves did not impact the price of the security, there would not be any losses or damages associated with them. That inquiry, however, is far more complex than it seems.

133. Lipton, *supra* note 129, at 1293–94.

134. See *supra* Part I.

10(b)'s scope.¹³⁵ But these inquiries undermine efforts to use disclosure to empower shareholders as corporate constituents.¹³⁶

1. Puffery

Puffery is a concept that exists in multiple areas of law and creates a legal immunity for vague, overly optimistic, or hyperbolic statements.¹³⁷ The intuition behind the doctrine is that salespersons can be expected to hype their wares with overclaims—"world's best coffee!"—and it would be unreasonable for purchasers to rely on such statements when transacting.

Puffery is vigorously employed by courts to dismiss claims under section 10(b).¹³⁸ It is typically defined as a species of immaterial statement that is so vague, optimistic, self-congratulatory, or boilerplate that investors are presumed to simply disregard it.¹³⁹ The puffery doctrine is a mechanism that courts can use to screen out claims that are, or appear to be, rooted in objections to management's conduct, rather than based on deceptive behavior. Per *Santa Fe*, absent a false statement, there has been no fraud, and thus no claim under section 10(b).¹⁴⁰ Puffing statements are not "statements" for section 10(b) purposes¹⁴¹; take them away, and all that's left is a complaint about management's substantive governance choices.

Thus, it is unsurprising that courts frequently dismiss on puffery grounds claims that facially appear to be failed products of the litigation process described above: namely, bad news was announced, attorneys searched for false statements, and, frequently in the absence of anything more concrete, seized upon banal, vaguely optimistic representations. For example, in *Rosenzweig v. Azurix Corp.*,¹⁴² after a company experienced business failures, the plaintiffs filed a section 10(b) action attacking such statements as "the second quarter was a period of significant accomplishment . . . [o]ur fundamentals are strong," and that the company had "growth opportunities" due to funding raised in its IPO.¹⁴³ In *IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Group, PLC*,¹⁴⁴ a section 10(b) lawsuit was filed when an ultimately unsuccessful merger was

135. See *infra* Part III.A–B.

136. See *infra* Part III.A–B.

137. See David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1400–14 (2006); Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-Emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1701–15 (1998).

138. David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 575 (2006); Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 354 (2008).

139. See *Southland Sec. Corp. v. INSpire Ins. Sols.*, 365 F.3d 353, 372 (5th Cir. 2004); Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 119 (2002).

140. *Santa Fe Indus. v. Green*, 430 U.S. 462, 473–74 (1977).

141. *Id.* at 477–79.

142. 332 F.3d 854 (5th Cir. 2003).

143. *Id.* at 860 (first alteration in original).

144. 783 F.3d 383 (2d Cir. 2015).

described as “off to a promising start.”¹⁴⁵ When a cruise company revealed sagging bookings, the plaintiffs filed suit alleging that earlier representations of “encouraging” prospects were fraudulent.¹⁴⁶ In one case, the plaintiffs openly alleged that the company failed to disclose a “change in business philosophy” that threatened its financial results, resulting in a dismissal on the ground that the prior business philosophy had been disclosed only in puffing terms.¹⁴⁷ Similar examples abound.¹⁴⁸ For these cases in particular, the plaintiffs’ chief complaint appears to be fundamentally rooted in objections to management performance with deception tacked on as a legal hook to shoehorn the claim into section 10(b).

The puffery doctrine has been heavily criticized by commentators, partly for the notorious inconsistency with which it is applied,¹⁴⁹ and partly for representing a kind of armchair market psychology. Courts purport to identify what information investors “truly” value, but there is extensive evidence that these assumptions are not correct.¹⁵⁰ Without disputing the validity of these criticisms, it is better to recognize that the doctrine is frequently not used as a mechanism for identifying statements that investors do, or do not, “actually” rely upon. Indeed, faced with evidence of actual reliance, courts have still rejected some claims on puffery grounds.¹⁵¹

Instead, the doctrine represents a rejection of at least some attempts to use section 10(b) to police the quality of management. As one court put it, “[i]nvestment gains and losses are risks inherent in a capitalist system, and these risks are tacitly accepted when any group or individual chooses to invest,”¹⁵² and therefore puffing statements do not “necessitate disclosure of every event that occurred in the course of [a corporation’s] daily

145. *Id.* at 388.

146. *In re Royal Caribbean Cruises Ltd.*, No. 1:11-22853-CIV., 2013 WL 3295951, at *3 (S.D. Fla. Apr. 19, 2013).

147. *In re XM Satellite Radio Holdings Sec. Litig.*, 479 F. Supp. 2d 165, 169 (D.D.C. 2007).

148. *See, e.g., In re Cutera Sec. Litig.*, 610 F.3d 1103, 1111 (9th Cir. 2010) (following announcement of layoffs, “we believe our employee relations are good”); *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1121 (10th Cir. 1997) (merger was moving “faster than we thought” and presented a “compelling set of opportunities”); *Local 210 Unity Pension & Welfare Funds v. McDermott Int’l Inc.*, No. 13-cv-02393, 2015 WL 10859309 (S.D. Tex. Mar. 13, 2015) (company would “implement[] a comprehensive project execution operating model that emphasizes our key project management disciplines”); *Zerger v. Midway Games, Inc.*, No. 07C3739, 2009 WL 3380653, at *5 (N.D. Ill. Oct. 19, 2009) (merger “is consistent with our strategy of adding depth to our internal product development organization and strengthening our ability to deliver high quality, compelling and commercially successful content for current and future systems”); *In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1167 (C.D. Cal. 2007) (“I am personally very excited about the fashion [Alfaro] has developed . . . and am looking forward to showing you the new assortment in the stores next year”).

149. *See Hoffman, supra* note 137, at 1403–04; Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 CASE W. RES. 143, 165 (2010).

150. *See Bainbridge & Gulati, supra* note 139, at 120–21; *Hoffman, supra* note 138, at 557; *Padfield, supra* note 138, at 340–41, 372.

151. *See, e.g., Police Ret. Sys. v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1060–61, 1064 (9th Cir. 2014).

152. *Plumbers Union Local No. 12 Pension Fund v. Ambassador’s Grp.*, 717 F. Supp. 2d 1170, 1178 (E.D. Wash. 2010).

operations.”¹⁵³ For this reason, it is hardly surprising that puffery, once declared to have “all but gone the way of the dodo,” enjoyed a reemergence just a few years after the Supreme Court endorsed the fraud-on-the-market doctrine.¹⁵⁴

The trouble with courts’ ad hoc judgment regarding what “counts” as a governance claim relative to a disclosure claim is that claims based on ESG statements, such as ethics codes and risk mitigation strategies, are particularly attractive targets for dismissal on puffery grounds.¹⁵⁵ In fact, it is common for plaintiffs to bring section 10(b) claims based on undisclosed regulatory violations or other morally questionable behavior, pinned to such allegedly false statements as “[the company] set the standard for best practices in risk management techniques”¹⁵⁶ or maintained a “culture of high ethical standards.”¹⁵⁷ At the same time, courts adhere to the principle 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.’”¹⁵⁸ Courts’ rejections of these claims—to the point of holding that even federally required disclosures are “puffery”¹⁵⁹—represent a rejection of federal attempts to enlist shareholders in the governance project.

One of the more overt holdings on the subject came from the Southern District of New York in a case against Barclays. The court noted:

Plaintiffs . . . argu[e], with respect to statements about legal compliance, that “when Barclays was telling the public that its ‘business *may not be* conducted in accordance with applicable laws around the world’ Barclays was, at that time, actively violating laws around the world by manipulating LIBOR.” If this were sufficient, then every individual who purchased the stock of a company that was later discovered to have broken *any* law could

153. *Id.*

154. O’Hare, *supra* note 137, at 1697.

155. *See, e.g.,* Bondali v. Yum! Brands, Inc., 620 F. App’x 483, 491 (6th Cir. 2015); *In re* Sanofi Sec. Litig., 155 F. Supp. 3d 386, 401–02 (S.D.N.Y. 2016); *In re* Anadarko Petroleum Corp. Class Action Litig., 957 F. Supp. 2d 806, 823–25 (S.D. Tex. 2013); *In re* UBS AG Sec. Litig., No. 07 Civ. 11225(RJS), 2012 WL 4471265, at *35–36 (S.D.N.Y. Sept. 28, 2012); Karam v. Corinthian Colls., Inc., No. CV 10-6523-GHK(PJWx), 2012 WL 8499135, at *10 (C.D. Cal. Aug. 20, 2012); Waterford Twp. Gen. Emps. Ret. Sys. v. BankUnited Fin. Corp., No. 08-CIV-22572, 2010 WL 1332574, at *9–10 (S.D. Fla. Mar. 30, 2010).

156. *ECA & Local 134 IBEW Joint Pension Tr. v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009).

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

158. *Pontiac Policemen’s & Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014) (quoting *ECA*, 553 F.3d at 206).

159. Pursuant to the Sarbanes-Oxley Act, the SEC promulgated regulations that require public companies either to disclose their ethics codes or to explain why they do not have them. *See* 17 C.F.R. § 229.406 (2016). Nonetheless, courts frequently find that such codes are puffery. *See, e.g.,* Retail Wholesale & Dep’t Store Union Local 338 Ret. Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1278–79 (9th Cir. 2017); *In re* Key Energy Servs. Sec. Litig., 166 F. Supp. 3d 822, 860–61 (S.D. Tex. 2016); *Brockton Ret. Sys. v. Avon Prods.*, No. 11 Civ. 4665(PGG), 2014 WL 4832321, at *15–16 (S.D.N.Y. Sept. 28, 2014).

theoretically sue for fraud. This is precisely what the Second Circuit sought to avoid [in its puffery rulings].¹⁶⁰

In other words, it is puffery to proclaim compliance with the law precisely because any other holding would force the company to remain true to that representation.¹⁶¹

In *Andropolis v. Red Robin Gourmet Burgers, Inc.*,¹⁶² another court explicitly wielded the puffery doctrine to prevent disclosure regulations from influencing substance. There, the court held that ethical codes are puffery *because* federal law requires that they be disclosed.¹⁶³ As the court put it, “[a] company’s essentially mandatory adoption of a code of ethics simply does not imply that all of its directors and officers are following that code of ethics.”¹⁶⁴ In fact, “the mandatory nature of the adoption of such a code makes clear that all public companies—whether run by crooks or angels—will adopt just such a code.”¹⁶⁵

The articulated rationale for many puffery holdings—that the statements are too similar to those offered by other companies to carry much weight in the minds of investors¹⁶⁶—is not only unpersuasive, but is something of a self-fulfilling prophecy. Corporations frequently make disclosures similar to those of other companies, from representations that their financial statements comply with Generally Accepted Accounting Principles¹⁶⁷ to declarations that a merger price is “fair” to shareholders,¹⁶⁸ and yet none of these statements are declared to be puffery on grounds of ubiquity. Moreover, in a world where computer programs analyze corporate SEC filings so as to instantly trade on even minute data changes,¹⁶⁹ if a corporation *did not*, for example, proclaim itself to exhibit “financial discipline” when all of its

160. *Gusinsky v. Barclays PLC*, 944 F. Supp. 2d 279, 289–90 (S.D.N.Y. 2013) (citations omitted), *vacated in part sub nom. Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC*, 750 F.3d 227 (2d Cir. 2014).

161. Notably, any section 10(b) claim would require plaintiffs to demonstrate that the misstatement or omission was intentionally or recklessly made. Nonetheless, the court feared that holding the company to its representations—even in the face of knowing or reckless violations of them—would impose too great a substantive burden.

162. 505 F. Supp. 2d 662 (D. Colo. 2007).

163. It should be noted that SEC regulations do not require adoption of an ethical code; they require only that companies disclose any code that exists or explain why none has been adopted. 17 C.F.R. § 229.406. However, both NYSE and NASDAQ require that listed companies adopt ethical codes. N.Y.S.E. LISTED COMPANY MANUAL § 303A.10; NASDAQ EQUITY RULES § 5610.

164. *Andropolis*, 505 F. Supp. 2d at 685–86.

165. *Id.* The court went on to recommend that the plaintiffs pursue state law governance claims instead of federal disclosure claims. *Id.* at 686; *see also* *Retail Wholesale & Dep’t Store Union Local 338 Ret. Fund v. Hewlett-Packard Co.*, 845 F.3d 1268, 1276 (9th Cir. 2017) (holding that the principles of *Santa Fe* require that codes of conduct be treated as puffery).

166. *See, e.g.*, *ECA & Local 134 IBEW Joint Pension Tr. v. JP Morgan Chase Co.*, 553 F.3d 187, 205 (2d Cir. 2009).

