ESG Securities Fraud

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When a public company deceives investors about its financial condition, it commits securities fraud. Many of the most significant securities fraud cases now are filed in the wake of a corporate scandal relating to an Environmental, Social, or Governance (ESG) issue that substantially affects a company's stock price. Some critics have questioned whether these lawsuits unduly expand the reach of securities regulation so that "everything is now securities fraud." This Article comprehensively analyzes the issue of ESG securities fraud and suggests an approach that courts can use in deciding whether a company deceived investors about ESG risk. The main question in such cases is whether corporate managers knew of a high probability of an ESG risk of substantial magnitude. The probability/magnitude test presumes that a corporation can calculate reasonable probabilities of a risk. Many of the major ESG securities fraud cases point to evidence that public companies were able to calculate internal probabilities of an ESG risk but were not forthright about such risk in their communications with investors. As law and norms push companies to assess ESG risk, the obligation of corporate managers to inform markets of such risk will increase.

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Introduction

The 2019 collapse of the Brumadinho dam in Brazil not only released 12 million tons of mining waste and took 270 lives, it prompted the filing of a major securities fraud

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enforcement case in the United States by the Securities & Exchange Commission (SEC).[1] Vale, the public corporation that owned the dam, had New York Stock Exchange-traded securities, which lost 25 percent of their value in the wake of the crisis. The SEC alleged that Vale knew there was a high risk that the dam could fail, especially because another one of its dams had collapsed just four years before.[2] The government lawsuit argued that Vale misled investors about the risk of its 2019 dam collapse, not only in the quarterly reports it must file with the SEC as a public company, but also in sustainability reports that it had voluntarily provided to investors.[3] In doing so, Vale allegedly violated various securities law provisions such as Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, which prohibit securities fraud.[4]

The Vale case is one of a number of high-profile securities fraud cases filed over the last decade by the SEC and investors alleging that a public company misled investors about the risk of a scandal or disaster.[5] These cases intersect with the growing importance of Environmental, Social, and Governance (ESG) matters to the modern public corporation.[6] The public and governmental agencies have become more concerned about corporate misconduct and the consequences of violating ESG norms and law can be severe. Investors have also become more interested in ESG issues and are demanding more disclosure on these issues from companies. As scandals relating to environmental pollution, sexual harassment, and violations of customer privacy have become associated with significant losses in market value, securities fraud enforcers have developed cases alleging ESG securities fraud.[7]

[1] Sec. & Exch. Comm'n v. Vale, Complaint, Civ. Action No. 22-cv-2405 (S.D.N.Y. April 28, 2022).

[2] *Id*. at ¶ 6. The collapse of that dam in 2015 also prompted the filing of a securities class action. *See* In re: Vale S.A. Sec. Litig., 1:15-cv-9539-GHW, 2017 WL 1102666 (March 23, 2017) (granting in part and denying in part motion to dismiss the case). The SEC did not bring a case but private plaintiffs won a $25 million settlement.

[3] *Id*. at ¶ 29.

[4] Section 10(b) of the Securities Exchange Act of 1934 permits the SEC to pass rules prohibiting any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security. Rule 10b-5 reads in full:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

[5] More generally, a significant percentage of securities class actions appear to target conduct that does not directly target shareholders. Emily Strauss finds that 16.5 percent of cases filed from 2010-2015 involve allegations of misconduct against outsiders to the corporation. *See* Emily Strauss, *Is Everything Securities Fraud?*, UC Irv. L. Rev. (forthcoming). Such cases are less likely to be dismissed and settle for larger amounts than on average. *Id*.

[6] *See, e.g.*, Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=6bc6f0231695.

[7] Some cases are also brought as state corporate law derivative claims. *See, e.g.*, Daniel Hemel & Dorothy Lund Shapiro, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583 (2018).

Some commentators have described ESG cases as event litigation,[8] where any corporate scandal that causes a significant stock price decline could potentially violate Rule 10b-5. If everything is securities fraud,[9] securities regulation would essentially police virtually all forms of corporate misconduct. Companies like Vale that destroy the environment and hurt workers will not only be punished by environmental and labor regulators but will also be investigated and sanctioned by securities regulators. It is unclear why investors should receive an additional payment for corporate misconduct that most directly impacts corporate stakeholders.[10] Moreover, unlike the typical securities fraud case, which relates mainly to efforts to deceive investors about a company's financial performance, ESG securities fraud relates to deceptions concerning risks that are more difficult for corporate managers to predict.[11] Broadening the scope of securities fraud in this way could impose significant litigation costs on public companies that will have to defend against a case every time a crisis hurts their stock price.

Closer examination shows that ESG securities fraud cases do not radically expand the reach of securities fraud doctrine. ESG securities fraud is essentially a variant of a theory that has long been asserted in Rule 10b-5 cases. The failure to adequately disclose the risk of an ESG risk is similar to the failure to adequately disclose the risk that efforts to develop an important product will not succeed. The question in both types of cases is the extent to which corporate managers were aware of a risk while downplaying such risk to public investors. To the extent that a stock price did not reflect the possibility of a significant business setback because of a deception, investors have a right to argue that they paid too much for the stock. The SEC can seek to encourage fuller disclosure of such risks by bringing enforcement cases when companies mislead investors about the extent of a risk.

That is not to say that ESG securities fraud cases do not raise special complications for courts and regulators. An important difference between ESG issues and more traditional business matters is that there is a clearer expectation that corporate managers are monitoring traditional business risks. Overseeing the development of a major product is a core area of concern to an organization and we can expect that high-level corporate officers will be aware

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[8] *See, e.g.*, Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation* (May 26, 2022), https://ssrn.com/abstract=4140444; ELISA MENDOZA & JEFFREY LUBITZ, EVENT-DRIVEN SECURITIES LITIGATION: THE NEW DRIVER IN CLASS ACTION GROWTH 2 (2020) (observing that "the trend of event-driven litigation is rising each year, while the more traditional accounting-based allegations are on the decline."); John C. Coffee, Jr., *It was the Best of Times, It was the Worst of Times*, THE CLS BLUE SKY BLOG (March 19, 2018) (noting in discussing "event-driven" class actions that "an adverse effect (whether a criminal misdeed or harmful side effect) can be the basis for a securities fraud class action" but that "cases filed in 2017 push the envelope on this principle to its limit.").

[9] Bloomberg columnist Matt Levine has often highlighted examples of cases that may push the boundaries of the concept of securities fraud. *See* Matt Levine, *Everything Everywhere is Securities Fraud*, BLOOMBERG OPINION (June 26, 2019), www.bloomberg.com/opinion/articles/2019-06-26/everything-everywhere-is-securities-fraud.

[10] Concerns about the redundancy of securities law remedies for misleading disclosure about corporate scandals are longstanding. *See, e.g.*, Bevis Longstreth, *SEC Disclosure Policy Regarding Managerial Integrity*, 38 BUS. LAW. 1413, 1425 (1983) (noting that adding "a securities law violation to the substantive violation" could exceed the SEC's authority).

[11] One question is why shareholders should receive compensation for such disasters when so many others have suffered direct harm. *See* Donald C. Langevoort, *Disasters and Disclosures: Securities Fraud Liability in the Shadow of a Corporate Catastrophe*, 107 GEO. L.J. 967, 970 (2019).

of setbacks that increase the risk of failure. When ESG matters were not a central concern of public companies, it was more difficult to argue that corporate managers were aware of such risks and essentially deceived investors about them. However, as it has become clear that ESG risks can affect corporate value, there is a stronger case that corporate managers should be accountable for assessing such risk. At the same time, courts should be careful not to assume that corporate managers are able to comprehensively monitor all types of corporate ESG risks.

Courts have not yet developed a coherent approach to analyzing ESG cases. They tend to engage in opaque analysis that is heavily fact-specific in assessing whether an ESG securities fraud lawsuit meets the elements of a Rule 10b-5 cause of action.[12] Many cases turn on whether a company issues statements relating to an ESG risk that are specific enough so that investors can reasonably rely on them. Courts have consistently found that general assurances that a company is a responsible ESG actor are insufficient to establish that a company issued a misstatement that would be material to investors. Such vague statements often fall under the puffery doctrine, which states that rosy statements of optimism should not be taken literally.[13] The problem with this approach is that cases turn on the parsing of corporate statements by courts without a clear test for what is or is not puffery. As a result, similar instances of ESG securities fraud can turn out quite differently depending on the judge.

This Article proposes a different approach to distinguishing between ESG risks that are actionable and those that are not. Relative to product failures, which are fairly common and within the core of a company's business, major ESG events are less common and difficult to accurately predict. In adjudicating ESG securities fraud cases, courts should primarily ask whether a company can calculate reasonably certain probabilities of an ESG risk. If it cannot, then the ESG risk is not sufficiently material to investors under the probability/magnitude test set forth by the U.S. Supreme Court in *Basic v. Levinson*.[14] Under that test, a contingent event is only material for purposes of securities fraud analysis when both the probability of the event occurring and the magnitude of the event are sufficiently high.

A necessary condition for the *Basic* test to apply is that it is possible to generate meaningful probabilities about the contingent event. For example, in the Vale case, there was evidence that Vale had calculated the probability that the dam would collapse and knew that its calculations showed that the dam was riskier than international standards.[15] Its prediction that the collapse would cause 240 deaths was very close to the actual toll.[16] Because the probability of dam collapse was knowable, it would be possible to argue that the ESG risk was material and that Vale's obfuscation of that risk was fraudulent. In contrast,

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[12] These elements include: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." Stoneridge Investment Partners, LLC *v.* Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).

[13] *See, e.g.*, In re Petrobras Sec. Litig., 116 F. Suup.3d 368, 381 (S.D.N.Y. 2015) (discussing puffery doctrine).

[14] Basic Inc. v. Levinson, 485 U.S. 223 (1988).

[15] Sec & Exch Comm'n v. Vale, *supra* note 1, at ¶ 53.

[16] *Id*. at 191.

when meaningful probabilities cannot be generated by a company, when a risk is essentially unknowable, securities fraud liability relating to that risk should not be triggered.

The probability/magnitude approach recognizes that the key question in an ESG securities fraud case is whether there is a significant asymmetry of information between corporate managers and investors. In some ESG cases, management will not be able to predict a potential ESG disaster. If that is the case, it is difficult to conclude that the corporate executives deceived investors given that they did not know more than those investors.[17] In contrast, when the probability of risk is known, a corporation's disclosures should be forthright about such a risk and to the extent that disclosures deliberately downplay such risk, there could be a case of securities fraud.

Developing a coherent approach for evaluating ESG securities fraud cases is especially important as the SEC increases mandatory disclosure requirements of ESG information.[18] One of the criticisms of such mandates is that they will increase the number of securities class actions that are filed against public companies.[19] The more disclosure a company is required to issue, the more opportunities for plaintiffs to argue that such disclosure was materially misleading. The probability/magnitude test can be used as a way of limiting the costs of such litigation by assisting courts in more easily separating good cases from bad. It is only when the probability of an ESG event can be meaningfully calculated by a corporation and its managers that misstatements about such ESG risk can be actionable. Even if disclosure mandates increase litigation costs, those costs should be manageable if the courts are careful to distinguish between material and immaterial risks.