167. *See* 17 C.F.R. §§ 229.308, 240.13a-15, 240.15d-15.

168. *See* Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1562 (2006).

169. Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678, 689 (2013).

competitors did,¹⁷⁰ investors would likely take the absence seriously.¹⁷¹ As a result, when courts treat all such statements as equally meaningless, they provide no incentive for corporations to refrain from making them when they are no longer truthful.¹⁷² The further effect is to raise costs for corporations desiring to single themselves out to shareholders by attesting to their discipline.¹⁷³ In other words, courts undermine the use of disclosure as a mechanism to invite shareholders to participate in the governance project.

2. Loss Causation and Damages

Under section 10(b), a plaintiff must prove the element of “loss causation,” namely, that the plaintiff experienced an economic loss due to the fraud. The precise amount of the loss—the plaintiff’s damages—must be established as well.¹⁷⁴ For both measures, courts assume that securities have a “true value” that represents the price at which they would have traded if investors were aware of all relevant facts. This “true value” is distinguished from securities’ “inflated value,” meaning the price at which the securities traded as a result of the lie. Cognizable losses and damages under section 10(b) are generally defined as the difference between the two.¹⁷⁵

These definitions are predicated on a conception of securities as static objects, worth a certain amount that is or is not distorted by a particular falsehood. But securities are not static. If someone represents that a glass ring is a diamond, the amount of the damage caused is readily ascertainable because the quality of the object remains the same.¹⁷⁶ By contrast, if shareholders are granted a real role in governance, disclosure *changes* the quality of the security. Admissions that internal controls are poor, for example, almost certainly ensure that management will invest in corrective measures, and confessions that a business initiative has a low probability of success are likely to cause investors to use all of the tools at their disposal—selling, voting, and engagement—to insist that the initiative be suspended. And if a company fails to attest that it has quality controls or risk management

170. *Wachovia Equity Sec. Litig. v. Wachovia Corp.*, 753 F. Supp. 2d 326, 354 (S.D.N.Y. 2011) (holding statements concerning conservative underwriting, integrity, and financial discipline to be puffery).

171. Indeed, the Seventh Circuit obliquely recognized this point, proclaiming in *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir. 1997), that “[w]here puffing is the order of the day, literal truth can be profoundly misleading,” thus conceding that whatever the standard representation may be, a deviation from that standard communicates information to investors. Cf. Ann M. Lipton, *Searching for Market Efficiency*, 57 ARIZ. L. REV. 71, 75 (2015).

172. Cf. Robert Gutsche et al., *Firm-Value Effects of CSR Disclosure and CSR Performance* (Oct. 7, 2016) (unpublished manuscript) (suggesting that investors overvalue CSR disclosures relative to CSR performance, apparently because of difficulty interpreting CSR disclosures, which are susceptible to management manipulation), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2821691 [<https://perma.cc/84RE-ZDR2>].

173. *Id.*

174. See, e.g., *FindWhat Inv’r Grp. v. FindWhat.com*, 658 F.3d 1282, 1985 (11th Cir. 2011).

175. See Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 885 (1990).

176. Fisch, *supra* note 71, at 845.

systems when all of its competitors do, investors are almost certain to demand reforms. Current conceptions of loss causation and damages fail to recognize shareholders' contributions to corporate value and thereby further impede the use of section 10(b) to enforce disclosure standards intended to empower shareholders as participants in governance.

In the context of publicly traded securities, establishing that losses were caused by fraud is a uniquely complex problem. These securities have established market prices, and, even if that price is too high (because it is inflated by fraud) any investor who purchases at that price has not experienced an economic loss until the price drops.¹⁷⁷ In *Dura Pharmaceuticals, Inc. v. Broudo*,¹⁷⁸ the Supreme Court held that a price drop, without more, is not sufficient to establish the element of loss causation; instead, the drop must be caused by the removal of the original artificial inflation.¹⁷⁹ Drops caused by intervening events, such as an unrelated economic disruption, have not been caused by the fraud and cannot form the basis of a section 10(b) claim.¹⁸⁰ So long as the market remains fooled, the investor has not been harmed specifically by the fraud itself.

The difficulty with this standard is that there is great uncertainty as to what it means for a loss to be “caused” by artificial inflation leaving the stock.¹⁸¹ Currently, there are two approaches, although the application of the rules can vary widely. Some courts have defined loss causation very narrowly, holding that the element is satisfied only if there is a price drop in response to a “corrective disclosure”—meaning that the specific statement that misled the market must be shown to have been false and the market must adjust to account for the correction.¹⁸² Other courts find that the element is satisfied if losses represent the “materialization of the risk” that the fraud itself concealed, even if the market is not at that time made aware of an earlier lie.¹⁸³ For example, a company may suddenly announce a liquidity crisis, causing a stock price drop, without disclosing that the crisis was the natural culmination of prior fraudulent financial statements.¹⁸⁴ While there may not be any loss causation under the corrective disclosure standard, loss causation exists under the materialization of risk standard because the crisis is the result of a concealed risk—financial failure—that materialized.

Conceptually, losses that result from materialization of the risk go beyond the difference between the purchase price at the time of the original lie and

177. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).

178. 544 U.S. 336 (2005).

179. *Id.* at 341–43.

180. *Id.*

181. Scholars have also identified basic conceptual problems with this approach: namely, if a fraud affects a calculation of the probabilities regarding a loss, then *any* misrepresentation of those probabilities, which ultimately makes loss more likely, inflicts economic harm. Fisch, *supra* note 71, at 854 (“The economic significance of the lie is in how it relates to the known risks at the time of investment, not the extent to which those risks materialize and result in harm. In a sense, the plaintiff’s injury is akin to a failure to get true odds in a bet.”).

182. *See, e.g., Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 230 (5th Cir. 2009).

183. *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005).

184. *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 306–07 (S.D.N.Y. 2005).

the security's true value at that time. In most cases, these losses represent a worsening of the original problem. For example, suppose a company has a pending new drug application with the Food and Drug Administration (FDA). The probability of a denial is 80 percent, but the company tells investors that the probability is 10 percent. The stock price is artificially inflated. When the FDA denies the application, the risk has materialized, but now the probability of a denial is 100 percent. The FDA's action will therefore cause the stock price to fall further than it would have had the company told the truth in the first place.¹⁸⁵

These kinds of losses are, in a sense, governance losses—they are not merely the result of the original artificial inflation leaving the stock, but are also the consequence of managers' substantive choices in running the company. Some losses may simply represent the worsening of a problem management sought to conceal, as in the FDA example, and some may even represent an aggravation of the problem caused by the cover-up, such as when a company makes ill-advised business moves in an effort to disguise an earlier accounting fraud.¹⁸⁶ Either way, they do not represent the impact of the lie alone; they additionally represent the damage to the company wrought by managerial decision-making.

The corrective disclosure standard has several problems, including that it misapprehends how information affects stock prices. A lie is a piece of information that investors use to value the stock. If newer, more accurate information later comes to light via materialization of the risk concealed by the lie (such as the FDA's denial of the drug application), the lie itself becomes irrelevant and its effects dissipate while investors update their information.¹⁸⁷ Requiring an explicit corrective disclosure makes little economic sense and, worse, allows corporations to evade liability by strategically timing their communications.¹⁸⁸

But the corrective disclosure standard is striking for a second reason: it represents a refusal to recognize interference with shareholders' governance rights as a cognizable section 10(b) harm. The theory behind ESG disclosures is that dysfunctional behavior will not persist because shareholder

185. Cornell & Morgan, *supra* note 175, at 889–891; Fisch, *supra* note 71, at 849.

186. See Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1910 (2013).

187. Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1442 (2004).

188. See, e.g., Fisch, *supra* note 71, at 851–52; Barbara A. Bliss et al., *Information Bundling and Securities Litigation 2* (San Diego Legal Studies, Working Paper No. 16-219, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2795164 [<https://perma.cc/F662-V33Q>] (finding that corporations “bundle” the release of information to impede plaintiffs' ability to detect the impact of corrective information). The problem also arises in the context of class certification. Some courts have accepted the argument that a false statement's impact on stock price can be divined by determining whether disclosure of truth resulted in stock price drop. See, e.g., *Burges v. Bancorpsouth*, No. 3:14-cv-1564, 2017 WL 2772122, at *10 (M.D. Tenn. June 26, 2017); *Willis v. Big Lots*, No. 2:12-cv-604, 2017 WL 1063479, at *16 (S.D. Ohio Mar. 17, 2017). This inquiry, which is facially similar to the search for a corrective disclosure for loss causation purposes, suffers from the same flaws.

pressure will force a correction. When corporations issue false information, they deny shareholders this opportunity, allowing managerial mistakes to snowball and inflict further damage on the company. And when courts refuse to recognize these losses, there is no value placed on shareholders' ability to influence corporate policy.

This orientation is rendered even more stark by the standard definition of section 10(b) damages. Most courts hold that section 10(b) usually permits only "out-of-pocket" damages, defined as the difference between the price paid for the security and its true value at the time of purchase.¹⁸⁹ Any further decrease in value that occurs after the purchase is not recoverable.¹⁹⁰ To ascertain the value that the security would have commanded at the outset, plaintiffs typically look to the price of the security when the truth is disclosed and the artificial inflation has been removed, and work from a baseline assumption that this price represents the stock's true value.¹⁹¹ They then calculate backward to determine the amount of artificial inflation that had been in the stock at various points in time since the fraud began.¹⁹²

Plaintiffs additionally have the burden of segmenting out intervening events that may also have pulled down the price of the stock.¹⁹³ These intervening events might be entirely unrelated phenomena, but they might also represent materializations of the original risk if the risk grew larger over time. For example, in *In re Vivendi, S.A. Securities Litigation*,¹⁹⁴ concealed liquidity problems worsened over the course of a long class period, and investors who bought at earlier points, when the situation was not as dire, were not entitled to damages resulting from the company's subsequent decline in fortunes.¹⁹⁵ Because many cases are like *Vivendi* in that the problem worsens before the fraud becomes known and the artificial inflation is eliminated from the stock,¹⁹⁶ the standard damages measure does not allow investors to recover for poor governance concealed and enabled by the fraud. Indeed, some theorists have argued that because any stock price decline associated with a disclosure of the fraud also represents losses due to shareholders' new doubts in management's abilities, these too should be segmented out and treated as unrecoverable.¹⁹⁷

This issue was on sharp display recently in *Ludlow v. BP, P.L.C.*¹⁹⁸ The plaintiffs alleged that BP falsely described the adequacy of its safety

189. See, e.g., *Ludlow v. BP, P.L.C.*, 800 F.3d 674, 682 (5th Cir. 2015).

190. See *id.*

191. See, e.g., *Glickenhous & Co. v. Household Int'l, Inc.*, 787 F.3d 408, 415 (7th Cir. 2015).

192. *Id.* at 415–16.

193. *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 254 (2d Cir. 2016).

194. 838 F.3d 223 (2d Cir. 2016).

195. *Id.* at 255.

196. See, e.g., *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 184 (S.D.N.Y. 2010) (finding that the loan quality allegedly worsened over the class period).

197. See, e.g., *Allen Ferrell & Atanu Saha, The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163, 181 (2007).

198. 800 F.3d 674 (5th Cir. 2015).

protocols.¹⁹⁹ The truth was not revealed, however, until Deepwater Horizon exploded, sending thousands of barrels of oil gushing into the Gulf of Mexico every day for months on end.²⁰⁰ Naturally, the disaster sent BP's stock price tumbling, far beyond the amount of artificial inflation that had been introduced into the stock as a result of the lie.²⁰¹ Or, to put it another way, had BP confessed to the abysmal state of its safety systems at the outset, its stock price surely would have dropped but not to the dramatic degree that occurred once the risk created by the deficient safety protocols materialized.²⁰²

The Fifth Circuit held that the plaintiffs could only collect damages that represented the amount they overpaid for the stock, namely, the portion of the drop attributable solely to the misstatements.²⁰³ According to the court, any damages due to materialization of risk, management's poor governance, or new doubts about management's abilities, were not part of the fraud itself because they did not represent the inflated purchase price that resulted from the lie, and therefore were not recoverable under section 10(b).²⁰⁴ Governance damages, the court presumed, were more properly the subject of a state law claim for fiduciary breach.²⁰⁵

This reasoning, of course, assumed that had the truth been disclosed, the stock would have been repriced to account for the newly increased risk of a disaster. Investors who bought at the new, lower price would be deemed to have accepted all of BP's reported profits and benefits at that time.²⁰⁶ Yet this counterfactual was never a possibility because BP could not have simply confessed to the truth and remained at the status quo. Had BP admitted the deficiencies in its safety protocols, investors—not to mention regulators—would have demanded their correction, thus rapidly diminishing (if not eliminating) the likelihood of a disaster of that magnitude. Disclosure would have functioned to correct the underlying substantive problem.²⁰⁷ Thus, the fraud did not simply conceal a risk that would have been factored into the price had it been disclosed: it denied shareholders the opportunity to improve the risk profile of the company. But these damages are entirely unrecognized by the out-of-pocket damages measure.²⁰⁸

199. *See id.* at 678–79.

200. *See id.*

201. *See id.* at 680.

202. *See id.* at 689.

203. *Id.* at 690.

204. *Id.* at 690–91.

205. *See id.*

206. *Id.* at 690.

207. One study has documented how direct shareholder engagement regarding ESG can lower the firm's risk profile. *See generally* Andreas Hoepner et al., ESG Shareholder Engagement and Downside Risk (Nov. 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874252 [<https://perma.cc/75Z6-PP24>].

208. This is because, by definition, they paid the “right” price at the time of purchase due to the fact that the artificial inflation (and thus damages) were only introduced later. Even if damages for such investors were measured at the time of the fraudulent statement that induced them to hold, the counterfactual scenario presumably would be a public announcement of the truth. Such an announcement would have caused a price decline and losses to the holder regardless of the fraud. The only losses a holder experiences as a result of the fraud itself are

The out-of-pocket damages rule places an additional burden on ESG-related claims because soft information, such as risk disclosures and sustainability reports, is the hardest to value *ex ante*, and thus the most difficult to separate from intervening causes *ex post*. In *BP*, shareholders were unable to model the value of the safety misstatements standing alone, causing the court to dismiss their claims.²⁰⁹ Thus, the standard both substantively and procedurally devalues ESG disclosures.²¹⁰

Courts' tendency to discount governance-related disclosures is particularly notable in cases like *Meyer v. Greene*.²¹¹ In *Greene*, the company experienced a significant stock price drop after the announcement of an SEC investigation into the defendant's accounting practices.²¹² The plaintiffs alleged that the announcement represented a corrective disclosure.²¹³ The Eleventh Circuit disagreed, holding that

the commencement of an SEC investigation, without more, is insufficient to constitute a corrective disclosure for purposes of § 10(b). The announcement of an investigation reveals just that—an investigation—and nothing more. To be sure, stock prices may fall upon the announcement of an SEC investigation, but that is because the investigation can be seen to portend an added *risk* of future corrective action. That does not mean that the investigations, in and of themselves, reveal to the market that a company's previous statements were false or fraudulent.²¹⁴

Similarly, in *Loos v. Immersion Corp.*,²¹⁵ the Ninth Circuit held:

The announcement of an investigation does not “reveal” fraudulent practices to the market. Indeed, at the moment an investigation is announced, the market cannot possibly know what the investigation will ultimately reveal. While the disclosure of an investigation is certainly an ominous event, it simply puts investors on notice of a *potential* future disclosure of fraudulent conduct. Consequently, any decline in a corporation's share price following the announcement of an investigation can only be attributed to market speculation about whether fraud has occurred. This type of speculation cannot form the basis of a viable loss causation theory.²¹⁶

The court's language is telling: changes to the risk profile of a security due to uncertainty about management misconduct is not a cognizable loss for section 10(b) purposes. Clearly, other types of changes to a stock's risk profile, such as an increased risk of an environmental disaster, have value, but when the change in risk is specifically due to concerns about management

the further declines in value that occur after the fraudulent statement that induces the investor to refuse to sell. These are precisely the damages that go unrecognized by the out-of-pocket damages measure.

209. *BP*, 800 F.3d at 690.

210. Notably, even when these issues are not directly litigated, they influence settlement discussions and reduce plaintiffs' recovery. See Bliss et al., *supra* note 188, at 30.

211. 710 F.3d 1189 (11th Cir. 2013).

212. *Id.* at 1193, 1197.

213. *Id.*

214. *Id.* (citations omitted).

215. 762 F.3d 880 (9th Cir. 2014).

216. *Id.* at 890.

truthfulness and quality, courts refuse to recognize a loss, at least so long as the investigation does not result in a finding of wrongdoing.²¹⁷ Such holdings legally mandate that shareholders not place any value on the increased risk of problematic governance, thus implicitly denying shareholders a governance role and contradicting explicit congressional policy. Indeed, the very purpose of certain mandated disclosures, such as certifications requiring a corporation's chief executive officer to attest to the adequacy of internal controls and the accuracy of corporate disclosures,²¹⁸ is to bolster investor confidence in corporate governance quality, which is then expected to assist with market valuation.²¹⁹ When courts disparage the importance of investor confidence, they impede the achievement of these federal goals.

Once again, many of these problems can be attributed to the functional elimination of the reliance requirement. *BP* is once again instructive. There, the Fifth Circuit held that its measure of cognizable damages—the decrease in the stock's price attributable solely to the dissipation of artificial inflation, without consideration of damages due to mismanagement—could be confined solely to cases brought under a fraud-on-the-market theory.²²⁰ If an investor actually relied on the misstatements, the investor could recover the damages resulting from the materialization of the risk.²²¹ The court's reasoning was that the market price represents an average judgment of the value of the stock given various risks, but some investors may have different risk tolerances than the market as a whole.²²² Whereas the rest of the market might be willing to assign a particular ex ante numeric value to the risk of a disastrous explosion—one that was distorted to some degree by BP's false statements—other investors may simply have been unwilling to tolerate that risk.²²³ Had the truth been disclosed, these investors would not have bought at all.²²⁴ They would therefore be entitled to recover for the “consequential” damages of the explosion because they could show that they had been forced to assume a specific risk they never intended to accept.²²⁵ Investors who accepted the market judgment did not avoid any particular risk, but instead

217. The Second Circuit reached a similar conclusion. *See In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 511–14 (2d Cir. 2010) (holding that a director's resignation due to concerns about corporate accounting did not, without more, satisfy the element of loss causation).

218. 17 C.F.R. § 240.13a-14 (2016).

219. Moreover, it is difficult to imagine any successful section 10(b) claim that would not also involve the falsity of the internal controls representations (because either the internal controls failed or the CEO ignored the information they provided). Therefore, the portion of section 10(b) losses attributable to defective governance is always, in some sense, tied to at least one false representation: the false representation of governance quality contained in the internal control certifications. *See* Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169, 178 (2010).

220. *Ludlow v. BP, P.L.C.*, 800 F.3d 674, 690–91 (5th Cir. 2015).

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

agreed to pay a certain price for a general risk profile, entitling them only to the price revision associated with the true, concealed risk profile.²²⁶

This reasoning does not go so far as to acknowledge the value that shareholders add to a company when permitted to exercise their governance powers, but it does illustrate that the functional elimination of the reliance requirement encourages courts to discount how shareholders individually interact with the companies in which they invest. Moreover, the Fifth Circuit's view has a certain appeal when viewed through a governance lens. After all, shareholders who do not directly rely on corporate statements cannot be said to have used them when making decisions about participation. And shareholders who involve themselves in governance only *after* a purchase—such as investors who buy on an index—do not use the governance disclosures for their purchasing decisions. Returning to *Blue Chip*, these shareholders have not experienced a harm to their governance rights in their specific capacity as a purchaser or seller.

At the same time, however, these purchasers, like all investors, expect that they are buying into a particular governance structure and price the securities accordingly. That structure includes the disciplining voice of investors, which is then baked into the valuation. When that voice is denied, even shareholders who did not individually rely on the misstatements at the moment of purchase experience the harm. That said, the Fifth Circuit's distinction between actual reliance and fraud-on-the-market reliance is a useful starting point for addressing false governance disclosure under section 10(b).²²⁷

3. Omissions Liability

The controversial issue of omissions liability further illustrates courts' discomfort with the use of disclosure standards as a mechanism for involving shareholders in governance.

Section 10(b) and Rule 10b-5(b) forbid both false statements and misleading omissions, which are defined generally as “half-truths” that leave investors with false impressions of fact.²²⁸ Silence, the Supreme Court has

226. The Fifth Circuit's view is in line with the Restatement (Second) of Torts, which provides that damages for misrepresentation include both the amount of overpayment and the “pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation.” RESTATEMENT (SECOND) OF TORTS § 549 (AM. LAW INST. 1977); cf. Fisch, *supra* note 71, at 870 (recognizing uncertainty as to how damages should be calculated in actual reliance claims). To be sure, courts used the out-of-pocket damages measure for section 10(b) claims even before the Supreme Court's endorsement of fraud-on-the-market theory in 1988, but it is only in more recent years that courts have made vigorous efforts to distinguish between the inflated purchase price and damages caused by worsening underlying conditions. See, e.g., *Esplin v. Hirschi*, 402 F.2d 94, 104 (10th Cir. 1968) (“It is not until the existence of the fraudulent conduct is known that the true value of the securities as an investment can be ascertained.”). *Esplin* is cited in a leading pre-*Dura Pharmacy* treatise. See ALAN R. BROMBERG, 2 SECURITIES LAW: FRAUD § 9.1 (1971).

227. See *infra* Part V.A.2.

228. *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 239–240 (2d Cir. 2016); *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 985 (9th Cir. 2008) (“[A] statement is misleading if it would give a reasonable investor the ‘impression of a state of affairs that differs in a material

held, is not misleading “absent a duty to disclose.”²²⁹ The question for courts has therefore been whether the SEC’s regulatory disclosure requirements create a “duty to disclose” such that the failure to speak qualifies as a misleading omission.²³⁰ If so, this would begin to close the enforcement gap that the puffery doctrine has opened and grant shareholders broad powers to require disclosure of governance-related information. This is particularly so because different disclosure requirements apply to different types of corporate filings, and the blanket application of section 10(b) to omissions glosses over these distinctions.

For example, SEC regulations require that proxy solicitations include a variety of governance-related disclosures, such as whether compensation policies encourage risk-taking²³¹ and the existence of prior reporting violations.²³² Some courts have interpreted section 14 to contain vigorous affirmative disclosure requirements for proxy solicitations.²³³ Yet Rule 14a-9, the only cause of action available to investors for deficient proxy disclosures,²³⁴ has been interpreted very narrowly.²³⁵ If section 10(b) can be used for *omissions* as well as misstatements, the omission of information from a proxy statement can be bootstrapped on to a 10(b) claim regardless of Rule 14a-9’s limitations. Similarly, companies have a bevy of affirmative disclosure requirements associated with the issuance of new securities, including the required disclosure of any material information that has not yet been reported.²³⁶ Although a narrow cause of action exists for investors who purchase securities pursuant to a defective registration statement,²³⁷ if section 10(b) applies to omissions of required information, that cause of action is, in a sense, extended to the entire marketplace of securities holders.

Section 10(b) would always have allowed liability for false statements in these documents, but the affirmative disclosure obligations are much broader and not subject to evasion via the puffery doctrine. Thus, courts examining omissions claims experience a dilemma similar to that in the puffery context: failure to disclose required information may well deceive investors who assume from silence that nothing worth reporting exists, but to impose liability for omissions based on the mere presumption that the omissions are deceptive is nearly indistinguishable from imposing liability for mismanagement alone.

For example, the SEC requires that companies identify “known trends or uncertainties” that are expected to impact revenues.²³⁸ This item instructs

way from the one that actually exists.” (quoting *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002)).

229. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

230. *See, e.g., Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015); *Shaw v. Dig. Equip. Corp.*, 82 F.3d 1194, 1221–22 (1st Cir. 1996).

231. 17 C.F.R. § 229.402 (2016).

232. *Id.* § 229.405.

233. *See Mendell v. Greenberg*, 927 F.2d 667, 674 (2d Cir. 1990).

234. 17 C.F.R. § 240.14a-9.

235. *See supra* notes 122–24 and accompanying text.

236. *See Registration Statement Under the Securities Act of 1933 (Form S.3)* (2017).

237. *See supra* note 52 and accompanying text.

238. 17 C.F.R. § 229.303.

issuers to disclose a wide array of potential future events, *unless* the issuer determines that the event is “not reasonably likely to occur.”²³⁹ In the face of such obligations, the distinction between imposing liability for *silence* about poor managerial decision-making and imposing liability for the decision-making itself may be “no sharper than that between twilight and dusk.”²⁴⁰ However, to exempt such requirements from private lawsuits necessarily leaves a gap in the enforcement regime—one that is disproportionately likely to affect the types of “soft” governance-related information that issuers can more easily omit from their filings.