As demands for ESG disclosure proliferate, it is natural that expectations that public companies assess ESG risk will also increase. Because ESG scandals can fundamentally change a company's prospects, it is important to create incentives for corporate managers to be forthright when communicating their views with respect to ESG risk. To the extent that companies are able to generate meaningful probabilities of ESG events, they should be held accountable when their public portrayals substantially diverge from their internal analysis.

Part I of the Article begins by analogizing ESG securities fraud to cases where a company deceives investors about the risk of a product failure. Part II describes the current approach taken by courts in adjudicating ESG securities fraud cases. Part III argues that the primary consideration in assessing such cases is whether it is possible to generate reasonable probabilities relating to the ESG risk. Part IV discusses some of the implications of this Article's approach for securities fraud doctrine and enforcement.

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[17] There are doctrines that recognize that misrepresentations are not material if there is no asymmetry of information between investors and managers. *See, e.g.*, In re Stac Elecs. Sec. Litig., 89 F.3d 1399, 1409 (9th Cir. 1996) (discussing truth-on-the-market defense).

[18] Most notably, the SEC is considering new disclosure rules relating to the risks associated with climate change. *See* Sec. & Exch. Comm'n, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11042; 34-94478, at 388 (March 21, 2022).

[19] *See, e.g.*, *id*. at 388 (noting concern that "the proposed rules may result in additional litigation risk since the proposed climate-related disclosures may be new and unfamiliar to many registrants."); Abigail Gampher, *ESG Litigation – Poised for an Increase?*, BLOOMBERG LAW (June 14, 2022), news.bloomberglaw.com/bloomberg-law-analysis/analysis-esg-litigation-poised-for-an-increase.

I. SECURITIES FRAUD AND RISK

The failure to adequately disclose the risk of an ESG crisis is in many ways similar to the failure to adequately disclose the risk that an important corporate product will fail to generate the revenue that was expected by the company. Courts have recognized that such product failure cases are actionable under Rule 10b-5 and such cases often survive dismissal and result in significant settlements. Product securities litigation often raises the question of whether managers knew of a high risk that a product would not work but misrepresented that risk to investors. In contrast, ESG securities fraud cases ask whether managers essentially knew that there was a high risk of an ESG scandal but issued statements that downplayed such risk. The difference between these two theories is that the risk of product failure is more common and there is an expectation that competent managers will monitor such risk. ESG risk is often more difficult to calculate and until recently has not been viewed as a core issue of managerial concern.

A. Securities Fraud and Product Failure

Companies that are public in that they have stock that can be traded by public investors are held to higher regulatory standards than private companies whose stock is owned by a few sophisticated investors. Public companies must disclose information about their business and financial condition on a quarterly basis.[20] Such disclosure must be truthful. Statutes and rules permit the SEC to bring suit if it believes that there is a material misrepresentation in the company's public disclosures.[21] The most significant sanctions tend to be reserved for misstatements that are issued with an intent to deceive investors.[22] Private investors may also bring suit under Rule 10b-5 when there is proof of such fraudulent intent.

Public corporations have incentives to issue material misrepresentations to convince investors that their financial performance is improving. Strong performance often translates into a higher stock price, which permits the corporation to raise funds on more favorable terms and increases its ability to acquire other companies.[23] They also have an incentive to issue material misrepresentations to hide the possibility that their financial performance will decline. The risk of a substantial setback would result in a lower stock price, which reduces the resources available to the company and increases the risk of a change in control. A common allegation in securities fraud cases is that corporate managers portrayed a product they were developing as promising while obscuring a substantial risk that the product would fail. Investors will argue that if they had known the risk of the product failure, they would have paid less for the stock.

Securities fraud cases arising out of product failure became common during the 1980s, when investors began to frequently file securities class actions against companies that

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[20] This periodic reporting requirement is set forth in Section 13 of the Securities Exchange Act. Quarterly reports are filed on Form 10-Q and Annual reports are filed on Form 10-K. Interim reports of certain events must be filed on Form 8-K.

[21] The SEC can bring suit under Section 10(b) of the Securities Exchange Act of 1934 and its implementing rule, Rule 10b-5, which prohibit fraud in connection with the purchase or sale of securities. It also often brings suit under Section 17 of the Securities Act of 1933, which prohibits fraud in connection with the sale of securities.

[22] Such cases are typically brought pursuant to SEC Rule 10b-5.

[23] A high stock price also benefits individual managers who see the value of their stock holdings rise.

were developing computers and related technologies.[24] Entrepreneurs in the computer industry formed public companies that often focused on developing a single product. Because of the willingness to speculate on the success of computer technology, the market value of such companies was often significant. If the product was not successful, the stock price of the company would collapse as prior market expectations that the product would generate revenue were not fulfilled. Investors would argue that corporate managers knew that the product was headed for failure but failed to warn markets.

For example, before it became the world's most valuable company, Apple was a newly public company with a market value of over $1 billion because of the success of its Apple II personal computer.[25] In order to justify its stock price, which anticipated that it would continue to develop new products, Apple needed another hit. It bet heavily on the development of a computer that would be sold for office use, the Lisa.[26] In the lead-up to the product launch, it made specific claims that the Lisa would have a high-performance disk drive.[27] It implied that the drive was essentially finished and had been subject to extensive testing. It stated that the computer's drive represented "three years of research and development and has undergone extensive testing and design verification during the past year."[28] In fact, at the time that Apple made this statement, the drive was not yet functional and there was significant pessimism within the company that the drive would ever work.

As it became clear that the Lisa was a commercial failure, and it had to replace the computer's disk drive because of its high failure rate, Apple's stock price lost a significant percentage of its value. Investors sued under Rule 10b-5. They raised a number of arguments, including the claim that Apple had withheld information that there was a high risk that the drive would fail. In response, Apple responded that it had acted in good faith to complete the drive but that as with many new technologies, the product had not come together in the end.

For Apple's conduct to be securities fraud, investors would have to show that Apple both represented that there was little risk that the drive would fail while essentially knowing there was a substantial risk that it would not work. Just as Vale would be liable if it represented that its dam was in little danger of collapse while knowing of a high risk of collapse, Apple's guilt depended on whether its knowledge of a risk diverged from its public statements about the risk. The Ninth Circuit Court of Appeals held that there was sufficient

[24] For an overview of the history of public company securities fraud and its regulation, see JAMES J. PARK, THE VALUATION TREADMILL: HOW SECURITIES FRAUD THREATENS THE INTEGRITY OF PUBLIC COMPANIES (2022).

[25] *See* MICHAEL MORITZ, RETURN TO THE LITTLE KINGDOM: HOW APPLE AND STEVE JOBS CHANGED THE WORLD 276 (1984).

[26] *See* BRENT SCHLENDER & RICK TETZELI, BECOMING STEVE JOBS 71 (2015); OWEN W. LINZMATER, APPLE CONFIDENTIAL 2.0: THE DEFINITIVE HISTORY OF THE WORLD'S MOST COLORFUL COMPANY 115 (2004).

[27] *See* FRANK ROSE, WEST OF EDEN: THE END OF INNOCENCE AT APPLE COMPUTER 60 (1989) (describing importance of high performance drive in Lisa).

[28] In re Apple Computer Sec. Litig., 672 F. Supp. 1552, 1565 (N.D. Cal. 1987).

evidence for the case to go to trial,[29] and a jury found two of Apple's executives liable for $100 million.[30]

Adjudicating a company's true knowledge of a risk can generate high litigation costs. It is difficult to determine the knowledge of managers of a complex corporate bureaucracy where there are differing opinions and viewpoints and information flows are not perfect. A plaintiff will have the right to request all documents, including e-mails, that relate to a corporation's assessment of a risk. Company managers will face extensive depositions seeking to establish their state of mind about the development of the product. Inquiries into states of mind are often inconclusive because they rely on circumstantial evidence of intent and such inquiries necessarily are conducted years after the relevant events. Courts may be reluctant to decide the issue on a motion to dismiss or motion for summary judgment and so the case will be decided by what the defendant perceives as an unpredictable jury.

There is an argument that the costs of such discovery are often not justified by the benefits of potentially finding evidence of a securities fraud. If in a high percentage of cases, corporate managers did not have knowledge of the risk of product failure, requiring companies to expend significant amounts to defend managerial decisionmaking might not be justified. Congress in 1995 thus passed the Private Securities Litigation Reform Act based on the premise that the costs of securities litigation were greater than its benefits.[31] Rather than eliminate securities class actions, the statute imposed procedural limits on their filing, notably requiring that plaintiffs produce specific allegations at an early stage of the case that the defendants acted with a fraudulent state of mind for a case to proceed to the discovery phase.[32] Issuing misleading statements about the risk of failure will not trigger liability if they reflected mistakes, they must be part of an effort to deceive investors.

The meaning of this provision was tested in a case that illustrates the expectation that corporate managers monitor the risk of product failure. In its 2007 *Tellabs* decision,[33] the U.S. Supreme Court considered the question of the plaintiff's burden of establishing fraudulent intent in the context of a securities class action arising out of poor product sales that impacted a company's earnings. The defendant in that case was the manufacturer of equipment for telecommunications networks.[34] After it revealed that demand for its flagship product was not as strong as previously projected, the company's stock price fell from a high of $67 to a low of $15.87.[35] Plaintiffs then brought a suit against the company alleging securities fraud under Rule 10b-5.

The main issue was whether the company's high-level corporate managers were aware that their prior statements of optimism about the product were incorrect.[36] As Judge

[29] *In re* Apple Computer Sec. Litig., 886 F.2d 1109 (9th Cir. 1989).

[30] That verdict was overturned on procedural grounds, but the high damages award was widely noted by technology companies. *See* PATRICK DILLON & CARL M. CANNON, CIRCLE OF GREED 197 (2010).

[31] Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737.

[32] *See* 15 USC §78u-4(b)(2) (requiring that plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

[33] Tellabs Inc. v. Major Issues & Rights Ltd., 551 U.S. 308 (2007).

[34] *Id*. at 316.

[35] *Id*.

[36] The Supreme Court also provided guidance on the legal standard for determining whether a complaint pleaded a "strong inference of fraudulent intent." It held that in determining whether a complaint

Richard Posner explained after the Supreme Court remanded the case for more factual findings, one possibility was that management was just as surprised as investors about the product's poor performance.[37] Lower-level employees may have failed to convey information to managers that the product's sales were flagging. If that was the case, the management claims that the product's performance was strong would have reflected a mistaken miscommunication within the organization rather than a deceptive scheme. But Judge Posner rejected this explanation as unlikely. Given the admitted centrality of the product and its revenues to the company's business, it was reasonable to conclude that the company's top executives would have kept close tabs on developments about its performance.[38] There was thus sufficient evidence that the managers knew of the risk that the product's performance would decline and thus misled investors when they conveyed that the product's performance would be strong.

The prevalence of product failure as an issue that triggers securities fraud cases is evidenced by the frequency with which investors file securities fraud product claims against life sciences companies.[39] The drugs and medical devices that such companies develop typically go through extensive review by the Food and Drug Administration. What seems like a promising treatment may fail such review, either because its effectiveness was not proven or because of the discovery of side effects, leading to a substantial adjustment of the company's stock price. Investors then allege that corporate managers knew that the product was not viable but continued to represent the product as a potential success. While such cases can have questionable merit, they show how the risk of product failure is accepted as a standard securities fraud theory.