Given this dilemma, it is not surprising that circuits are split as to whether omissions liability should be permitted at all.²⁴¹ As of this writing, the Supreme Court has granted certiorari to resolve the split.²⁴² If the Court holds that the omission of information can serve as the basis of a fraud-on-the-market section 10(b) claim, lower courts are likely to continue to police the governance-disclosure distinction by narrowing their interpretations of corporations’ primary disclosure obligations. Such an outcome would represent the worst of all worlds: it would directly interfere with federal efforts to encourage governance disclosures and render the regime impossible to police by shareholders or even by government authorities.

IV. SHAREHOLDER PREFERENCES AS IMPOSED BY THE JUDICIARY

As the preceding discussion demonstrates, courts have developed a variety of tools to distinguish claims rooted in deception from claims rooted in governance without explicit reference to the element of reliance. These tools, operating in broad strokes, tend to devalue disclosures designed to empower shareholders within the corporate form, thus impeding federal efforts to include shareholders in the governance project.

The consequences go beyond inhibiting shareholders’ ability to minimize agency costs. As federal law increasingly takes a hands-off approach to regulation of corporate conduct, many theorists have turned to shareholders as a potential moderating force that, working within the corporate structure, can help to police antisocial behavior and curb corporate externalities. But, as explained below, the judiciary has carved into section 10(b) doctrine a particular vision of the shareholder as amoral and short-term, with no interests beyond the maximization of the stock price of the firm at issue.²⁴³ Such a portrait is not only factually inaccurate, but stands in opposition to the

239. Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 43 SEC Docket 1329, 1335 (May 31, 1989) (emphasis added).

240. *Kansas v. Crane*, 534 U.S. 407, 412 (2002) (quoting GARY B. MELTON ET AL., *PSYCHOLOGICAL EVALUATIONS FOR THE COURTS* 216 (3d ed. 2007)).

241. *Compare* *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016), *with In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014).

242. *SAIC*, 818 F.3d 85, *cert. granted sub nom.*, *Leidos, Inc. v. Ind. Pub. Ret. Sys.*, 137 S. Ct. 1395 (Mar. 27, 2017) (No. 16-581).

243. *See infra* Part IV.A.

ethos of modern attempts to enlist stockholders as a moderating force in the corporate governance structure.

A. Shareholders: Victims or Enablers?

In recent years, there has been a particular disenchantment with direct government regulation as a mechanism for curbing corporate externalities.²⁴⁴ Corporations that operate internationally may be beyond the power of any one country to control, the complexity of corporate systems may exceed regulators' comprehension, and political gridlock may stifle attempts to adapt regulations to a changing world.²⁴⁵ The new presidential administration and Congress have already exhibited a preference for deregulation on the theory that federal regulation is not only ineffective, but actively anticompetitive and inimical to growth.²⁴⁶

As a result, some reformers have sought to curb corporate externalities by manipulating the balance of power within the corporate form itself. In particular, commentators argue that shareholders, given the appropriate incentives and powers, can serve as a restraining influence, encouraging prosocial behavior and discouraging antisocial conduct.²⁴⁷ The assumption underlying these efforts is that antisocial corporate behavior is a species of agency cost. Under this view, the dispersed shareholders of a public corporation are left without power or incentive to monitor their agents (directors and officers),²⁴⁸ and, as a result, are victimized by corporate managers who engage in socially irresponsible behavior.

The precise manner in which corporate misbehavior victimizes investors is articulated in different ways. Sometimes, it is argued that antisocial conduct is simply a counterproductive way of doing business, resulting in short-term gains at the expense of longer-term corporate health.²⁴⁹

244. Pargendler, *supra* note 83, at 365.

245. *Id.* See generally Tom C.W. Lin, *The New Financial Industry*, 65 ALA. L. REV. 567 (2013); Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665 (2010); Steven L. Schwarcz, *Excessive Corporate Risk-Taking and the Decline of Personal Blame*, 65 EMORY L.J. 533 (2015).

246. See, e.g., Nick Timiraos & Andrew Tangel, *Donald Trump's Cabinet Selections Signal Deregulation Moves Are Coming*, WALL ST. J. (Dec. 8, 2016), <https://www.wsj.com/articles/donald-trump-cabinet-picks-signal-deregulation-moves-are-coming-1481243006> [<https://perma.cc/GL4L-WRRH>].

247. See, e.g., Azgad-Tromer, *supra* note 1, at 184–89; Barnali Choudhury, *Social Disclosure*, 13 BERKELEY BUS. L.J. 183, 216 (2016); Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 651 (2016); Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN J.L. BUS. & FIN. 31, 64 (2005); Pargendler, *supra* note 83, at 378–96; Gretchen Morgenson, *Want Change?: Shareholders Have a Tool for That*, N.Y. TIMES (Mar. 24, 2017), <https://www.nytimes.com/2017/03/24/business/proxy-climate-change-executive-pay.html> [<https://perma.cc/G2RA-PJ29>]. The idea dates back at least to the original passage of the Securities Act when theorists proposed that advisory councils recommend to shareholders how to vote their shares in the public interest. See Mitchell, *supra* note 114, at 1545.

248. Technically, directors are not agents of shareholders, in part because shareholders wield such little power in the corporate structure. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (AM. LAW. INST. 2006).

249. See, e.g., Azgad-Tromer, *supra* note 1, at 189–90. Various studies purport to show how attention to externalities, at least along some dimensions, can also lead to greater

Shareholders, misled as to the nature of the business, overvalue the company and are harmed when the truth is revealed, the improper conduct halted, and corporate penalties and fines imposed. Shareholders may also be harmed to the extent the corporation suffers reputational damage and endures the expense and disruption associated with legal action, changes in personnel, and new compliance costs. Particularly egregious conduct may prompt regulatory responses that further hamper the business.²⁵⁰

Alternatively, shareholders may be harmed in their nonshareholder capacities, even if the externality-generating behavior benefits the corporate entity itself. Shareholders who are members of the surrounding community may be harmed by corporate pollution.²⁵¹ Shareholder-employees may be harmed by exploitatively low wages and poor working conditions.²⁵² Shareholder-citizens may be harmed to the extent they object to corporate practices, such as political donations in favor of causes with which they disagree or that can work to their detriment.²⁵³ Shareholders may also be harmed in their capacity as investors in *other* companies. Some shareholders, for example, invest in a wide variety of companies, and therefore “own[] the economy.”²⁵⁴ For such investors, the externality-generating conduct of one company may harm their other investments, ultimately harming their

shareholder returns. *See, e.g.*, Choudhury, *supra* note 247, at 213; Ho, *supra* note 247, at 665–67; Hoepner, *supra* note 207, at 2 (finding that ESG engagement by shareholders can reduce firm downside risk).

250. For example, companies that sharply increased the price of generic drugs, while legally permitted to do so, have become the targets of extraordinary congressional and prosecutorial scrutiny. *See, e.g.*, David Crow, *Valeant Shares Fall 5.6% After U.S. Prosecutors Announce Fraud Charges*, FIN. TIMES (Nov. 17, 2016), <https://www.ft.com/content/952e9f82-132b-3aa0-a3c1-4b65fdb7b37?mhq5j=e1> [<https://perma.cc/KCC6-UTKB>]; Joseph Walker, *Mylan to Pay \$465 Million to Settle Medicaid Claims*, WALL ST. J. (Oct. 7, 2016), <https://www.wsj.com/articles/mylan-to-pay-465-million-in-epipen-settlement-1475874312> [<https://perma.cc/WKP8-JMPN>].

251. Azgad-Tromer, *supra* note 1, at 179.

252. David H. Webber, *The Use and Abuse of Labor’s Capital*, 89 N.Y.U. L. REV. 2106, 2149–51 (2014).

253. Victor Brudney, *Business Corporations and Stockholders’ Rights Under the First Amendment*, 91 YALE L.J. 235, 237 (1981).

254. Anabtawi, *supra* note 109, at 583 (quoting JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* 21 (2002)); *see* James Hawley & Andrew Williams, *The Emergence of Universal Owners: Some Implications of Institutional Equity Ownership*, 43 CHALLENGE 43, 45 (2000); Ho, *supra* note 247, at 673. There is evidence that large investors vote their shares to maximize wealth across the portfolio rather than to maximize wealth at particular companies. *See, e.g.*, Miguel Anton et al., *Common Ownership, Competition, and Top Management Incentives* (Ross Sch. of Bus., Working Paper No. 1328, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2802332 [<https://perma.cc/XBS4-ZGV3>]; Andriy Bodnaruk & Marco Rossi, *Dual Ownership, Returns, and Voting in Mergers* (Feb. 13, 2013) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2348094 [<https://perma.cc/9P88-VVJD>]; Chris Brooks et al., *Institutional Cross-Ownership and Corporate Strategy: The Case of Mergers and Acquisitions* (Dec. 21, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2747036 [<https://perma.cc/ZM7U-ME58>].

portfolio overall, assuming that the gains to the antisocial corporations are not symmetric with the harms to others.²⁵⁵

Though these descriptive accounts differ as to the source of the shareholder harm, they ultimately come to the same conclusion: at least some forms of antisocial corporate conduct are contrary to shareholders' interests, and shareholders, if given sufficient power within the corporate structure, can serve as a mitigating influence.

That said, these relatively benign views of how shareholders might utilize enhanced power within the corporate structure are not free from controversy.²⁵⁶ Many commentators argue that corporate managers simply respond to market incentives. Shareholders vote for directors—thereby ratifying their decisions—and reward high profits with high stock prices. Institutional shareholders must respond to the demands of their beneficiaries who expect to see immediate short-term increases in the value of their holdings.²⁵⁷ Diversified shareholders in particular value risk-taking and reward managers who externalize costs.²⁵⁸ In this model, shareholders benefit from, and bear a moral responsibility for, harms inflicted by the corporation on the wider society.²⁵⁹ Risk-taking and lawbreaking are not

255. See, e.g., Barbara Novick, *How Index Funds Democratize Investing*, WALL ST. J. (Jan. 8, 2017), <https://www.wsj.com/articles/how-index-funds-democratize-investing-1483914571> [<https://perma.cc/N26H-3G7W>] (arguing that BlackRock asset managers would not favor anticompetitive conduct in the airline industry because however much it might benefit the airlines it would place additional burdens on virtually all other industries in which BlackRock invests).

256. See generally Jennifer G. Hill, *Images of the Shareholder: Shareholder Power and Shareholder Powerlessness*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER (Jennifer G. Hill & Randall S. Thomas eds., 2015) (describing how shareholders can alternatively be characterized as victims of rapacious managers, checks on managerial overreach, or enablers of misbehavior).

257. See David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911, 930–36 (2013).

258. See, e.g., John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 44 (2014); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1267 (1982); Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 138 (2012).

259. LOUIS D. BRANDEIS, THE CURSE OF BIGNESS: MISCELLANEOUS PAPERS OF LOUIS D. BRANDEIS 75 (Osmond K. Fraenkel ed., 1935) (“There is no such thing . . . as an innocent stockholder. He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of a system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare.”); see also *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430-VCS, 2011 WL 2176479, at *29 n.185 (Del. Ch. May 31, 2011) (“The primary protection for stockholders against incompetent management is selecting new directors. It may well be that the corporate law does not make stockholders whole . . . when it is alleged that corporate managers skirted laws protecting other constituencies in order to generate higher profits for the stockholders Remember that to the extent that Massey kept costs lower and exposed miners and the environment to excess dangers, Massey’s stockholders enjoyed the short-term benefits in the form of higher profits. The very reason for laws protecting other constituencies is that those who own businesses stand to gain more if they can keep the operation’s profits and externalize the costs. Thus, the stockholders of corporations, especially given the short-term nature of holding periods that now predominate in our markets, have poor incentives to monitor corporate compliance with laws protecting society as a whole and may well put strong pressures on corporate management to produce immediate profits.”).

agency costs; they are the natural result of corporate managers responding to the desires of the corporation's owners.

It is self-evident that shareholders have interests beyond their status as investors in a particular company and may, therefore, prefer that corporations *not* maximize their own wealth if doing so would damage these interests. Therefore, the above argument frequently is accompanied by the corollary that when shareholders vote to advance their parochial interests over the corporate good, other shareholders—and the enterprise itself—will be exploited.²⁶⁰ This problem has been recognized and accounted for in the context of controlling shareholders,²⁶¹ but it may arise even for shareholders with a minority stake. Union shareholders, for example, may try to extract concessions for employees,²⁶² employee-shareholders may resist hostile takeovers,²⁶³ hedge funds may advocate for forms of financial engineering that leech immediate value from the company,²⁶⁴ public pension funds may encourage firms to engage in political activism,²⁶⁵ and bondholders who also own stock may use their equity positions to increase the value of their debt holdings.²⁶⁶ These moves may benefit certain shareholders—and more broadly, the classes of interests of which they are a part—even as they damage the corporation as a whole. In other words, the very ESG project is itself viewed with suspicion because it may enable some shareholders to use the corporate form to advance their idiosyncratic preferences to the detriment of other shareholders.