Product failure claims have been made not only in cases against public companies but in a case against a notable private company that raised funds by selling stock to sophisticated investors. In the notorious Theranos fraud, the company's success depended on its aspiration of developing a blood testing machine that could run multiple medical tests on a single drop of blood.[40] The SEC found it implausible that the company's founder and top executives were unaware that they had failed to produce a product that fulfilled the vision it had conveyed to investors and the pharmacy chains that were already using the machine to run tests on consumers.[41] Like Apple decades before, the Theranos defendants argued that

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met this standard, the court should weigh any allegations negating such intent against allegations supporting an inference of such intent. The court would have to dismiss a complaint if the allegations negating the inference of intent were more persuasive than the allegations supporting the inference of intent. *See id*.

[37] Makor Issues & Rights Ltd. v. Tellabs Inc., 513 F.3d 702 (7th Cir. 2008).

[38] Some courts have interpreted this language as establishing a "core operations" doctrine where misstatements relating to a company's important operation are more likely to be made with scienter. *See, e.g.*, Michael J. Kaufman & John M. Wunderlich, *Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation*, 73 OHIO ST. L.J. 507 (2012) (discussing doctrine and its limitations).

[39] *See, e.g.*, Eric Schmid, *Fraud of Confusion: A Pill for Chronic Securities Litigation in the Life Sciences Sector*, 61 B.C. L. REV. 1899, 1900-01 (2020) (noting that 20 percent of securities class actions in 2017 were filed against life sciences companies). The Supreme Court has often heard Rule 10b-5 cases involving such life sciences companies. *See, e.g.*, Amgen, Inc. v. Conn. Retirement Plans & Trust Funds, 568 U.S. 455 (2013); Merck & Co. v. Reynolds, 559 U.S. 633 (2010).

[40] For an excellent overview of the scandal, see JOHN CARREYROU, BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP 30 (2019).

[41] Sec. & Exch. Comm'n v. Holmes and Theranos, Inc., Complaint, Case No. 5:18-cv-01602 (March 14, 2018).

they genuinely believed that they would succeed in meeting their goals. But regulators and two juries concluded that the prospects for the product were so bleak that Theranos's management could not have believed their statements predicting its success.[42]

B. Predicting ESG Risk

A product failure is essentially a form of business failure. ESG problems can also be viewed as business failures to the extent that they affect a company's financial performance. An ESG scandal can drive away customers, destroy employee morale, and trigger harsh regulatory penalties. They can effectively have the same economic impact as the failure of a product, which could reduce the company's credibility with customers and affect the company's ability to attract talent. When an ESG event has a substantial impact on a company's market value, misleading the market about potential ESG risks could be actionable under Rule 10b-5 under a similar theory as the failure to adequately warn of the risk of a product failure. However, ESG securities fraud cases are not quite the same as product failure cases. Part of the reason why product failure cases have had some success is that they relate to a particular risk rather than just a general business risk. While public corporations and their management can be expected to have a comparative advantage in assessing whether a product will fail,[43] it is less clear that they can predict when an ESG problem will arise.

When an ESG scandal or disaster occurs, a company can argue that it was just as surprised as investors. For example, in discussing an ESG case against British Petroleum (BP) that arose out the explosion of its Deepwater Horizon rig, one prominent commentator observed that "it might be doubted that BP knew that the Deepwater Horizon was likely to explode or that it acted with scienter to conceal this remote risk."[44] In the Vale case, the company might argue that it was also surprised by the failure of the dam (though that argument might not be convincing as discussed below). The probability of collapse was so low that corporate managers could not have predicted that the dam would fail at the time that it did. For a large company with sprawling global operations, there are dozens if not hundreds of places where a disaster could take place. Investors would be overwhelmed with information if they received disclosure warning that there is a risk of an environmental disaster at each and every one of a company's facilities.

Another area of ESG litigation has arisen out of cyber attacks where customer data is stolen from a company, triggering regulatory action and reputational harm.[45] Efforts by hackers to attack and compromise a company's computer systems are widespread and it is difficult to predict when severe breaches will occur and what their impact will be. Inevitably, there will be some failures of security systems that could result in shareholder losses. The

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[42] *See, e.g.*, Heather Somerville, *Theranos's Ramesh 'Sunny' Balwani Found Guilty on All 12 Fraud Counts*, WALL ST. J., July 7, 2022; Sara Randazzo, et al., *The Elizabeth Holmes Verdict: Theranos Founder is Found Guilty on Four of 11 Charges in Fraud Trial*, WALL ST. J., Jan. 3, 2022.

[43] For an argument that managers generally have an informational advantage over investors, see Michael Simkovic, *Limited Liability and the Known Unknown*, 68 DUKE L.J. 275, 270-80 (2018).

[44] Coffee, *supra* note 8; *see also* MENDOZA & LUBITZ, *supra* note 8, at 2 (asserting that "[n]o one can foresee a catastrophic event occurring or witness what goes on behind the closed doors of a publicly traded company or know that a data breach is occurring until after the event has occurred and been exposed.").

[45] For an overview of this issue, see Sec. & Exch. Comm'n, Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release Nos. 33-10459; 34-82746 (Feb. 21, 2018).

question is whether a company that was the victim of such an attack should have issued specific disclosures relating to the particular risk of the attack that harmed the company. It can be difficult to construct such disclosures because of the rapid evolution of cyber threats. Moreover, because cyber security is a technical subject, it is an area that will be difficult for generalist managers and boards of directors to monitor effectively. It is thus less likely that corporate managers will have particular knowledge that a company is particularly vulnerable to a cyber attack, making it difficult to establish corporate liability for securities fraud.

ESG cases often relate to regulatory enforcement that imposes significant penalties on a company that spur a stock price decline. Anticipating the risk of enforcement requires that corporate managers are both aware of wrongdoing within the company as well as the probability that government agencies will bring a substantial enforcement case. With respect to wrongdoing, unless high level managers are involved, it can be difficult to detect violations within a large organization. Even when there is an investigation, there is no guarantee that the enforcer will actually bring a case.[46] The company will often vigorously defend its actions in the hope of persuading the enforcer not the bring a case, and a disclosure acknowledging the merit of a possible investigation could undermine that effort. Adding the secrecy and unpredictability of the decision-making process by government actors makes it challenging to clearly define when a corporation misleads investors by failing to acknowledge the possibility that it will be subject to regulatory action.[47]

ESG fraud on its surface resembles standard Rule 10b-5 cases that arise out of product failures. But because ESG scandals are difficult to predict, it is challenging to determine when the failure to squarely acknowledge the risk of an ESG scandal in advance is fraudulent. Without an adequate assessment of whether a risk was known, ESG securities fraud cases would resemble a form of strict liability that makes every corporate failure a securities fraud.

II. THE LAW OF ESG SECURITIES FRAUD

In deciding ESG securities fraud actions, courts have developed a number of doctrines to identify those cases where managers deceived investors about ESG risks. In doing so, they have struggled to find a principled approach to assessing whether a company has issued a material misstatement relating to an ESG matter. Most decisions depend on somewhat arbitrary distinctions about the content and specificity of corporate statements. Decisions in many cases appear to be motivated primarily to limit private securities litigation and do not do enough to meaningfully define the boundaries of ESG securities fraud.

A. Puffery

One of the difficulties of bringing an ESG securities fraud case is identifying a clear misstatement by the corporation. The failure to disclose an ESG risk by itself is not

[46] Richman v. Goldman Sachs Group, Inc., 868 F.Supp.2d 261, 274 (S.D.N.Y. 2012) (finding that receipt of Wells Notice was insufficient to put company on warning that it would be subject to regulatory action because prior Wells Notices had not resulted in a suit).

[47] On the complexity of decisions to disclose government investigations, see David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 BUS. LAW. 973 (2009).

actionable as securities fraud because there is no general duty to disclose material information.[48] The plaintiff will thus need to find affirmative statements that materially misrepresent the ESG risk. Even if it does not have a general obligation to issue statements on ESG matters, a company may do so if there is a specific provision of the securities laws that requires disclosure or the company voluntarily issues specific information on the risk. But if there are no specific statements by the company denying that there is an ESG risk, it can be difficult for a plaintiff to establish the requisite material misrepresentation necessary for a securities fraud violation.

When there are not statements specifically denying an ESG risk, a common strategy is to point to general statements by the company that it is committed to high ESG standards. Companies routinely claim publicly that they have strong cultures of compliance and ethics.[49] For example, a company may assert that it is committed to safety in the workplace. The plaintiff could argue that an accident that harms workers shows that the statement was false. Another example would be a company that claims its culture is ethical but then becomes embroiled in a government investigation for regulatory violations. A corporation that touts its rigorous measures to prevent cyber breaches could be accused of misrepresentations when such a breach actually occurs and exposes weaknesses in that system.[50]

Courts often reject ESG claims when they are based mainly on such broad statements of ESG compliance. They will often apply the longstanding puffery doctrine, which instructs that some statements cannot be the basis for a fraud claim because they are not meant to be literally true. Such statements may be too imprecise to be considered a misrepresentation with respect to an actualized risk. Alternatively, statements that are not understood to be literally true would not be material to an investor.[51] A customer cannot win a fraud claim

[48] This point has been well-established in the caselaw. *See* Basic v. Levinson, 485 U.S. 224, 239 n.17 (1988); In re Time Warner Sec. Litig., 9 F.3d 259, 267 (2d. Cir. 1993); *see also* Langevoort, *supra* note 11, at 971 (noting that there is no general duty to disclose material information "for a host of doctrinal, pragmatic, and political reasons. . . ."). As one court recently explained, "[w]hile society may have become accustomed to being instantly in the loop about the latest news (thanks in part to Twitter), our securities laws do not impose a similar requirement. . . . companies do not have an obligation to offer an instantaneous update of any internal developments, especially when it involves the oft-tortuous path of product development." Weston Family Partnership LLP v. Twitter, Inc., 29 F.4th 611, 620 (9th Cir. 2022). The court explained that such a duty to disclose "would inject instability into the securities markets, as stocks may wildly gyrate based on even fleeting developments." At the same time, courts have recognized more limited versions of a duty to disclose. For example, the issuance of statements that are incomplete can trigger a duty to disclose a more complete statement. *See, e.g.*, Meyer v. Jinkosolar Holdings Co., 761 F.3d 245, 250 (2d Cir. 2014).

[49] Even Enron famously had a code of ethics.

[50] As one court noted, "the SEC advises companies against ''mak[ing] detailed disclosures that could compromise [their] cybersecurity efforts—for example, by providing a 'roadmap' for those who seek to penetrate a company's security protections.'" Construction Laborers Pension Trust for Southern California v. Marriott Inter., Inc., 31 F.4th 898, 905 (4th Cir. 2022) (quoting SEC Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. 8166, 8169 (Feb. 26, 2018)). On the other hand, the SEC more recently noted that "academic research so far has not provided evidence that more detailed cybersecurity disclosures would lead to more attacks." *See, e.g.*, Sec. & Exch. Comm'n, Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release Nos. 33-10459; 34-82746, at 75 (Feb. 21, 2018).

[51] *See, e.g.*, *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016) (holding that statements in a company's Annual Report about its commitment to ethics and integrity were not actionable due to their

against a pizza parlor that advertises its pizza as the "best in the world" because a reasonable customer would not believe that the statement must be true. The statement would thus not be a misrepresentation and would also not materially affect the investor's decision. In an example of the application of puffery in the securities law context, a federal appellate court found that a corporate statement by the auto manufacturer Ford on its "commitment to quality, safety, and corporate citizenship" was not made misleading by a major tire recall.[52] The court also concluded that "[s]uch statements are either mere corporate puffery or hyperbole that a reasonable investor would not view as significantly changing the general gist of available information, and thus, are not material, even if they are misleading."[53] The courts have also rejected claims directed at statements on issues ranging from a commitment to comply with regulations, general codes of ethics, and commitments to protect customer information.[54]

A securities fraud plaintiff might respond that the puffery doctrine is misguided because the reasonable investor will believe and rely upon general statements about a commitment to ESG standards.[55] This is a plausible argument. Why shouldn't companies be held to statements that they are ethical and are committed to safety? Shouldn't investors be able to rely on these commitments and wouldn't they pay less for a stock if they knew the truth?[56]

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generality "preventing them from rising to the level of materiality required to form the basis for assessing a potential investment").

[52] *In re* Ford Motor Co. Sec. Litig., 381 F.3d 563, 570 (6th Cir. 2004); *see also* City of Monroe Employees Retirement System v. Bridgestone Corporation, 399 F.3d 651 (2005) (finding statements too vague to support securities fraud case arising out of tire recall).

[53] *Id*; *see also* Longman v. Food Lion, 197 F.3d 675, 685 (4th Cir. 1999) (noting that statement that company's stores were "clean and conveniently located" were "the kind of puffery and generalizations that reasonable investors could not have relied upon when deciding whether to buy the stock.").

[54] *See, e.g.*, Singh v. Cigna Corp., 918 F.3d 57 (2d Cir. 2019) (finding that "statements in Cigna's Code of Ethics are a textbook example of 'puffery.'); Employees' Retirement Sys. v. Whole Foods Market, 905 F.3d 892, 902 (5th Cir. 2018) (finding that "generalized statements about Whole Foods' transparency, quality, and responsibility are the sort of puffery that a reasonable investor would not rely on."); Retail Wholesale & Department Store Union Local 328 Retirement Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1276 (9th Cir. 2017) (finding that code of ethics was aspirational); Indiana State District Council of Laborer v. Omnicare, 583 F.3d 935 (6th Cir. 2009) (finding that representation about compliance with Medicare rules was too vague); Metzler Investment GMBH v. Corinthian Colleges, Inc., 540 F.3d 1049, 1070 (9th Cir. 2008) (noting that plaintiff's explanation for falsity of statements relating to financial health of for-profit colleges was "decidedly vague."); In re First American Financial Corp., CV 20-9781, at *9 (C.D. Cal. Sept. 22, 2021) (finding that statement that a company was "committed to safeguarding customer information" was puffery); Construction Laborers Pension Trust for Southern California v. CBS Corp., 435 F.Supp.3d 515, 532 (S.D.N.Y. 2020) (finding that code of ethics was too broad to be misleading); *In re Braskem S.A. Securities Litigation*, 246 F. Supp. 3d 731, 754-56 (S.D.N.Y. 2017) (holding code of ethics was aspirational).

[55] A number of scholars have found evidence that ordinary investors would rely upon statements that courts have classified as puffery. *See, e.g.*, David A. Hoffman, *The "Duty" To Be a Rational Shareholder*, 90 Minn. L. Rev. 537 (2006); Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. Pa. J. Bus. & Employ. L. 339 (2008).

[56] To the extent that puffery doctrine is based on the opinion-like nature of statements, the Supreme Court's decision in Omnicare provides a stronger basis for scrutinizing opinions. *See* James D. Cox, *"We're Cool" Statements After Omnicare: Securities Fraud Suits for Failure to Comply with the Law*, 68 SMU L. REV. 715, 718-19 (2015).

The reason for dismissing claims based on statements of puffery can be better justified on the ground that making such broad statements actionable would mean that virtually every ESG event could trigger a securities fraud suit. Corporate managers cannot fairly anticipate every possible problem. Not applying the puffery doctrine would mean that virtually every setback could support a Rule 10b-5 claim. Investors cannot reasonably believe that a general statement of compliance will mean that a corporation will never face a compliance issue or scandal. They should discount public company stocks to some extent because of the risk of bad decisions that could be viewed as inconsistent with broad commitments to ethics and corporate responsibility.

Plaintiffs have been more successful when they are able to point to specific ESG statements that are misleading.[57] For example, in a case involving the collapse of a dam in Brazil (a different one than the one that collapsed in the Vale case), a district court found that repeated assurances about the safety of the dam in response to specific concerns were misleading when they did not reveal an ESG risk.[58] In adjudicating ESG securities fraud cases relating to cyber security cases, plaintiffs tend to be most successful when they point to the falsity of specific assurances by a company that it had implemented particular measures to address cyber security risk.[59]

A court found that statements relating to safety in a sustainability disclosure by the energy company British Petroleum (BP) were actionable under Rule 10b-5 because they were meant to address investor concerns after prior accidents.[60] After a number of problems at its oil rigs, BP made efforts to regain investor trust in its commitment to safety. It thus commissioned internal reforms and made specific positive statements about its "progress in process safety as measured against the metrics" set forth in an earlier report that had

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[57] *See, e.g.*, In re Signet Jewelers Ltd. Sec. Litig., 389 F.Supp.2d 221, 231 (S.D.N.Y. 2019) (finding that assurances that culture was not toxic were sufficiently specific and "a reasonable investor – who otherwise would be concerned about how grave allegations concerning rampant sexual misconduct might affect her investment in Signet – took Defendants at their work."); In re Equifax Inc. Sec. Litig., 357 F.Supp.3d 1189, 1224 (N.D. Ga. 2019) (concluding that while "the alleged statements, when viewed in isolation, might constitute puffery, the fact that they were made repeatedly to assure investors that Equifax's systems were secure could lead a reasonable investor to rely upon them as reflecting the state of Equifax's cybersecurity."); Edgar v. Anadarko Petroleum Corp., Civ. Action No. H-17-1372, 2018 U.S. Dist. LEXIS 101780 (S.D. Tex. 2018) (finding that an affirmative statement regarding a company's compliance with laws and regulations, included in its Health, Safety, Environmental, and Sustainability Overviews, were sufficiently specific to be actionable); *see also* Construction Laborers Pension Trust for Southern California v. CBS Corp., 435 F.Supp.3d 515, 532 (S.D.N.Y. 2020) (describing "rare circumstances" where "courts have allowed statements in a code of conduct to survive a motion to dismiss, holding that under the unique circumstances of the case, the statements could be viewed as material statements of fact.").

[58] *See, e.g.*, In re BHP Billton Ltd. Sec. Litig., 276 F.Supp.3d 65, 80 (S.D.N.Y. 2017) (noting that "even if some of the statements are general enough that, had they been made in isolation, they might not be actionable, we cannot ignore the fact that defendants allegedly made these representations about BHP's commitment to safety over and over and over."); see also *In re Petrobas Sec. Litig.*, 116 F. Supp. 3d 368, 381 (S.D.N.Y. 2015) (concluding that even though isolated statements about reputation, integrity, and compliance can be mere puffery, where such statements are made repeatedly and in an effort to reassure investors about a company's integrity, "a reasonable investor could rely on them as reflective of the true state of affairs at the company.").

[59] *See, e.g.*, In re Zoom Sec. Litig., No. 20-cv-02353-JD, 2022 WL 484974, at *3 (N.D. Cal. Fed. 16, 2022) (concluding that claim that company provided "end-to-end encryption" was actionable); In re Solarwinds Corp. Sec. Litig., 1:21-CV-138-RP, 2022 WL 958385 (W.D. Tx. March 30, 2022).

[60] *In re* BP p.l.c. Sec. Litig., 843 F. Supp.2d 712 (S.D. Tex. 2012).

measured its safety measures.[61] Investors argued that these statements were false and hid the risky practices that resulted in the explosion of the Deepwater Horizon oil rig, which caused billions of dollars in environmental damage and resulted in a 48 percent decline in BP's stock price. Rather than arguing that a general commitment to safety was misleading, the plaintiffs successfully argued that more specific statements that were meant to address particular investor concerns were misleading.

The specificity of a company's statements on an ESG issue may indicate that the issue is of particular importance to investors and that the reasonable investor would rely on that statement in assessing that particular risk. When a company specifically addresses an issue in its public communications, that could be evidence that corporate managers know that a risk could affect the company's valuation. Their failure to adequately disclose such a risk could support an inference that they did so because they feared that investors would have an adverse reaction to a forthright disclosure.

On the other hand, it is unclear why the specificity of company statements should be the primary focus of courts in assessing whether there is a material misrepresentation to investors. A rigid requirement that a company issue statements on a particular ESG risk may unfairly immunize companies from securities fraud scrutiny when they obscure substantial risks to investors. There may be cases where investors should be permitted to rely on general assurances about a company's ethics and commitment to social responsibility. Otherwise, such disclosures would be effectively meaningless. Moreover, it is difficult to assess how specific a statement must be to avoid classification of puffery. ESG securities fraud cases often turn on extensive factual analysis that requires judges to search the record and make a determination about the specificity of a corporate statement.[62] Courts may stretch to find specificity when a crisis is particularly severe at a company. They may also characterize company disclosures as general and vague when they view an ESG event as minor. As a result, ESG securities fraud cases may turn on arbitrary determinations of particular district court judges.[63]

B. Risk Disclosure

In some ESG cases, a company issues a disclosure warning of the risk of an ESG event, and the plaintiff alleges that at the time that the company made the risk disclosure, the ESG risk had already been actualized. In its 2019 case against the social media company Facebook, the SEC alleged that "Facebook misleadingly presented the potential for misuse of use data as merely a hypothetical investment risk" when in fact it knew that "a researcher had, in violation of the company's policies, transferred data relating to approximately 30 million Facebook users to Cambridge Analytica."[64] A disclosure that describes a potential

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[61] *Id*. at 757.

[62] *See, e.g.*, Hemel & Lund, *supra* note 7, at 1654 (concluding that "the viability of securities law claims against companies that fail to disclose the extent of sexual misconduct will be case specific.").

[63] *See, e.g.*, Langevoort, *supra* note 11, at 972-93 (comparing differing results in cases and asking if "wordplay" should be determinative).

[64] *See* Sec. & Exch. Comm'n v. Facebook, Inc., Complaint, 3:19-cv-04241, at ¶ 6 (N.D. Cal. July 19, 2019). The case was settled for $100 million. In contrast, Facebook won dismissal of a securities class action alleging that the company made misleading statements about its privacy policies on the ground that it was unclear that the risk had materialized. *In re* Facebook Inc. Sec. Litig., 405 F. Supp.3d 809, 842 (N.D. Cal. 2019).

risk to the business without revealing that the risk is in the process of actually occurring seems misleading.[65] But courts have differed in how they treat these cases. Some courts conclude that a risk disclosure cannot be misleading because it provides investors sufficient warning about the risk that allows them to take that risk into account in their decisionmaking. Other courts have held that the company should have provided additional disclosure that the risk had become real because investors would take that into account in valuing the stock.

Public companies are required to file disclosures with the SEC on significant risks to their business.[66] They also have an incentive to make cautionary statements about their statements regarding their future performance in order to qualify for a safe harbor that protects them from Rule 10b-5 litigation if such predictions are not actualized.[67] Securities regulation encourages risk disclosure to encourage corporations to apprise investors of risk as they make their investment decision.