B. A Perfect Storm in Section 10(b)

Section 10(b) represents a perfect storm of conflicted portraits of the role of the shareholder in corporate governance, where prospective investors are envisioned as vulnerable to corporate wrongdoing until a purchase is completed, at which point they immediately become complicit in that wrongdoing. On the one hand, to the extent shareholders are granted a cause of action against the entity for the fraud of its agents, shareholders are treated as victims of the corporation. On the other hand, because damages are paid by the corporation itself, the costs of the lawsuit are borne by the corporate entity, and, ultimately, its shareholders—suggesting that shareholders are in some sense enablers of, or responsible for, the losses.²⁶⁷

260. Anabtawi, *supra* note 109, at 575–93.

261. *See generally* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

262. Anabtawi, *supra* note 109, at 590.

263. *Id.* at 587.

264. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Investors*, 60 STAN. L. REV. 1255, 1290–92 (2008).

265. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 800, 803 (1993); Rui A. Albuquerque et al., *Public Pension Funds and Corporate Political Activism* 22 (European Corp. Governance Inst., Working Paper No. 470/2016, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2572666 [<https://perma.cc/4TQ7-E9T9>].

266. Anabtawi & Stout, *supra* note 264, at 1288–89; Bodnaruk & Rossi, *supra* note 254, at 3.

267. *See generally* Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243.

Neither, of course, is strictly true. Not every prospective investor is a stranger to the corporate polity. Investors frequently maintain positions in companies while buying and selling smaller amounts of their holdings. As a result, investors continuously have one foot in and one foot out. Moreover, the investor's purchase simultaneously consummates the fraud (for that particular investor) and assists in its accomplishment (by pushing prices higher for other investors).²⁶⁸

Fraud-on-the-market exacerbates these tensions. With the element of reliance functionally eliminated and the focus on the underlying business practice rather than the corporate disclosures, the section 10(b) action raises the specter of awarding damages to shareholders who raised no objection to—or even implicitly encouraged—the conduct that led to the loss based on an *ex ante* calculation that the potential benefits outweighed the risk. Permitting lawsuits when those problems come to light creates a moral hazard.²⁶⁹ At the same time, it would be detrimental to the enterprise as a whole to rigorously enforce a pretense of virtue favored only by a small minority of investors.

This is what courts are implying when they caution against section 10(b) becoming a form of “investor insurance.”²⁷⁰ Indeed, courts have explicitly declared that investors prefer risk and that securities laws should not be used to stifle that preference, even to the point of suggesting that investors want to see managers break the law on their behalf.²⁷¹

Courts examining section 10(b) claims must navigate this dilemma. If shareholders transform governance disputes into claims ostensibly rooted in deception, necessarily tasking courts with distinguishing “true” deception

268. James Park theorizes that investors as stockholders have fundamentally different interests than investors as traders. Stockholders would prefer less disclosure and less stock price fluctuation, whereas traders would prefer that stocks be accurately valued. *See* Park, *supra* note 22, at 146. The problem with this categorization is that investors are not purely one or the other. Moreover, pricing and the right of entry and exit have long been conceptualized as part of the governance structure on which existing stockholders rely. *See supra* Part I.

269. *See* *Plumbers Union Local No. 12 Pension Fund v. Ambassador's Grp.*, 717 F. Supp. 2d 1170, 1178 (E.D. Wash. 2010).

270. *See, e.g., Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (“[A]llowing recovery in the face of affirmative evidence of nonreliance would effectively convert Rule 10b-5 into a scheme of investor's insurance.” (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part))); *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 156 (S.D.N.Y. 2004) (“The securities laws are not intended as investor insurance every time an investment strategy turns out to have been mistaken.” (citation omitted)).

271. *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982); *Gaines v. Haughton*, 645 F.2d 761, 777–79 (9th Cir. 1981) (holding that bribery payments made in violation of law are never material so long as there is no self-dealing, and noting that “[t]he objective of business corporations is to maximize the economic return received by their shareholders; data about a corporation's questionable payments is not clearly significant in any economic sense”); *Amalgamated Clothing & Textile Workers Union v. J. P. Stevens & Co.*, 475 F. Supp. 328, 330 (S.D.N.Y. 1979) (rejecting claim by union shareholders that company failed to disclose labor law violations in part because their actions may have been “intended for the corporation's benefit” (quoting *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979))); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

claims from illusory ones, then courts must pinpoint the degree of corporate misconduct that shareholders are deemed to expect—and, indeed favor—on the assumption that shareholders will not rely upon any denials of misconduct that fall below that level. But when that threshold is breached, corporate misbehavior is no longer conducted with tacit shareholder approval. Instead, it stands in opposition to their interests and expectations, marking the point at which shareholders may be deceived by denials of wrongdoing.

Thus, when it comes to claims based on corporate misconduct and antisocial behavior, identifying true instances of deception requires courts to determine what level of corporate misconduct shareholders can be expected to accept. Essentially, courts must decide the background factual assumptions that shareholders make about the companies in which they invest and determine when a deviation from those assumptions reaches the point of becoming misleading. Courts must police the line between deception and governance by making a judgment about the kind of unethical behavior in pursuit of greater profits that is considered unremarkable. And the very fact of doing so requires courts to take a side in the above debate. That is, courts must develop a vision of what shareholders value when making an investment decision. Or, more accurately, courts must develop a vision of what shareholders will be permitted to value, such that their interests will be judicially acknowledged.

This is accomplished in the first instance by malleable and inconsistent approaches to the puffery doctrine. As explained above, puffery is typically defined as a species of immateriality: certain statements are so hyperbolic or mundane that investors are unlikely to give them any weight.²⁷² Employing this definition, courts can dismiss claims that appear to be objections more to the quality of the underlying governance than to the misstatement itself.

That said, courts have the option of moderating their approach to puffery when the behavior seems beyond the bounds that even amoral shareholders would tolerate—namely, by offering a different definition of puffery itself. For example, in *In re Countrywide Financial Corp. Securities Litigation*,²⁷³ investors alleged that Countrywide Mortgage (a company that later became notorious for issuing mortgages to unsuitable borrowers) falsely described its core mortgage operations as sound.²⁷⁴ In a lengthy discussion, the court held:

The federal securities laws do not create liability for poor business judgment or failed operations. Nor do the laws require public companies to disclose every change in operations. But the [Complaint's] allegations present the extraordinary case where a company's essential operations were so at odds with the company's public statements that many statements that would not be actionable in the vast majority of cases are rendered cognizable to the securities laws.

For example, descriptions such as "high quality" are generally not actionable; they are vague and subjective puffery not capable of being material as a matter of law. On an individual level, this is because a

272. See *supra* notes 137–38 and accompanying text.

273. 588 F. Supp. 2d 1132 (C.D. Cal. 2008).

274. See *id.* at 1153–56.

reasonable person would not rely on such descriptions; on a macro scale, the statements will have little price effect because the market will discount them. However, the [Complaint] adequately alleges that *Countrywide's practices so departed from its public statements that even "high quality" became materially false or misleading*; and that to apply the puffery rule to such allegations would deny that "high quality" has any meaning.²⁷⁵

Here, the court begins by describing puffery as a species of materiality, such that puffing statements simply cannot affect stock prices, but ends by altering the definition to be rooted in *falsity*, theorizing that puffing statements are ones that are so vague that they could still be truthful for a wide range of underlying conditions.²⁷⁶ When those conditions are so extreme as to fall outside the bounds of even broad representations that the company had adopted a "quality control process" to "improve consistency,"²⁷⁷ a fraud claim can proceed.²⁷⁸

The switch from a *reliance* interpretation of puffery to a *falsity* one is fraught with governance implications. If one assumes—as most courts do—that puffing statements are ubiquitous, and if one assumes—as most courts do, including the *Countrywide* court—that investors do not take these statements seriously, then the reinterpretation of puffery suggests that corporations are free to engage in unethical, risky, or illegal behavior, until they cross a particularly extreme line, outside the bounds of how shareholders would ordinarily expect corporations to behave. At that point, it is not so much the company's statements, but its *business model* that acts as a fraud on shareholders; its mere existence on the market in the guise of a legitimate investment becomes actionable under section 10(b). And, in fact, some courts have come close to making this reasoning explicit.²⁷⁹

275. *Id.* at 1144 (emphasis added).

276. *See id.*

277. *Id.* at 1153.

278. Courts routinely adopt similar reasoning. *See, e.g.,* Ark. Teacher Ret. Sys. v. Bankrate, Inc., 18 F. Supp. 3d 482, 485 (S.D.N.Y. 2014) (stating that "high quality" may be puffery in some contexts but "is clearly a material misrepresentation when applied to assets that are entirely worthless"); *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 190 (S.D.N.Y. 2010) (finding that statements regarding the quality of risk management cease to become puffery when "juxtaposed against detailed factual descriptions of the Company's woefully inadequate or non-existent credit risk procedures"); *In re RAIT Fin. Tr. Sec. Litig.*, No. 2:07-cv-03148-LDD, 2008 WL 5378164, at *6 (E.D. Pa. Dec. 22, 2008) (noting that although investors recognize some statements as puffery, "[w]e cannot say that a statement claiming that RAIT's 'credit underwriting involves an extensive due diligence process' is mere puffery when Plaintiffs allege that RAIT 'did not conduct any meaningful ongoing credit analysis whatsoever'").

279. *Strougo v. Barclays PLC*, 312 F.R.D. 307, 319 (S.D.N.Y. 2016) (holding that a case alleging corporate ethical failures was rooted more in its omissions—its failure to affirmatively confess to the misconduct—than its misstatements about integrity); *see also* *Bach v. Amedisys, Inc.*, No. 10-00395-BAJ-RLB, 2016 U.S. Dist. LEXIS 111077, at *35–36 (M.D. La. Aug. 19, 2016) ("The Court acknowledges that Plaintiffs have not, in every instance, identified which 'particular statements are false or misleading. But the reason for this is relatively simple: most of Plaintiffs' falsity allegations are centered around the major allegation that Defendants failed to disclose and omitted certain material information [regarding illegal conduct] from the second quarter of 2005 through the second quarter of 2010 'Amedisys's decision to withhold that information therefore constitutes a material misrepresentation within the meaning of Rule 10b-5.'" (alterations omitted) (first quoting *In*

This reasoning further suggests that courts draw a crude line between antisocial behavior that shareholders are deemed to buy into by virtue of their participation in the marketplace (antisocial behavior that is conducted on shareholders' behalf) and more extreme forms of antisocial behavior that puts management at odds with shareholders, to the point where shareholders are no longer the architects of management misconduct, but the victims of it. At that point, courts can trust that even in the absence of evidence of reliance, shareholders were, in fact, deceived, so that puffery makes way for a viable section 10(b) claim.

Omissions liability and loss causation present courts with similar dilemmas. In both situations, courts must engage with a hypothetical alternative world in which the truth had been disclosed and determine how shareholders would have reacted. Courts must gauge whether shareholders expected or encouraged the concealed (and presumably, negative) behavior—and they may conclude that they did. For example, in several cases involving for-profit colleges, shareholders alleged that the defendants failed to disclose unethical or illegal recruiting methods and students' inability to pay tuition.²⁸⁰ Courts responded by suggesting that the omitted tactics were ones that investors should have expected given the nature of the industry—or even that investors should have favored them.²⁸¹ One case held that statements inflating the quality of education provided might be sufficient for an *enrollee* to bring a fraud claim, but as to *investors* constituted puffery—presumably because stockholders would have no interest in (or perhaps would even expect) the exploitation of students.²⁸² Other courts have simply imposed special burdens on claims regarding ethical conduct: such claims may proceed, but only if the defendant explicitly attributes its

re ArthroCare Corp. Sec. Litig., 726 F. Supp. 2d 696, 710 (W.D. Tex. 2010); then quoting *Basic Inc., v. Levinson*, 485 U.S. 224, 231–32 (1988)).

280. *See, e.g.*, *Or. Pub. Emps. Ret. Fund v. Apollo Grp. Inc.*, 774 F.3d 598, 600 (9th Cir. 2014) (finding that shareholders should have expected the recruitment of students unable to pay tuition); *Okla. Firefighters Pension & Ret. Sys. v. Capella Educ. Co.*, 873 F. Supp. 2d 1070, 1079 (D. Minn. 2012) (“[E]ven accepting Plaintiff’s allegations that [defendant’s recruiting] practices were overly aggressive and abusive, there is no plausible theory that Defendants’ actions, had they been timely disclosed, would have made a difference with respect to investors’ decisions.”); *In re ITT Educ. Servs.*, 859 F. Supp. 2d 572, 581 (S.D.N.Y. 2012) (holding that statements that overstated the schools’ criteria for admitting students were immaterial because “selectivity is not necessarily positively correlated with profitability, in fact, the opposite may be true”).