There are different views on the effectiveness of risk disclosures. One view is that risk disclosure is helpful and should be encouraged. Another view is that risk disclosures are not that useful to investors but are instead just a means of shielding companies from liability. As company risk discussions have become more extensive, it is difficult for investors to distinguish between those risks that are serious and those that are trivial. A boilerplate risk disclosure could make it difficult for stock purchasers to assess whether a risk is merely hypothetical or real.[68]

If the goal is to encourage risk disclosure, then there is reason to avoid imposing liability for misleading risk disclosures. The fact that a risk disclosure is somewhat incomplete would not be materially misleading under this view. Some decisions in the Ninth Circuit imply that a disclosure that risk factors "may" affect the company's financial performance are not misleading even if the risk factors already "are" affecting a company's financial performance.[69] In one case, the Ninth Circuit concluded that a disclosure of risk that "could" impact the repayment of loans "in the future" was not a misrepresentation just because "that risk had already come to fruition."[70]

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[65] The SEC has consistently taken this position. *See, e.g.*, Sec. & Exch. Comm'n v. Mylan N. V., Complaint, Case No. 1:19-CV-2904, at ¶¶ 38-41 (Sept. 27, 2019) (noting that "Mylan misleadingly stated that the company faced merely the risk" that a regulator would find its classification of a drug was "incorrect" when regulator had already taken the position that the "classification . . . was incorrect and asked Mylan to correct the classification").

[66] Regulation S-K, which sets forth guidance on SEC disclosure documents, requires risk disclosures in Item 105.

[67] This safe harbor was passed as part of the PSLRA. It provides that a forward-looking statement cannot give rise to liability as a material misstatement if it is identified as forward-looking and accompanied by a "meaningful cautionary statement." *See* 15 U.S.C. §§ 77z-2, 78u-5 (2012). Risk disclosures would qualify as "cautionary" statements that would provide such liability protection.

[68] *See, e.g.*, Langevoort, *supra* note 11, at 991 (noting that "disclosures can easily devolve into boilerplate, offering a recitation of risks the majority of which an intelligent investor could surmise even without the disclosure.").

[69] *In re* Volkswagen "Clean Diesel" Marketing, Sales Practices, and Products Liability Litig., MDL No. 2672 CRB, Order Granting in Part and Denying in Part Volkswagen's Motion to Dismiss, at 10 (Aug. 20, 2020) (quoting In re LeapFrog Enters., Inc. Sec. Litig., 527 F.Supp. 2d 1033 1048 (N.D. Cal. 2007).

[70] Lloyd v. CVB Fin. Corp. 811 F.3d 1200, 1207 (9th Cir. 2016).

On the other hand, if the worry is that risk disclosures could themselves lull investors into a false sense of security, liability should be permitted in some situations when such disclosures are misleading. Federal courts outside of the Ninth Circuit have made it clear that "under certain circumstances, cautionary statements can give rise to Section 10(b) liability."[71] One court found that a general warning that a company faced "regulatory risk" was misleading when the company "knew or was recklessly ignorant" of violations of New York Stock Exchange rules.[72] The Fourth Circuit U.S. Court of Appeals has held that a "generic warning of a risk will not suffice when undisclosed facts on the ground would substantially affect a reasonable investor's calculations of probability."[73]

The question of whether a risk disclosure is misleading will often require a close analysis of a variety of factors. Courts must assess the extent to which a risk was actualized at the time a risk disclosure was made along with the content of the risk disclosure. Even in the Ninth Circuit, courts have been willing to find that risk disclosures are misleading depending on the context, perhaps reflecting disagreement about a bright-line rule that would completely immunize risk disclosures from Rule 10b-5 scrutiny. For example, a California district court refused to dismiss a Rule 10b-5 class action against Volkswagen that was filed after investors suffered losses in the wake of penalties imposed by U.S. regulators against the company for deliberately rigging its cars to cheat on emissions tests. The court found that while Volkswagen's risk disclosures that acknowledged the possibility of regulatory action were not misleading in isolation, they were misleading when viewed in combination with statements about its commitment to research and development of clean technologies.[74] Some courts have concluded that more nuanced risk disclosures are less likely to trigger liability, even when a risk is brewing, than a generic risk disclosure.[75] Such an approach would encourage companies to go beyond boiler plate in describing risks to investors. As with the puffery doctrine, the question of ESG securities fraud liability will depend on the content of a particular company's disclosure.

C. Scienter

For a misrepresentation relating to an ESG risk to support a claim for securities fraud, it must have been made with fraudulent intent, that is, scienter. If a corporation and its managers mistakenly describe a risk, even if they do so negligently, it would not violate Rule 10b-5.[76] Corporate disclosures cannot be perfect and only misstatements that are meant to deceive investors are actionable as securities fraud. There are two tests that courts typically

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[71] 40 F.Supp.2d 388, 400 (S.D.N.Y. 2005).

[72] *Id*.

[73] Singer v. Reali, 883 F.3d 425, 442 (4th Cir. 2018).

[74] *See, e.g.*, In re Volkswagen Clean Diesel, Fed. Sec. L. Rep. P 99817 (C.C.H.), 2017 WL 3310179, at *8-9 (C.D. Cal. July 19, 2017) (finding risk disclosure misleading in light of other disclosures).

[75] Compare In re Alphabet, Inc. Sec. Litig., 1 F.4th 687, 703-04 (9th Cir. 2021) ("risks that 'could' or 'may' occur" can be misleading when a defendant "knew that those risks had materialized" but only if the disclosures "speak[] entirely of as-yet-unrealized risks and contingencies and do not alert[] the reader that some of these risks may already have come to fruition.") and Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1207 (9th Cir. 2016) (statement that real estate market "could" affect customer ability to pay loans in future was not misleading when "accompanied by information about . . . credit losses and charge-offs" and warning of future writeoffs).

[76] This is a longstanding rule that dates back to the 1970s. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

apply in determining whether corporate managers acted with scienter.[77] The first, which is less relevant in the ESG setting, looks at whether there was a motive and opportunity for a manager to defraud investors. The second asks essentially whether managers acted with a high degree of recklessness.

One complication with determining scienter in ESG securities fraud cases is that it is difficult to establish that an individual corporate officer had the motive and opportunity to deceive investors about ESG risk. In applying this doctrine, courts typically look to whether corporate managers had a personal motive to defraud investors. A general motive to increase or maintain the company's stock price is not sufficient.[78] Plaintiffs often establish motive by showing that managers personally profited in some way through the fraud.[79] In a financial fraud case, this is often established through proof of unusual amounts of insider trading by managers during the period of a fraud.

Unlike a case where corporate managers allegedly inflated the stock price by overstating the company's financial performance, it is more challenging to link ESG securities fraud to a personal gain. Because the risk of a particular ESG event is often small, it is more difficult to make the case that the motive for deceiving investors about ESG risk was to enrich individual corporate executives. Since managers are not completely certain that the ESG risk will be actualized, it seems unlikely that they obfuscated such risk so that they could sell their stock at a higher price. In contrast, when a corporation hits its earnings targets and boosts the stock, that provides a clearer opportunity for managers to sell their stock at an artificially inflated price.

In ESG cases, scienter is usually determined by the second test, which asks whether corporate executives were reckless in that they knew of a high probability of a significant ESG risk but led investors to believe that such risk was trivial.[80] Courts have not developed a clear test for assessing recklessness. As they do in applying the puffery doctrine and assessing risk disclosures, courts tend to apply a case-by-case analysis that tends to focus on the severity of the risk that was not disclosed.[81] They often look to whether there were "red

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[77] *See, e.g.*, Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000). There are some differences among circuits in the test for scienter. For example, the Ninth Circuit only recognizes one way of establishing scienter and requires a high degree of recklessness. *See In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 988 (9th Cir. 1999) (holding that to establish a strong inference of scienter, a complaint must describe "in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misbehavior.").

[78] *See, e.g.*, Kalnit v. Eichler, 264 F.3d 131, 139 (2d Cir. 2001) ("Insufficient motives, we have held, can include (1) the desire for the corporation to appear profitable and (2) the desire to keep stock prices high to increase officer compensation."); Chill v. Gen. Elec. Co., 101 F.3d 263, 268 (2d Cir. 1996) (finding that creating the appearance of investment profit is insufficient).

[79] *See, e.g.*, Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124, 1130 (2d Cir. 1994) (explaining that motive "entail[s] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged.").

[80] *See, e.g.*, Plotkin v. IP Axess Inc., 407 F.3d 690, 697 (5th Cir. 2005) (noting that a securities class action "plaintiff must prove that the defendant either consciously misbehaved . . . or was so severely reckless that it demonstrates that the defendant must have been aware of the danger of misleading the investing public.").

[81] *See, e.g.*, In re BP P.L.C. Sec. Litig., 843 F.Supp.2d 712, 788 (S.D. Tx. 2012) (noting that statement was "reckless, in revealing a much lower spill estimate than BP actually possessed").

flags" that corporate managers knew of but did not respond to.[82] Courts are more likely to conclude that managers knew of a risk when there are enough specific facts to conclude that they were aware of the risk.

While it has brought a significant number of ESG securities fraud cases, the SEC has not provided much guidance on the line between fraudulent and non-fraudulent ESG misrepresentations. It has brought many of its headline ESG enforcement actions using securities law provisions that do not require a showing of fraudulent intent.[83] At the same time, it has insisted on substantial penalty payments to settle such cases,[84] signaling it viewed such corporate conduct as reflecting substantial misconduct. In doing so, the SEC has left the doctrine on fraudulent intent undefined.

III. ASSESSING ESG RISK

The courts have largely taken an ad hoc approach in assessing the merits of ESG securities fraud lawsuits. As noted in the last Part, they have mainly focused on the specificity of corporate statements in screening which cases may proceed past a motion to dismiss.[85] It is difficult, though, to explain why an analysis of specificity is what should determine whether a case involves a likely fraud. This Part proposes a more coherent approach. The key question in ESG litigation is whether the corporation and its managers knew of a ESG risk but deceived investors about it. Such a finding presumes that a particular ESG risk is capable of calculation. The primary question in most ESG securities fraud cases is whether reasonable probabilities of an ESG risk can be generated. If they can be, corporate managers should not mislead investors and downplay the risk. In contrast, public companies should not be liable under Rule 10b-5 when an ESG risk was too uncertain to assess.

A. Materiality and Probability

For a misstatement to trigger liability under Rule 10b-5 and other securities fraud provisions, it must be material -- important to investors in making their decision to purchase a stock.[86] A materiality requirement reflects that securities fraud prohibitions are meant to protect investors. If a misstatement does not impact investors, there is no need to protect them. In the ESG context, the materiality inquiry would ask whether an ESG risk was important enough so that statements that obscured such risk would affect the mix of

[82] *See, e.g.*, In re Van Der Moolen Holding N.V. Sec. Litig., 405 F. Supp.2d 388, 404-405 (S.D.N.Y. 2005) (concluding that managers were reckless in ignoring red flags relating to rule violations).

[83] *See, e.g.*, Sec. & Exch. Comm'n v. Facebook, Inc., *supra* note 110; Sec. & Exch. Comm'n v. Volkswagen, *supra* note 113.

[84] For example, the SEC did not charge Facebook with a violation of Rule 10b-5 but required it to pay a $100 million penalty to resolve the case.

[85] Defendants almost always file a motion to dismiss against a securities class action complaint. Discovery is stayed upon the filing of a motion to dismiss and the PSLRA gives defendants an opportunity to argue that the complaint does not meet a heightened pleading standard. If a motion to dismiss is not granted, it is more likely that a case will settle to avoid the costs of discovery and the risk of a jury trial.

[86] *See, e.g.*, Basic v. Levinson, 485 U.S. 224, 231-32 (1988) (defining information as material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.") (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). The Supreme Court has instructed that the issue of materiality should be determined by a "fact-specific inquiry" with "consideration of the source, content, and context" of the statement. *See* Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 43 (2011).

information about the company available to investors. If an ESG risk is trivial, then misleading investors about the risk would not be actionable under Rule 10b-5.[87]

Determining materiality for a contingent event, one that may or may not occur, is particularly challenging. Even if an event could have a catastrophic impact on a company, if it is extremely unlikely to occur, it is unlikely to be material for investors. It would not be useful for a public corporation to warn investors of every possible serious ESG event that might occur, no matter how improbable. Disclosures are meant to be summaries that are accessible to investors rather than an incomprehensible deluge of information.[88]

Courts have not developed a coherent approach to assessing materiality in ESG securities fraud cases. The materiality inquiry tends to be made in passing by judges who will generally discuss their sense of whether a piece of information was important. Many courts will simply point to the reaction of the company's stock price to the revelation of a scandal to show that the information was material.[89] But such a method is problematic because it would mean that essentially every consequential event in a corporation's life is material. The question is not whether the corporation suffered a significant loss. The question is whether the risk of a consequential loss was high enough so that investors should have been given greater warning of it before the event actually occurred.

In its 1988 decision in *Basic v. Levinson*,[90] the U.S. Supreme Court set forth a test that courts can use to assess the materiality of "contingent or speculative information or events."[91] In *Basic*, a corporation publicly lied about whether it had been approached by another company with an acquisition offer.[92] It was in merger talks but denied three times that it was negotiating a transaction, presumably because if it disclosed the transaction the stock price would increase in anticipation of the merger, which would make the transaction more expensive for the bidder and increase the risk that it would walk away. An investor who sold his stock before news of the merger was confirmed sued under Rule 10b-5, arguing that the lie artificially kept the stock price low, causing him damage because he sold his stock for too little.[93]

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[87] Courts often conflate the issue of materiality with the issue of whether there was a duty to disclose a risk. That is because there can only be a duty to disclose if the failure to disclose a risk would make a company's past disclosures inaccurate or misleading. Courts will thus often discuss the materiality of a risk in the context of a duty to disclose inquiry. *See, e.g.*, Richman v. Goldman Sachs Group, Inc., 868 F.Supp.2d 261, 273-74 (S.D.N.Y. 2012) (discussing materiality in the context of whether there was a duty to disclose a risk).

[88] *See, e.g.*, Troy A. Paredes, Blinded by the Light*: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003).

[89] For example, in determining whether an investigation was material, one court explained: "the alleged corrective disclosures included the announcement of a nationwide investigation into one of MetLife's important businesses and an increase in reserves that caused operating earnings for insurance products to be down 23 percent for the quarter. Plaintiff alleges that MetLife's shares dropped in value after the disclosures. This is sufficient." *See, e.g.*, Westland Police and Fire Ret. v. Metlife, Inc. 928 F.Supp.2d 705, 719 (S.D.N.Y. 2013).

[90] 485 U.S. 223 (1988).

[91] *Id*. at 239.

[92] *Id*. at 223-24.

[93] *Id*. at 228. Most securities fraud cases are brought by investors who argue that they paid too much for a stock rather than too little.

Basic Incorporated argued that the lie was not material because it was far from certain that the acquisition would occur. Even if there were talks, the prospect of a merger was still uncertain and so it was unclear that the stock price would be affected in the end. Instead of adopting a bright line rule governing when merger discussions are material, the Court adopted a more fact intensive approach. It instructed that in determining whether the possibility of a contingent event such as an acquisition was material, it would weigh both the probability that the event would occur along with the magnitude of the event.[94] It instructed that materiality would depend "upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of company activity."[95] An acquisition possibility would only be material to investors if both its probability and magnitude were sufficiently high.[96]

The probability/magnitude test presumes that a corporation can assess the probability of a contingent event. Without the ability to assess the probability of an event, it will be impossible to determine whether information about that event is material to investors. In the acquisition context, it may be fair to assume that the probability of a transaction can be estimated because the corporate managers who are negotiating the acquisition are in the best position to evaluate whether or not it will succeed.[97] But for many other contingent events, it is not always clear that a corporation can calculate a meaningful probability of that event. Courts have thus differed in their willingness to apply the probability/magnitude test outside of the merger context.[98]

Because ESG securities fraud cases typically deal with the contingent possibility that an ESG scandal or crisis will erupt at a company, the probability/magnitude test is a good fit

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[94] *Id*. at 238.

[95] *Id*. The test originated in an earlier decision by the Second Circuit in *Texas Gulf Sulphur*. *See* 401 F.2d 833 (1968). In that case, the issue was whether the possibility of a mineral find was material information that should have been disclosed before insiders traded on it. The probability/magnitude test asks a similar question as the famous Learned Hand test for assessing whether a defendant should be liable for failing to implement precautionary measures. In United States v. Carroll Towing, 159 F.2d 169 (2d Cir. 1947), Judge Hand explained that the probability and magnitude of the accident should be compared with the cost of the precautionary measures. If the probability/magnitude of the accident is greater than the cost of such measures, it would be negligent not to implement them.

[96] In the merger context, it is a given that the magnitude of a merger on the future of a company is high. The Basic court cited language that "a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death." *See* Basic, 485 U.S. at 237.

[97] The Court listed a number of facts it might look to in assessing the probability of a merger. *See, e.g.*, *Basic*, 485 U.S. at 238 (noting that "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest"). Many courts have applied the Basic test in the merger context to find that such discussions were material given the probability of a merger. *See, e.g.*, *U.S. v. Mylett*, 97 F.3d 663, 667 (2d Cir. 1996) (pointing to hiring of outside counsel and internal meetings as evidence that merger was probable).

[98] The probability/magnitude test is most often applied in the context of merger-disclosure. One exception seems to be in the context of whether a company should disclose a government investigation. *See, e.g.*, *Lewis v. YRC*, 2020 U.S. Dist. LEXIS 53471 (N.D.N.Y. 2020) (applying probability/magnitude test to materiality of ongoing government investigation); David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 BUS. LAW. 973, 974 (2009) ("Whether the information [on an investigation] is material depends on an assessment of the probability and magnitude of the outcome, which, in turn, requires analyzing the nature of the facts or alleged misconduct subject to investigation the positions of company personnel involved or implicated, the likelihood of an enforcement proceeding or an indictment, and the probable impact of any legal proceeding likely to result.").

in that context. The critical question in ESG cases is whether it is reasonable to expect that corporate managers can meaningfully predict the risk of an ESG event. If they can, then there is a stronger case that such risks can be material to investors. Moreover, it is more likely that a corporation and its top executives have knowledge of an ESG risk when they have information that an ESG problem is highly probable. It will be more difficult for such managers to argue that they were simply negligent in denying an ESG risk when they have calculated that the risk is high. In contrast, when the risk of an ESG event cannot be calculated, it will be less likely that corporate managers can be faulted when the event actually occurs.

B. Assessing the Probability of ESG Events

The main challenge with applying the probability/magnitude test is that calculating precise probabilities of contingent events can be difficult. Predicting the future is inherently challenging. The *Basic* test for materiality has thus not been widely used by courts outside of the merger context.[99] However, an examination of recent ESG cases shows that public companies actually do calculate probabilities with respect to ESG events. It should thus be often possible to distinguish situations where probabilities can be calculated from those where they cannot. This Section offers guidance that can be used by courts in assessing probability, particularly with respect to ESG risks. One way of distinguishing between material and immaterial ESG risks is by examining whether a corporation can calculate reasonable probabilities with respect to a specific ESG risk.

The first question that a court should ask in applying the probability/magnitude test is whether the event is one for which a meaningful probability can be calculated. The University of Chicago economist Frank Knight famously distinguished between risks, where probabilities can be determined, and uncertainties, where probabilities are not calculable.[100] This basic dichotomy, while itself is somewhat imprecise, can serve as a rough guide in determining whether an ESG risk is material. A contingent event should only be material if it reflects Knightian risk rather than Knightian uncertainty.

The modern public corporation is characterized by its ability to calculate Knightian risk.[101] The main task of corporate managers is to understand their businesses so that they can be managed. Understanding risk within the corporation is essential to allocating resources to promising projects.[102] Investors expect public company managers to accurately forecast revenue, cost, and earnings on a quarterly basis. Companies that do not deliver predictable financial results will not be valued as highly by stock markets as companies that are successful forecasters.

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[99] In contrast, the test is cited routinely in Rule 10b-5 cases arising out of mergers. One court has described the *Basic* test as applying specifically "in the context of mergers." See *Rizzo v. McManus*, 158 F.Supp.2d 297, 303-304 (S.D.N.Y. 2001).

[100] FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT 233 (1921) (HOUGHTON MIFFLIN COMPANY ED.) (observing that a "risk" is a "measurable uncertainty" while "uncertainty" is "immeasurable.").

[101] *See, e.g.*, James J. Park, *Investor Protection in an Age of Entrepreneurship*, HARV. BUS. L. REV. (forthcoming).

[102] *See, e.g.*, OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975) (discussing internal capital markets).

On the other hand, corporate managers do not have perfect knowledge of all potential events. In the aftermath of the financial crisis of 2008, questions were raised about why more securities fraud cases were not brought against the financial institutions that were driven to the brink of collapse by massive losses in their housing-related investments.[103] One explanation for the lack of successful fraud cases is that the banks were just as surprised by the extent and ferocity of the crisis as outside investors.[104] They could not have adequately warned stock markets about the uncertain prospect of an unprecedented financial storm because they were surprised by these events.

The main question for ESG cases is whether reasonable probabilities can be generated for ESG risks.[105] As noted earlier, companies might argue that ESG risk is essentially unpredictable. There are so many possible scandals that it is impossible for corporate managers to predict them all. Companies might also contend that ESG risk is not the sort of information that corporate managers understand how to assess. They would contend that they simply do not have the ability to calculate such risk and that their efforts would be better spent on normal business operations. Corporations may argue that efforts to argue they deceived investors about ESG risk are thus unfair. The actual occurrence of a significant ESG disaster can influence factfinders to conclude ex post that the risk was predictable ex ante. Such hindsight bias can result in a finding that a risk was predictable even when it was not.[106]

The problem with this argument is that public companies are increasingly calculating certain ESG risks, both for internal purposes and to respond to investor demands. To the extent that companies are actually generating ESG probabilities, it is difficult to argue that such probabilities cannot be calculated. Moreover, hindsight bias can be checked to some extent by looking at the probabilities that were actually calculated ex ante. The probability/magnitude test for materiality will thus be more relevant as norms evolve so that public companies generate risk information internally.