281. *See supra* note 280.

282. *In re ITT*, 859 F. Supp. 2d at 580 (noting that even if false statements about outcome-focused education “might establish a strong claim for a dissatisfied student to bring against ESI[,] . . . the alleged misleading statements, when made to investors, amount to typical corporate puffery, and as such, they are not actionable under the securities laws”). Similar holdings arose out of claims associated with the financial crisis. For example, false statements by ratings agencies that they were independent of the securities issuers were deemed to be material to investors in the rated securities but puffery to investors in the ratings agencies themselves. *Compare* *United States v. McGraw-Hill Cos.*, No. CV 13-0779 DOC(JCGx), 2013 WL 3762259, at *5 (C.D. Cal. July 16, 2013), *with* *Boca Raton Firefighters & Police Pension Fund v. Bahash*, 506 F. App’x 32, 35 (2d Cir. 2012).

financial success to its ethics.²⁸³ Once again, these holdings create a doctrinal principle that investors only concern themselves with ethics in certain narrow circumstances, typically tied to short-term financial gain.

Courts use the definition of scienter to similar effect. Section 10(b) only prohibits intentional or reckless conduct,²⁸⁴ but courts offer varying explanations as to *what* precisely the defendant must intend or be recklessly indifferent about. Usually, the defendant must simply intend to *mislead* investors, on the theory that section 10(b), and federal law generally, seeks to protect the accuracy of information used to value securities. Thus, in *Basic Inc. v. Levinson*,²⁸⁵ the Supreme Court rejected the defendants' argument that their false statements had been intended to protect shareholders.²⁸⁶ It held that "creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the regulation might be 'bad for business,' is a role for Congress, not this Court."²⁸⁷ In *Nakkhumpun v. Taylor*,²⁸⁸ the Tenth Circuit came to a similar conclusion, holding that, whatever the defendant's ultimate motive, section 10(b) liability would be imposed if he intentionally or recklessly misled investors.²⁸⁹

But in other situations, courts reinterpret scienter to mean not merely an intention to *mislead* investors but to *defraud* them. For example, in *ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co.*,²⁹⁰ the plaintiff-stockholders of JP Morgan Chase (JPMC) claimed that the bank had assisted Enron's fraud by disguising loans to Enron as derivative trades so that Enron could appear to its own shareholders as having less debt than was actually the case.²⁹¹ The fraud was intended to enable Enron to falsify its own financial statements, but a necessary consequence was that JPMC itself falsely listed the loans as trades in its own SEC filings.²⁹² When JPMC's role in Enron's fraud was disclosed, its stock price fell, harming its own shareholders.²⁹³ Nonetheless, the Second Circuit held that the plaintiffs failed to allege scienter against JPMC because they did not

show an intent to defraud JPMC's shareholders rather than Enron's shareholders. . . . Indeed, Plaintiffs have argued that JPMC concealed its transactions with Enron in return for excessive fees It seems implausible to have both an intent to earn excessive fees for the corporation and also an intent to defraud Plaintiffs by losing vast sums of money.²⁹⁴

283. See, e.g., *Brockton Ret. Sys. v. Avon Prods.*, No. 11 CI 4665, 2014 WL 4832321, at *15 (S.D.N.Y. Sept. 28, 2014); *In re UBS AG Sec. Litig.*, No. 07 Civ. 11225(RJS), 2012 WL 4471265, at *36 (S.D.N.Y. Sept. 28, 2012).

284. *Zak v. Chelsea Therapeutics Int'l, Ltd.*, 780 F.3d 597, 606 (4th Cir. 2015).

285. 485 U.S. 224 (1988).

286. *Id.* at 239 n.17.

287. *Id.*

288. 782 F.3d 1142 (10th Cir. 2015).

289. *Id.* at 1150.

290. 553 F.3d 187 (2d Cir. 2009).

291. *Id.* at 193–95.

292. *Id.* at 195–96.

293. *Id.* at 194.

294. *Id.* at 203. Other decisions have followed a similar pattern. See, e.g., *Pipefitters Local No. 636 Defined Benefit Plan v. Zale Corp.*, 499 F. App'x 345, 351 (5th Cir. 2012) (no scienter

In other words, the Second Circuit modified the definition of scienter to distinguish between misbehavior done on shareholders' behalf and misbehavior that positioned managers as adverse to shareholders. The key assumption underlying this move is that shareholders welcome attempts to increase their wealth by any means necessary. The inclination, then, is to assume that shareholders are short-term wealth seekers to the exclusion of other concerns. Courts' unstated assumptions stand in direct opposition to efforts to utilize shareholders as a disciplining influence on corporate behavior.

This is not to say that courts reject all claims based on undisclosed misconduct intended to maximize shareholder wealth; to the contrary, many such claims succeed.²⁹⁵ The point is that the tools developed to police the distinction between disclosure and governance can easily be, and often are, used to inscribe into legal doctrine a conception of shareholders as risk-seeking, short-term-wealth maximizing, and amoral—precisely the opposite of the kind of shareholder who might act to curb antisocial corporate tendencies.

One irony of this approach is that in courts' zeal to police the governance/deception line, they have come close to reviving the now-defunct “fraud created the market” doctrine. As described above, in the absence of market efficiency, shareholders generally cannot win the presumption of reliance that permits them to bring claims on a class basis.²⁹⁶ For a time, courts accepted “fraud created the market” as an alternative. Under this theory, regardless of the efficiency of the market, investors are entitled to presume that publicly traded securities are not so deficient as to be essentially unmarketable.²⁹⁷ When undisclosed problems reach that level of severity, the security's mere existence on the market, masquerading as a legitimate purchase, works a deception.

The fraud created the market doctrine has been rejected in most modern decisions,²⁹⁸ but when courts distinguish between shareholder-favored and

alleged against executive who falsified accounting entries because she “acted with the intent to maintain the good appearance of her department rather than to defraud investors”); *Doshi v. Gen. Cable Corp.*, No. 2:14-cv-22(WOB-CJS), 2015 WL 366644, at *11 (E.D. Ky. Jan. 27, 2015) (“Although Sandoval may have been aware of problems and failed to disclose them, there are no facts to support that he did so with intent to defraud. Instead, the allegations support an inference that his intent was one shared by most corporate executives: to be profitable and achieve business goals.”).

295. *See, e.g., Pirnik v. Fiat Chrysler Autos., N.V.*, No. 15-CV-7199(JMF), 2016 WL 5818590, at *10 (S.D.N.Y. Oct. 5, 2016).

296. Occasionally, plaintiffs can obtain a presumption of reliance for claims based on omissions, rather than affirmative misstatements. *See infra* Part V.A.3.

297. *Joseph v. Wiles*, 223 F.3d 1155, 1163 (10th Cir. 2000). In some formulations, investors are entitled to believe that the regulatory regime and the process involved in bringing securities to market protect against the sale of completely valueless or unmarketable securities. *See, e.g., T.J. Raney & Sons, Inc. v. Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir. 1983).

298. *See, e.g., Pa. Pub. Sch. Emps. Ret. Sys. v. Morgan Stanley & Co.*, 772 F.3d 111, 120–21 (2d Cir. 2014); *Nuveen Mun. High Income Opportunity Fund v. City of Alameda*, 730 F.3d 1111, 1116 (9th Cir. 2013); *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 751–52 (3d Cir. 2010).

shareholder-disfavored business models, its spirit lives on. Courts are reluctant to permit liability for concealed misconduct deemed to be within a rational, wealth-maximizing investors' risk tolerance, but when the risks plainly exceed what any investor would want, investors change status from enablers to victims. Then, courts functionally will allow fraud claims to be pursued even in the absence of statements that, in another context, would be deemed deceptive.

V. REVIVING RELIANCE

Today, disclosure does more work than it has done in the past, and the private rights of action were not designed for its new role. Yet even within current doctrinal constraints, efforts to enhance shareholders' ability to influence corporate governance are stymied by courts' distrust of the project. This distrust is fueled by concerns about the potential for shareholder abuse, courts' uncertainties about whether federal law should be regulating governance, and courts' judgment that investors are indifferent to externality-generating behavior. Courts' constrained view of deception and damage threatens to become even more consequential in coming years, as it is likely the federal government will retrench from command-and-control style regulation in favor of self-regulation and market constraints. Shareholders may become an important component of these alternative regulatory mechanisms and, therefore, their right to participate in corporate governance deserves a vigorous defense.

A. *Distinguishing Between Actual Reliance and Fraud-on-the-Market Claims*

As described above, decades ago, the legal system opted for deterrence over compensation as a mechanism for enforcing the securities laws.²⁹⁹ In other words, monetary damages are emphasized as a "stick" that discourages bad behavior, with only after-the-fact legal fees offered to attorneys as the "carrot" for bringing the claim. But when shareholders are viewed as part of the governance structure the compensation rationale takes on additional importance as a "carrot" to encourage shareholders to shoulder the burdens of these responsibilities in the first place. It has long been assumed that shareholders have little reason to monitor corporate managers because they bear the expenses of doing so but capture only a small portion of the benefits.³⁰⁰ Institutional investors' large stakes, coupled with their lower monitoring costs, may have changed the calculus,³⁰¹ but the costs have not been entirely eliminated and surely remain a barrier to participation. Thus, if shareholders are to participate fully in the corporate enterprise—and serve as a force to reign in managerial misconduct—it is particularly important that

299. See *supra* Part I.B.

300. See, e.g., J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 834 (2007).

301. See *supra* Part II.

the legal system find ways to encourage investor participation and fully reimburse investors' losses when they are misled.

Previous commentators have singled out active traders as especially deserving of compensation in section 10(b) actions, though their particular recommendations have varied. The basic insight is that active trading incorporates information into stock prices, which benefits both passive investors and the economy generally. Active traders who perform this task take disproportionate risks in the form of lack of diversification. They therefore are more entitled to damages when corporate information proves to be false than are passive investors.³⁰² Moreover, to the extent all shareholders pay when a corporation is forced to fund fraud-on-the-market damages, it is appropriate that passive investors fund a kind of investor insurance that is more likely to benefit active investors.³⁰³

But actual reliance has a further benefit: it is a precondition for participating in corporate governance. To the extent shareholders are misled, they cannot perform their monitoring function. It is therefore appropriate to enhance remedies to shareholders who take their monitoring role seriously and—to the extent those payments are funded by the corporate entity—to indirectly tax the remaining investors for a service that federal law encourages them to perform. Additionally, imposing a reliance requirement minimizes the chance that investors who enabled the problem will still be able to collect “investor insurance” damages when the risks did not pan out. Following the lead of the Fifth Circuit, the section 10(b) action could be altered to provide greater rights to investors who can establish actual reliance.³⁰⁴ These greater rights, described in more detail in the sections that follow, could then serve as an incentive for institutions both to monitor such disclosures and to enforce them after the fact.

Courts' suspicion of section 10(b) claims is at least partly rooted in the functional elimination of the element of reliance. When reliance is presumed from surrounding facts, courts must be wary of allowing the presumption on a hair trigger, particularly given the conflicting incentives facing shareholders in the context of corporate misconduct. But if investor reliance is restored as an integral part of the cause of action and must be established by the plaintiff, courts can be confident that investors were, in fact, deceived, without the necessity of making value judgments regarding the types of conduct investors might tacitly encourage.

302. See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 101–02 (2011) (arguing that only active traders should receive section 10(b) damages); A.C. Pritchard, Halliburton II: *A Loser's History*, 10 DUKE J. CONST. L. & PUB. POL'Y 27, 51 (2015) (same).

303. Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 347–50 (noting that holders who cannot recover provide insurance for the benefits conferred by active traders); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 342–44 (2009) (same).

304. In this context, reliance should be interpreted to include investors who outsource decisions to advisors, who themselves rely on corporate misstatements. Reliance should also be defined to include computer algorithms that include such statements in trading decisions.

Importantly, however, these investors should not be required to establish that they would not have bought at all had they known the truth, or that they would have bought at a different price, because such a high burden would be difficult (if not impossible) to meet. Instead, the only inquiry should be whether the challenged statements factored favorably into their investment decision. Reliance, under this standard, would operate like a subjective version of the standard test for materiality. Such a shift would capture the reality that even when investors cannot identify a single statement as the but-for cause of their purchasing decisions, corporate representations may still play a role in the investment process. Investors who can make this more moderate showing are likely to continue to monitor corporate representations in their capacity as shareholders and engage as necessary when corporate managers veer into more dangerous territory. If the goal of increased liability is to reward investors who purchase with the intention to monitor the quality of governance, requiring investors to demonstrate attention to the relevant issues is all that should be required.

To be sure, it may be somewhat counterintuitive to rely on active traders to police governance disclosures because their interests may diverge from those who buy stock in a particular company and maintain their position.³⁰⁵ Yet the divergence may not be that stark. Even investors who expect to take a long-term position are likely to periodically buy and sell in accordance with various investment strategies.³⁰⁶ Thus, despite their status as traders, which entitles them to damages under *Blue Chip*,³⁰⁷ they may also maintain an interest in corporate governance.

Moreover, most institutional investors are intermediaries; they manage money for beneficiaries, such as retirees. If these institutions disclose their participation in section 10(b) litigation and any recovery (or better yet, if they are required to do so),³⁰⁸ investors can determine if they are, in fact, monitoring corporate management and thereby detect shirking.³⁰⁹ Institutions may improve their own monitoring functions so that they can demonstrate reliance should the need arise—with the beneficial side effect of correcting problems before they begin. Indeed, one study found that particular institutions tend to be “bad” monitors; they end up investing in more firms targeted for litigation than do other investors, suggesting they are

305. Cf. Park, *supra* note 22, at 146 (highlighting the divergent interests between stockholders-as-owners and stockholders-as-traders).

306. See, e.g., Collier v. ModusLink Glob. Sols., Inc., 9 F. Supp. 3d 61, 74 (D. Mass. 2014).

307. See *supra* notes 59–62 and accompanying text.

308. Currently, that data is not publicly available. In one study, researchers had to contact settlement administrators to collect it. See, e.g., Cox & Thomas, *supra* note 78, at 413.

309. Some have argued that mutual funds have little incentive to monitor management because the benefits are distributed to all stockholders, including competing funds. See Fischel, *supra* note 258, at 1276–77; Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1824 (2011). Experience appears to have demonstrated that funds do, in fact, engage in monitoring, see *supra* Part II, though perhaps less than they would if they were not mindful of competitors. An “actual reliance” damage award might allow more vigorous monitors to differentiate themselves from other funds while partially compensating their costs.

failing to use the tools at their disposal.³¹⁰ The incentives provided by these proposed alterations to section 10(b) doctrine may improve the situation.

That said, one of the barriers to bringing actual reliance claims is that they cannot be certified for class treatment and the expenses of individual actions are high.³¹¹ Those expenses can be minimized, however, when the individual action is tied to a class claim, and the individual can utilize discovery obtained in the class action. Increasingly, institutional investors are choosing to opt out of class actions and coordinate with the class in hopes that they can win higher settlements.³¹² Though these investors frequently rely on the fraud-on-the-market presumption, many also allege that they actually relied on the false statements.³¹³ If they knew they could collect additional damages by claiming actual reliance, more investors would be incentivized to do so,³¹⁴ and actual reliance claims would be more feasible.

An even more attractive alternative would be to litigate class actions in the expectation that some investors may be entitled to receive “actual reliance” damages. Classes could be certified for specific issues under Rule 23(c)³¹⁵ so as to allow reliance and damages to be segmented out. Investors who claim they actually relied on a misstatement could prove that fact in separate trials, while the remainder of the class would have reliance determined using a fraud-on-the-market theory. These kinds of flexible procedures are often employed in complex class actions.³¹⁶ Because few shareholders are likely to take advantage of the actual reliance option, and those who do are likely to have comparatively large stakes, designing class procedures in this manner would impose minimal additional burdens, while avoiding any frictions that might arise when investors bring entirely separate actions.³¹⁷

310. *See, e.g.*, Chishen Wei & Lei Zhang, Identifying Ineffective Monitors from Securities Class Action Lawsuits 2 (Nov. 28, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2756247 [<https://perma.cc/54F4-T9YJ>].

311. Fisch, *supra* note 71, at 818.

312. *Id.* at 869–70.

313. *See, e.g.*, Complaint ¶ 474, *T. Rowe Price Growth Stock Fund v. Valeant Pharm.*, 3:16-cv-05034-MAS-LHG (D.N.J. Aug. 15, 2016); Complaint ¶ 329, *North Sound Capital LLC v. Merck & Co.*, 3:13-cv-07240-FLW-DEA (D.N.J. Nov. 14, 2013); Complaint ¶¶ 339–41, *British Coal Staff Superannuation Scheme v. AIG*, No. 1:12-cv-04555-LTS-DCF (S.D.N.Y. July 9, 2012).

314. Right now, one of the major potential barriers to opt-out litigation is the statute of repose. The Supreme Court recently concluded that the repose period will continue to run after a class action has been filed, thus potentially barring individual litigants from coming forward later in the process. *Cal Pub. Emps. Ret. Sys. v. ANZ Sec., Inc.*, 137 S. Ct. 2042, 2049 (2017). Though a full discussion of the repose period is outside the scope of this Article, this doctrine could be modified to permit actual reliance claims to be filed as tagalongs to section 10(b) class actions. Even if it is not modified, presumably investors with potential actual reliance claims will know that from the outset and can file within the period.

315. FED. R. CIV. P. 23(c).

316. *See, e.g.*, *Kern v. Siemens Corp.*, 393 F.3d 120, 126–27 (2d Cir. 2004); *Mullen v. Treasure Chest Casino, LLC*, 186 F.3d 620, 628–29 (5th Cir. 1999); *McPhail v. First Command Fin. Planning, Inc.*, 251 F.R.D. 514, 519–20 (S.D. Cal. 2008).

317. These procedures might also mitigate any tensions between institutional investors, who may remain large shareholders, and corporate management. To avoid souring ongoing relationships, institutions may be reluctant to initiate litigation on their own but be comfortable simply submitting damages claims in larger class actions with proof of their own reliance.

A proposed framework for adjusting the section 10(b) cause of action to distinguish between actual reliance claims and fraud-on-the-market claims involves redesigning puffery, loss causation and damages, omissions, and claims for securities holders. This framework recognizes the value of governance-related disclosures and investors' role in the corporate structure.

1. Redesigning Puffery

The puffery doctrine, which disproportionately devalues governance-related disclosures,³¹⁸ should be adjusted. There are at least two potential paths for reform.

First, and most obviously, the doctrine could be entirely eliminated for investors who allege actual reliance. Courts apply the puffery doctrine with a special vigor in the context of section 10(b) due to courts' fear that fraud-on-the-market liability could become entirely decoupled from affirmative disclosures.³¹⁹ This is simply not a concern for investors who demonstrate actual reliance on the alleged misstatement.

The shift would not be as dramatic as it sounds. Though materiality—of which puffery is a facet—is ostensibly defined by reference to an objective, “reasonable person” standard,³²⁰ courts have long been in the habit of tacitly adjusting their definitions of materiality to match the circumstances of targeted investors.³²¹ Eliminating the puffery concept entirely when actual reliance has been established would simply make the practice more explicit.

A broader solution would be to revise the doctrine across the board, even in fraud-on-the-market cases. It may not be feasible to jettison the doctrine entirely, for precisely the reasons it was first adopted, but it can be reoriented to explicitly focus on falsity rather than the presumed immateriality to investors. Rather than gauging whether the statements are too vague for shareholders to rely upon—or less logically, whether they are unreliable because of their similarity to statements issued by comparable companies—courts should focus on whether the tone of the statement was significantly at odds with the underlying facts. The focus should be on the nexus between the statements and the aspect of the business being challenged. Under this test, general positive statements about the business would not be rendered false by problems confined to one small segment *unless* those problems are extremely severe. The more hyperbolic the language used, the more likely it would be rendered false by smaller or more confined problems. The balance would be between the generality of the statement, the tone of the statement, and the generality and severity of the underlying problem. Courts should be comfortable employing this analysis because it is quite similar to the test for

318. *See supra* Part III.A.

319. *See supra* Part III.A.

320. *Amgen, Inc. v. Conn. Ret. Plans & Tr. Funds*, 133 S. Ct. 1184, 1191 (2013).

321. *See Flannery v. SEC*, 810 F.3d 1, 11–12 (1st Cir. 2015); *United States v. Litvak*, 808 F.3d 160, 182 (2d Cir. 2015); Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473, 481 (2006) (concluding that materiality standards should be altered for inefficient markets).

materiality generally, which involves a balance of the probability of a contingent event relative to its magnitude.³²²

This approach would discourage disappointed investors from using section 10(b) as “investor’s insurance,” while at the same time preventing courts from making armchair judgments about the significance information might hold to a hypothetical investor.³²³ It would also recognize what we understand intuitively and has been documented by researchers³²⁴—that investors respond to the degree of enthusiasm with which corporate opinions are expressed. Investors treat mild statements of self-praise differently from more extreme statements, and a revised puffery doctrine that focuses on the disparity between the statement and the underlying truth would capture this reality. For example, claims based on an ethics policy would not be dismissed merely because the policy was aspirational.³²⁵ Instead, courts would consider whether, given the pervasiveness of the wrongdoing relative to the business or the knowledge of senior management, the company was not, in fact, even aspiring to meet the terms of its own policy.³²⁶

2. Actual Reliance and Loss Causation

Reformation of the puffery doctrine, however, would not completely resolve the issue. Loss causation and damages, omissions liability, and *Blue Chip* standing requirements continue to block compensation to investors who misdirect their governance efforts due to false statements or material omissions. For these elements, taking a page out of the Fifth Circuit’s playbook in *BP*, investors who actually relied on the misstatement could collect “materialization of the risk” damages, incurred as a consequence of the fraud or the conditions it concealed.³²⁷ Such a shift would reward investors who take an active interest in the quality of the corporate governance and compensate them for governance-related losses they incur when their ability to participate is stymied.

322. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988). It is also not far removed from the inquiry courts must undertake when addressing half-truths, namely, a determination of “what sorts of statements touch closely enough on the [undisclosed facts] to make them technically true but misleading.” Langevoort, *supra* note 22, at 459–60.

323. Such determinations typically occur on a motion to dismiss, in the absence of any record. See Padfield, *supra* note 138, at 354.

324. See, e.g., Khrystyna Bochkay et al., *Hyperbole or Reality?: Investor Response to Extreme Language in Earnings Conference Calls* (Ga. Tech Scheller Coll. of Bus., Working Paper No. 17-21, 2017), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2781784 [<https://perma.cc/W4MB-3B34>].

325. See, e.g., *Pontiac Policemen’s & Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014); *Nathanson v. Polycom, Inc.*, 87 F. Supp. 3d 966, 976–77 (N.D. Cal. 2015).

326. Given the flexible nature of the puffery doctrine, some courts already employ a similar analysis. See, e.g., *Strougo v. Barclays PLC*, 105 F. Supp. 3d 330, 345–46 (S.D.N.Y. 2015) (rejecting general ethics statements because they were not rendered false by allegedly improper behavior in one small division); *In re Dynex Capital, Inc. Sec. Litig.*, No. 05 Civ. 1897(HB), 2009 WL 3380621, at *8 (S.D.N.Y. Oct. 19, 2009) (“At some point, statements by a defendant that it ‘generally’ adheres to a particular policy become misleading when in fact there is no such policy or the policy is something else altogether.”).

327. See *supra* notes 220–26 and accompanying text.

Notably, this shift would allow damages to be awarded even for misstatements that do not impact (or cannot be proved to have impacted) the security's price. As described above, part of the theory as to *why* investors care about governance is less about stockholder wealth maximization than the advancement of other values.³²⁸ Courts have demonstrated at least some degree of resistance to recognizing such values legally, and to the extent they are correct that external concerns do not influence stock prices, investors may have difficulty using fraud-on-the-market theory to bring claims based on false corporate pretensions to ethical behavior. If damages are awarded based on actual reliance, however, it is less important that the market as a whole take the information into account.

For example, suppose a company makes false statements about a commitment to diversity in hiring. The statements have little (provable) impact on price because, as rational wealth maximizers, most shareholders are uninterested in diversity. Yet some class of investors relies on those statements. Later, the company reveals the statement to be false when it announces that it is the target of a class action lawsuit for racial discrimination and its stock price falls. Under the current section 10(b) regime, no investor could collect damages because no investor could show that the price they paid for their shares was higher than its true value at the time of purchase. But if damages could be awarded to investors who relied on the false claims, regardless of price impact at the time of the initial lie, they would be compensated for some of their monitoring costs.³²⁹ Such a regime would further the federal interest in encouraging stockholders to take an interest in issuers that advance moral causes even when they do not directly contribute to stockholder wealth.