There are numerous examples of ESG securities fraud cases based on internal risk calculations by public companies. In the Vale case, the earlier collapse of one of its other dams led the Brazilian company to assess the safety of all of its dams.[107] The mining company's own internal reports calculated that the risk of a collapse was higher than

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[103] *See, e.g.*, JESSE EISINGER, THE CHICKENSHIT CLUB: WHY THE JUSTICE DEPARTMENT FAILS TO PROSECUTE EXECUTIVES (2017) (arguing that risk aversion by prosecutors explained the failure to bring cases); Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014) (noting lack of criminal prosecutions would be a travesty if the crisis was the result of intentional fraud).

[104] For an example of securities litigation that rejected a broad securities fraud theory asserted against a bank that almost failed during the financial crisis, see *In re* Citigroup Inc. Sec. Litig., 753 F. Supp.2d 206 (S.D.N.Y. 2010).

[105] This is a problem that is not unique to the ESG securities fraud context. *See, e.g.*, Keith N. Hylton, *Information and Causation in Tort Law: Generalizing the Learned Hand Test for Causation Cases*, 7 J. TORT L. 35, 54-55 (2014) (noting that in applying the Learned Hand test, which assesses probability and magnitude, "the ex ante intervention likelihood may be unknown and not even capable of determination by the trial court."

[106] Federal courts have long warned about the danger of finding securities fraud by hindsight. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir. 1990); Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978).

[107] Sec & Exch Comm'n v. Vale, *supra* note 1, at ¶ 6.

international norms.[108] Rather than acknowledge this possibility, Vale affirmatively represented to investors that its dams were safe.[109] Given that it had actually calculated the probability of collapse, it will be difficult for Vale to argue that the risk was not calculable.

Similarly, the SEC's cases against BP in the wake of the Deepwater Horizon disaster focused on the company's statements about its estimates of the extent of the ensuing oil spill.[110] It alleged that BP "materially misrepresented and understated the estimated range of flow rate of oil leaking from the well."[111] The company's public statements were at odds with multiple internal estimates of the spill (which were made available to BP's upper level management) that were multiples higher than the estimates that were made to the public.[112] It was difficult for BP to argue that it did not understand the extent of the spill when it had its own internal analysis predicting its size.

Finally, the SEC's case against Volkswagen (VW) for its failure to apprise investors of the risk of significant regulatory enforcement for its intentional evasion of U.S. environmental regulation cited a VW internal analysis of the regulatory risk.[113] The SEC's complaint alleged that "multiple internal memos were circulating inside VW among its most senior officials . . . detailing the depths of the problems VW was facing" and that "its potential financial liability for the fraud exceeded $20 billion."[114] Even knowing of this substantial risk, VW sold billions of dollars in bonds to U.S. investors without acknowledging its scandal risk and representing "that its cars complied with applicable laws, that there were no pending or threatened governmental investigations involving its diesel vehicles, and that it was committed to reducing harmful emissions and manufacturing environmentally-friendly cars."[115]

Even when a company cannot generate a precise probability of a risk, its past experience can give guidance as to whether a risk is fairly low or high. For example, in a case involving whether the investment bank Goldman Sachs should have disclosed more about the risk that it would be the subject of SEC enforcement, the plaintiff pointed to the receipt of a Wells Notice where the SEC had warned that it was considering bringing an enforcement action against the bank.[116] However, Goldman Sachs successfully argued that the filing of a Wells Notice did not mean it was "substantially certain" that the SEC would file a case because the agency had earlier filed such a notice against one of the bank's employees but decided not to pursue an action. Thus, the court concluded that "the Defendants were not obligated to predict and/or disclose their predictions regarding the

[108] *Id*. at ¶ 53.
[109] *Id*. at ¶¶ 221-49.
[110] Sec. & Exch. Comm'n v. BP p.l.c., Complaint, Case 2:12-cv-02774 (E.D. La. Nov. 15, 2012).
[111] *Id*. at ¶ 5.
[112] *Id*. at ¶¶ 24, 27, 33.
[113] *See* Sec. & Exch. Comm'n v. Volkswagen, Complaint, 19-cv-01391 (N.D. Cal. March 14, 2019).
[114] *Id*. at ¶¶ 15-16.
[115] *Id*. at ¶ 151. Bondholders are in a more conservative position with respect to risk than shareholders. *See, e.g.*, James J. Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. 585 (2015).
[116] *See* Richman v. Goldman Sachs Group, Inc., 868 F.Supp.2d 261, 274 (S.D.N.Y. 2012). For descriptions of the Wells process, see U.S. SEC. & EXCH. COMM'N DIV. ENF., ENF. MAN. 27-34 (2010); Joshua A. Naftalis, *"Wells Submissions" to the SEC as Offers of Settlement Under Federal Rule of Evidence 408 and Their Protection from Third-Party Discovery*, 102 COLUM. L. REV. 1912, 1918–20 (2002).

likelihood of suit."[117] By showing that the probability of a significant SEC action was not high, Goldman Sachs persuaded the court that the risk of such an action was not material.

One possible objection to ESG securities fraud liability is that it would create a disincentive to assess ESG risks. If liability hinges on a showing that a probability can be calculated, companies could avoid securities law obligations by not performing such calculations. It is likely, though, that the benefits of assessing ESG risk will be substantial enough for public companies to outweigh the costs. Good companies will understand that they can avoid losses by better understanding the risks of their business. Moreover, if it becomes clear that some companies are deliberately ignoring a risk that can be calculated, courts could find that such willful blindness to risk is material to investors.

Not only will companies calculate risks on their own, the SEC can prompt them to focus on particular risks. Until recently, cybersecurity breaches were not viewed as an issue that was within the purview of high-level management. As the value of consumer data has increased and the consequences of compromising such data greater, data breaches have become an issue of greater corporate concern. The SEC thus issued guidance in 2018 on disclosure relating to such breaches.[118] In doing so, it signaled that companies should be mindful of informing investors when appropriate about such events. The SEC's guidance was cited by a district court in concluding that Alphabet's statements about the risk of cyber privacy breaches were materially misleading.[119] The SEC supplemented its cyber guidance in 2022 with rule proposals requiring disclosure about cyber security breaches. Notably, in describing the materiality of such disclosure, the SEC referenced the probability/magnitude test, noting that "[e]ven if the probability of an adverse consequence is relatively low, if the magnitude of the loss or liability is high, the incident may still be material."[120] The proposed rules would require disclosures relating to a company's policies and procedures to identify cybersecurity risks and whether the company's board and management are qualified to manage such risk.[121] Such disclosure would create incentives for public companies to do more to evaluate the probability of cybersecurity risk, and in doing so, would generate information that would inform disclosures to the public. As it becomes the norm to calculate such risks, the failure to describe such risks in disclosures would be more likely to qualify as a material misrepresentation.

In other areas such as climate change, the SEC has proposed rules requiring more disclosure about the risks associated with such change on a company's business.[122] Notably, in its discussion of the rules, the SEC observed that "the materiality determination with regard to potential future events requires an assessment of both the probability of the event occurring and its potential magnitude, or significance to the registrant."[123] If adopted,

[117] *Id*.

[118] *See, e.g.*, Sec. & Exch. Comm'n, Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release Nos. 33-10459; 34-82746, at 11 (Feb. 21, 2018) ("The materiality of cybersecurity risks and incidents also depends on the range of harm that such incidents could cause.").

[119] *See, e.g.*, In re Alphabet, Inc. Sec. Litig., 1 F.4th 687, 703 (9th Cir. 2021).

[120] Sec. & Exch. Comm'n, Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, Release Nos. 33-11038; 34-94382, at 23 (March 9, 2022).

[121] *Id*. at 19.

[122] Sec. & Exch. Comm'n, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11042; 34-94478, at 56-62 (March 21, 2022).

[123] *Id*. at 64-65

companies would have to devote more resources to computing the probability of climate-related losses. If they do so, they will generate more material information about risk that will be useful to investors.[124]

There are questions about whether efforts to mandate that all public companies focus on ESG risk could be problematic. Corporate law has traditionally given boards wide discretion in how they operate. Securities regulation has been careful not to directly regulate corporate governance.[125] Even though these new proposed mandates are couched as disclosure provisions,[126] they will put pressure on public company boards to spend time assessing a longer list of issues. While it is beyond the scope of this Article to assess whether the costs of such additional attention to ESG matters outweigh the benefits, it is worth noting that there may be negative consequences to such mandates.

Even without mandates, companies have incentives to provide investors with voluntary ESG disclosure that will require them to calculate probabilities of ESG events. Many ESG securities fraud cases cite statements made by companies in Sustainability Reports that were voluntarily disclosed to investors. Stavros Gadinis and Amelia Miazad document the increasing interest in sustainability in public companies and argue that such efforts can help companies manage social risk.[127] Regardless of whether reducing social risk is a desirable goal, to the extent that such efforts generate better information about ESG risk, the argument that such risks are material to investor decisions will become stronger.

Even as ESG issues gain greater prominence, it is unclear that companies can be expected to generate meaningful probabilities of every ESG risk. Courts will have to be careful to distinguish between ESG events for which reasonable probabilities can be generated and those that are characterized by uncertainty. They will have to be mindful of the real challenge of predicting a wide range of contingent events that could generate shareholder losses.

IV. ESG SECURITIES FRAUD LIABILITY

Companies commit ESG securities fraud when high level executives: (1) are able to calculate the probability of an ESG event; (2) the probability and magnitude of such risk is high; (3) yet the company misrepresents that risk with the intent to deceive investors. This basic approach clarifies to a great degree what courts should look for in deciding whether an ESG securities fraud case should proceed. This final Part concludes by discussing how courts

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[124] Notably, early efforts to characterize the failure to disclose climate risks as fraudulent failed because the projections of such risk were too speculative. As the New York Supreme Court explained after trial in a case brought by the New York Attorney General against Exxon Mobil, "ExxonMobil's disclosures were not intended to enable investors to conduct meaningful economic analysis of ExxonMobil's internal planning assumptions, and no reasonable investor would have viewed speculative assumptions about hypothetical regulatory costs projected decades into the future" as material. *See* People of the State of New York v. Exxon Mobil Corp., Index No. 452044/2018 (Dec. 10, 2019).

[125] The Supreme Court has held that Rule 10b-5 does not extend to all forms of corporate mismanagement. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

[126] *See* James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. Rev. 116 (2017).

[127] *See* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401 (2020).

and enforcers can judge whether the probability and magnitude of an ESG risk are high enough to trigger securities fraud liability. It also considers the question of why shareholders should be able to recover for fraud that primarily impacts stakeholders.

A. Evaluating the Probability/Magnitude of ESG Risk

One of the difficulties of applying the probability/magnitude test is that the Supreme Court was silent in *Basic* about the level of combined probability/magnitude that would make a contingent event material.[128] Courts have not clarified and developed doctrine on the issue. Even when the probability of an event can be reasonably calculated, the question of whether the expected value of the impact of the event is material can be answered in a number of different ways.

One possible approach would be to evaluate the probability/magnitude in terms of a company's market capitalization. The advantage of this approach is that the company's stock price will reflect a wide range of potential costs. An ESG event might not only directly affect current period revenue and profits, it could have direct and indirect effects that extend into the future. A scandal may not only trigger a financial penalty, it could cloud a company's reputation with the public for years. Investors will take into account all of these various costs in calculating what they will pay for the stock. If there is a ten percent risk of a $10 billion impact on a company's market value, the expected value of the event would be $1 billion. Such a loss in market value would be substantial for a company with a $5 billion market capitalization, but it would not be significant for a company with a $200 billion market capitalization.