One point of objection might be that these are governance damages, rooted in the notion that managers mismanaged the corporation, thus causing losses to the entity directly and to shareholders indirectly. As such, they already are remediable in derivative actions under state law. Shareholders may step into the shoes of the corporate entity and bring claims against faithless managers on the entity's behalf, with damages returned to the entity itself.³³⁰ Richard Booth, for example, has argued that many section 10(b) claims should more properly be characterized as derivative actions.³³¹ Derivative actions, however, do not recognize the precise harm described here: managerial misstatements that have the effect of denying shareholders their role in the

328. *See supra* Part IV.

329. Of course, if there was no price impact, a class action might not be possible, and these investors would have to determine if the costs of an action were worth the reward without the ability to tie their claims to fraud-on-the-market class claims. In practice, the choice may not be as stark. Very often, class plaintiffs bring claims based on a variety of misstatements, some of which are dismissed as the case progresses. There could easily be situations where a class action might proceed for one set of statements, while actual reliance claims—based on a subset of statements related to, but dismissed from, the large class action—proceed in tandem. *See infra* Part V.A.3.

330. *Schleiff v. Balt. & Ohio R.R.*, 130 A.2d 321, 327 (Del. Ch. 1955).

331. Richard A. Booth, *What Counts as Price Impact for Securities Fraud Purposes?*, 10 VA. L. & BUS. REV. 37, 40 (2015).

governance structure. The harm is not merely that managers damaged the company; it is that managers denied shareholders the opportunity for input. That harm is personal to the investor.

Additionally, plaintiffs may only pursue derivative actions if corporate directors are operating under a conflict that prevents them from bringing the claims on the corporation's behalf.³³² This point is central to the notion of a derivative action: directors are the only rightful governors of the corporation, and shareholders are permitted a role only in the most extreme circumstances. The goal under federal law, by contrast, is to encourage shareholders to take a more active role in the governance structure. And of course, more practically, if we want to award damages to specific investors to compensate them for their monitoring activities, that goal is not realized via derivative actions because damages are paid to the corporate entity.

3. Actual Reliance and Omissions

Actual reliance claims may also be used to adopt a compromise position on omissions liability under section 10(b). To understand why, it is necessary to trace the history of the presumption of reliance to the pre-*Basic* case of *Affiliated Ute Citizens v. United States*.³³³ There, the Supreme Court held that when a section 10(b) claim is predicated on a misleading omission rather than an affirmative false statement, it would be too difficult to expect investors to prove that they "relied" on missing facts.³³⁴ Instead, investors are entitled to a presumption that omitted material facts would have altered their investment decision.³³⁵ Defendants then have a right to rebut that presumption.³³⁶

Several years later, the Supreme Court decided *Basic*, after which most plaintiffs seeking a presumption of reliance chose to utilize fraud-on-the-market rather than omissions liability. However, in cases where an efficient market was lacking—and therefore *Basic* was unavailable—plaintiffs often sought a presumption of reliance under *Affiliated Ute*, leading to many disputes about whether claims concerned omissions or concerned affirmative false statements.³³⁷

Some courts properly recognized that unless the plaintiff alleges that he or she *actually read* the document that omitted the relevant information, the *Affiliated Ute* presumption has little force.³³⁸ The logic is simple: the presumption of reliance under *Affiliated Ute* is rebutted if the defendant can

332. See, e.g., DEL. CH. CT. R. 23.1; *Beam v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004).

333. 406 U.S. 128 (1972).

334. *Id.* at 152–53.

335. *Id.* at 153–54.

336. *Id.*

337. See, e.g., *Binder v. Gillespie*, 184 F.3d 1059, 1063–64 (9th Cir. 1999); *Dodona I, LLC v. Goldman, Sachs & Co.*, 296 F.R.D. 261, 269 (S.D.N.Y. 2014).

338. See, e.g., *Eckstein v. Balcov Film Inv'rs.*, 58 F.3d 1162, 1171 (7th Cir. 1995); *Shores v. Sklar*, 647 F.2d 462, 475 (5th Cir. 1981); cf. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1159 (6th Cir. 1994) (noting that the *Affiliated Ute* presumption is limited to face-to-face transactions); *In re GenesisIntermedia, Inc. Sec. Litig.*, 232 F.R.D. 321, 334 n.16 (D. Minn. 2005) (same).

show that had the truth been disclosed, the investor would not have behaved differently. If the plaintiff *never read* the document, a disclosure could not have made a difference in the absence of a fraud-on-the-market claim (which, by hypothesis, is unavailable). Thus, properly understood, *Affiliated Ute* should be limited to cases in which the investor actually read and relied upon the document from which information was omitted, limiting its utility in class actions.

Omissions claims based purely on failure to comply with SEC disclosure requirements could be interpreted similarly. Courts could permit such claims to proceed, but only for investors who demonstrate that they actually relied on the document that should have, but did not, contain the required information. Such a compromise, subject to defendants' right to prove that a disclosure would not have made a difference, would give courts more comfort that the claim is rooted in actual deception. At the same time, it would provide those investors who engage in monitoring activities with additional incentives. Better yet, corporations that omit information they previously stated that they would provide—an issue of growing importance in light of investors' agitation for increased disclosure—could also incur liability to relying investors. For maximum effectiveness, under this approach, if puffing statements continue to be treated as immaterial, courts should also conclude that puffing statements cannot legally qualify as adequate disclosures. That is, if there is a requirement that certain information be disclosed, and the disclosure itself is deemed puffery, the company should be treated as having omitted required information under section 10(b), such that investors who actually read the document may pursue section 10(b) claims under *Affiliated Ute*.³³⁹

4. Claims for Securities Holders

A more dramatic, and controversial, change would be to loosen the *Blue Chip* standing requirements for actual reliance claims. Investors would be able to bring section 10(b) claims if they could show that had the truth been disclosed, they would have sold their holdings. Such a shift in policy would, if coupled with “materialization of the risk” damages,³⁴⁰ allow greater recognition of the right to sell as part of a shareholder's role in governance and as a mechanism by which investors discipline managers. For most institutional investors, proof could likely come in the form of documented

339. Section 18 of the Securities Exchange Act imposes liability for false statements contained in SEC filings and is only available to persons who can prove reliance on the misstatement. 15 U.S.C. § 78r (2012). However, section 18 would not provide an adequate substitute for the type of liability proposed here. First, it does not, by its terms, provide liability for omissions. Second, it requires the investor to prove that the misstatement impacted the security's price. Third, it only applies to documents filed with the SEC, and many corporate statements occur outside of SEC filings. Finally, though there is little law on the subject, courts have assumed that damages are calculated as they would be for section 10(b). *See, e.g.*, *Harris v. Am. Inv. Co.*, 523 F.2d 220, 225 (8th Cir. 1975).

340. *Blue Chip* operates in tandem with damages limitations; so long as the out-of-pocket rule applies to damages, investors who merely hold stock would not have a claim. *See supra* notes 208–10 and accompanying text.

investment policies, thus mitigating the concern of the *Blue Chip* Court that proof regarding a failure to transact would be too speculative to entertain.³⁴¹ Moreover, because these claims would only be available in the actual reliance context, they could not be brought as a class (though, as above, they might be attached to class claims). This, too, would mitigate the *Blue Chip* Court's concern regarding "vexatious" lawsuits that force settlements with the threat of large damages.³⁴²

B. *Imagining a Governance Right of Action*

All of these proposals, however, are not a complete fix, in part because they depend on the presence of an active investor. Passive investing dominates today, and its market share is growing.³⁴³ Passive investors may well monitor and engage with management after making a purchase, but they do not make buy and sell decisions based on company-specific information. Therefore, the most radical potential change would be to allow investors to bring a claim for deceit if the misstatements influenced their engagement decisions, preventing them from mitigating (if not eliminating) their losses. No such claim is permissible under section 10(b), which only prohibits deceit "in connection with the purchase or sale" of a security.³⁴⁴ A new cause of action, however, would truly demonstrate federal law's commitment to giving shareholders a voice in corporate governance.

If a new statutory cause of action were crafted, it could require proof of direct reliance by the individual shareholder, but loosen the tight causation requirements of Rule 14a-9 and expand beyond misstatements in proxy solicitations.³⁴⁵ This way, passive investors, who cannot establish actual reliance in connection with a purchase or sale, could collect damages for interference with their governance rights, partly compensating them for their efforts on behalf of all investors.

As with all claims rooted in actual reliance, one of the biggest stumbling blocks would be the expenses associated with the action in the absence of the potential for class certification. But once again, if the particular claim is also associated with a fraud-on-the-market section 10(b) action, the litigation could be coordinated to minimize expenses. Moreover, if the passive investors have large enough holdings, simple joinder with other investors, each of whom proves reliance individually, might be sufficient to make the actions cost efficient.

341. This claim, intended to encourage investors to correct corporate malfeasance, would be unavailable for the admittedly rare cases where management is alleged to have low-balled the stock in order to discourage purchases as the original *Blue Chip* plaintiffs alleged. That way, at least some of the concern of the *Blue Chip* Court—that proof would be hard to come by—would be mitigated. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754 (1975).

342. *Blue Chip*, 421 U.S. at 739–41.

343. See Sarah Krouse & Corrie Driebusch, *Investors Snub Money Managers for Market Clones*, WALL ST. J. (Jan. 13, 2016), <https://www.wsj.com/articles/morningstar-says-actively-managed-mutual-funds-saw-outflows-in-2015-1452701873> [<https://perma.cc/HP6F-W5UN>].

344. 15 U.S.C. § 78j(b).

345. See *supra* Part III.

Looking further down the road, we might also begin to consider a scheme where disclosure violations are penalized more heavily in firms that minimize shareholder governance rights (dual class stock, staggered boards, and so forth) on the theory that if shareholders have fewer levers of power, it is less appropriate to characterize them as enablers. For example, Snap—the parent of Snapchat—recently held an initial public offering of stock that offers *no* voting rights.³⁴⁶ Investors in such companies must rely on buying, selling, and suing, to discipline management, making disclosures ever more critical. Moreover, where shareholders' power is minimized, they are less responsible for corporate misbehavior, and courts need not harbor the same concerns that they may have tacitly encouraged it. Thus, for such companies, ESG disclosures attesting to management quality and ethics could be treated as having particular importance, and puffery-like arguments could be especially disfavored.³⁴⁷

CONCLUSION

The more that the federal government retreats from substantive regulation of corporate behavior, the greater the potential for shareholders to fill the void. It is far from ideal that shareholders—whose interests may differ from the broader society³⁴⁸—should occupy that role, but it may be the most viable near-term option. Still, shareholders cannot fulfill that responsibility if the disclosures they rely upon are underenforced by courts relying on outdated distinctions between valuation and governance. Long term, the solution may be to develop causes of action that are more specifically tailored to deception that influences how shareholders behave as corporate constituents. Until then, there are potential changes to section 10(b) doctrine that can correct the problem and provide better support for federal policy, while still maintaining section 10(b)'s essential character as a claim rooted in deception.

At least part of the problem for courts stems from the practical elimination of the reliance element from section 10(b) claims. Without evidence of the actual reliance of particular investors, courts are forced to draw broad conclusions about information that investors may have relied upon, leading to rules of thumb designed to differentiate investors who were truly defrauded from those who are the architects of their own misfortune. Unfortunately, these rules encourage courts to paint a doctrinal portrait of a ruthlessly short-term wealth-maximizing shareholder that is, or appears to be,

346. See Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, WALL ST. J. (Jan. 16, 2017), <https://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034> [<https://perma.cc/3KJQ-KFMY>].

347. Cf. Ian Appel, *Governance by Litigation 17–18* (June 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2532278 [<https://perma.cc/2X7R-XT7T>] (finding that when investor litigation rights are diminished at the state level, firms perform more poorly, and that the effect is especially pronounced when investors have fewer alternative mechanisms for disciplining management).

348. Thomas W. Joo, Comment, *Corporate Governance and the “D-Word,”* 63 WASH. & LEE L. REV. 1579, 1587–88 (2006).

at odds with many investor preferences and the project of enlisting shareholders as a restraining influence on corporate excess.

There are legitimate reasons for softening the reliance requirement for open-market frauds, but the protective measures that have built up around that doctrinal shift are not necessary—and are in fact counterproductive—in certain contexts. Moreover, the rise of institutional investors has made actual reliance claims more feasible, particularly when they can be tied to pending class actions. Therefore, a solution that narrows situations in which statements are found to be immaterial as a matter of law, and that distinguishes between actual reliance claims and fraud-on-the-market claims, can better encourage investor monitoring and better enable investors to protect their interests.