Courts could develop rules of thumb where the expected impact of an ESG event would be judged in reference to a numerical standard. A potential loss that is greater than that threshold would be presumed to be material, while a loss that is less than that threshold would be presumed to be immaterial. For example, in the context of financial statements, the rule of thumb at one time was a five percent standard.[129] A financial misstatement on revenue or profits that did not meet that threshold was presumed to be immaterial. For ESG risks, there is a case that the standard could be the same or higher – say 10 percent of market capitalization.

If it were judged in terms of expected impact on market capitalization, it is unclear that the risk that Vale's dam would collapse would have been material to investors. According to the SEC's complaint, Vale's internal analysis showed a risk of 1 in 10,000 per year of a rupture in the dam that would cause $1.4 billion in losses.[130] In the wake of the disaster, the company's securities on the New York Stock Exchange declined by 25 percent,

[128] Litigants and courts tend to make vague arguments about whether a risk was sufficient to be material. *See, e.g.*, In re BHP Billton Ltd. Sec. Litig., 276 F.Supp.3d 65, 88 (S.D.N.Y. 2017) (asserting that alleged risks of dam collapse were "not 'events' that, at the time, were 'reasonably likely' to have a material effect on BHP Billiton's economic condition.").

[129] SEC Staff Accounting Bulletin: No. 99, 17 CFR Part 211 (Aug. 1999). The SEC has instructed that the five percent standard is no longer a bright-line rule and that qualitative considerations should be weighed in assessing the materiality of financial misstatements. *See* James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. Corp. L. 513 (2009).

[130] Sec. & Exch. Comm'n v. Vale, *supra* note 1, at ¶ 191.

an amount of over $4 billion.[131] While these losses were substantial, the expected value of the loss in market capitalization was $400,000 per year. For a multi-billion dollar company, it's unclear that investors would be concerned about such a modest probability-magnitude.

Rather than focusing solely on an inflexible numerical standard, a court could also look at qualitative factors in assessing the materiality of an ESG event. They could consider the human toll of the disaster. They could consider externalities that are not reflected in the company's stock price. They could also consider the probability/magnitude of the ESG risk in relation to the probability/magnitude of other risks. For example, if a $400,000 expected loss in market capitalization was of a significantly greater magnitude than other ESG risks to Vale, there would have been a stronger case that that the $400,000 risk from the dam collapse should have been disclosed.

B. Puffery and Risk Statements

Rather than evaluate the specificity of corporate statements in isolation to determine whether a company issued a material misrepresentation, courts should consider them in light of the extent of the relevant ESG risk. When there is a higher probability/magnitude of an ESG risk, then courts should require less specificity in determining whether a misrepresentation was made. When the probability/magnitude of an ESG risk is low, courts should require more specificity in determining whether a misrepresentation was made.

Consider a company with a $10 billion market value that represents that it generally adheres to high ethical standards. If a corporate review finds that there is a ten percent probability of a sexual harassment scandal involving lower-level employees that would impact the company's market value by $10 million, the expected $1 million impact would not be significant. It would be possible for that company to assert that its assurances of high ethics, at least to the extent that they would not affect the company's market value, are accurate. On the other hand, if a corporate review finds a fifty percent chance of an event that would have a $1 billion impact on the company's market value, the expected impact of $500 million would likely be material. Such knowledge would make the assertion that the company's ethics are high enough to avoid a significant scandal misleading. Even though the statement of ethics compliance is general, at the very least, it should be read as reflecting a commitment that corporate management does not know of a substantial risk of a significant ethics breakdown.

This approach would avoid the inconsistent decisions that have resulted when courts come to different conclusions about the specificity of corporate statements. While it would not ensure that decisions are completely consistent, broadening the inquiry to consider the extent of the risk at issue could help courts better determine whether investors were misled.

In cases where a risk has already materialized, the court should only have to weigh the magnitude of the risk in determining whether a risk disclosure was misleading. When a risk is materializing, that indicates a higher probability that the risk will occur, and so the only question in evaluating the risk is its impact. Companies should not be permitted to release a formulaic set of risk factors without revealing that there is a very high probability of a substantial risk. As the U.S. Court of Appeals has noted, "[a] generic warning of a risk

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[131] *Id.* at ¶ 3.

will not suffice when undisclosed facts on the ground would substantially affect a reasonable investor's calculations of probability."[132] At the very least, a risk disclosure should be understood to mean that such risk has not materialized to the extent that it will certainly affect the company's market value. To the extent that the Ninth Circuit's decisions imply that there is a bright line rule where risk disclosures can never be misleading, the Ninth Circuit or Supreme Court should overrule or minimize this line of decisions.[133]

C. Enforcement

When it is difficult to determine whether the extent of an ESG risk is sufficient to trigger securities fraud liability, it might be most appropriate for a public enforcer to bring an action. The SEC can bring cases under a wider range of provisions than private enforcers. It can even bring cases against public companies for misleading statements even when they are not material under the books and records provision of Section 13 of the Securities Exchange Act.[134] By doing so, it could avoid close calls about whether a combined probability/magnitude is material enough to investors, while instructing companies about its views on ESG disclosure.

The SEC has notably taken on an active role in bringing ESG securities fraud cases. Unlike other periods in its history when it has been passive relative to private enforcers,[135] the SEC has not taken a narrow view of securities fraud in bringing cases against companies like Vale, BP, Facebook, and Volkswagen.[136] Some of these cases have alleged securities fraud pursuant to Section 10(b) and Rule 10b-5,[137] while others have relied on provisions that do not require a showing of fraud such as Section 17(a)(2) and (a)(3) of the Securities Exchange Act.[138] In doing so, the SEC has given credibility to ESG securities fraud theories.

While private securities litigation are subject to more obstacles that may make it more difficult to bring ESG securities fraud cases, it is clear that investor lawsuits will play some role in regulating the disclosure of ESG risk. Private enforcement will most likely play a substantial role where significant ESG risks were very clearly withheld from investors and it is apparent that they paid too much for the stock given such risk.[139] When the probability

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[132] Meyer v. Jinkosolar Holdings Co., Ltd., 761 F.3d 245 (2d Cir. 2014).

[133] In more recent decisions, the Ninth Circuit appears to have backtracked from its earlier decisions. *See, e.g.*, In re Alphabet, Inc. Sec. Litig., 1 F.4th 687 (9th Cir. 2021).

[134] Securities Exchange Act of 1934 § 13(b)(2)(A).

[135] *See, e.g.*, THE VALUATION TREADMILL, *supra* note 24.

[136] *See, e.g.*, Sec & Exch Comm'n v. Vale, *supra* note 1; Sec. & Exch. Comm'n v. BP p.l.c., *supra* note 110; Sec. & Exch. Comm'n v. Facebook, Inc., *supra* note 110; Sec. & Exch. Comm'n v. Volkswagen, *supra* note 113.

[137] *See, e.g.*, Sec & Exch Comm'n v. Vale, *supra* note 1, at ¶¶ 277-79; Sec. & Exch. Comm'n v. BP p.l.c., *supra* note 110, at ¶¶ 41-44.

[138] The SEC can bring cases targeting material misrepresentations in connection with securities sales pursuant to Section 17 of the Securities Act of 1933. That provision has virtually identical language as Rule 10b-5 (except that Rule 10b-5 applies to both the purchase and sale of securities rather than just the sale of securities). While the U.S. Supreme Court requires a showing of fraudulent intent for all Rule 10b-5 cases, it has held that for cases brought pursuant to Subsections 17(a)(2) and (3) of the Securities Act of 1933, there is no requirement of scienter. *See* Aaron v. SEC, 446 U.S. 680 (1980). Unlike Rule 10b-5, there is no private right of action that permits investors to bring suit under Section 17. Thus, only the SEC may utilize this provision.

[139] Securities plaintiffs should not be permitted to recover the entire loss after an ESG disaster occurs. They would only be entitled to the inflation at the time that purchased the stock, which would reflect the

of an ESG risk is high and calculable, it is more likely that a plaintiff can demonstrate that there were red flags that were ignored by corporate management, permitting the plaintiff to establish the requisite scienter under Rule 10b-5.[140] They can point to knowledge of internal reports and data that corporate managers were aware of but obfuscated.[141] In contrast, when risks are difficult to calculate or there are good faith mistakes in calculating a risk, it will be less likely that a court should find scienter.[142] When an ESG misrepresentation is clearly motivated by deceptive conduct, investors should be permitted to exercise their right to recover damages.

D. Why Shareholders?

A criticism of ESG securities fraud litigation is that it permits shareholders to recover for losses caused by misconduct that mainly harms stakeholders.[143] Why should Vale be independently liable for millions of dollars to investors when workers lost their lives and local communities were destroyed?[144] Part of the impetus for a greater emphasis on ESG is the belief that corporations should consider a broader set of interests and not focus so narrowly on increasing shareholder wealth. Can ESG disclosure really benefit stakeholders if misleading statements on ESG issues can only generate a remedy for stockholders? Why should corporate resources be diverted to paying penalties that benefit shareholders rather than reinvesting those resources to further stakeholder interests?

The question is whether truthful ESG disclosure can encourage better decisionmaking by public corporations that will help them better manage ESG risks to avoid disasters that will harm stakeholders. If the goal is to help identify companies that are taking on excessive ESG risk, then it is essential that ESG disclosure be accurate. And the best way to help ensure reliable disclosure is to enforce norms against fraud.

Shareholders are in the best position to monitor corporate disclosures and bring claims for fraud. Disclosure can be accessed by stakeholders who can use it to advance their interests,[145] but the primary beneficiaries of corporate disclosure are shareholders. They can

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inflation from the ESG risk that was not forthrightly revealed. For an extensive analysis of this point, see Fox & Mitts, *supra* note 8.

[140] *See, e.g.*, No 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 933-34 (9th Cir. 2003) (finding sufficient pleading of scienter when internal reports and correspondence from a regulator informed airline of maintenance problems that resulted in government sanctions).

[141] *See, e.g.*, City of Monroe Employees Retirement Sys. v. Bridgestone Corp., 399 F.3d 651, 684 (6th Cir. 2005) (finding scienter in part because of "data known or available" to tire company "concerning the evidence of defective tires . . . and three years of a marked rise in the rates of deaths, injuries and claims and lawsuits based on several thousand rollover accidents, hundreds of injuries, and nearly 200 fatalities in the United States").

[142] *See, e.g.*, In re PXRE Group, Ltd. Sec. Litig., 600 F. Supp.2d 510, 536 (S.D.N.Y. 2009) (concluding that managers were not reckless because they did not have information about flawed loss estimates).

[143] Moreover, securities fraud can itself have an impact on stakeholders. *See* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

[144] Bondholders, who are non-shareholder stakeholders, can recover for securities fraud but that does not in itself resolve the criticism that the benefits of ESG securities fraud cases go to a narrow set of investors.

[145] *See, e.g.*, Ann Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, YALE J. REG, 499 (2019).

commit billions of dollars of capital based on truthful disclosure. They thus have the greatest incentive to ensure that the disclosure system is working well.

To the extent that shareholders have become more concerned about ESG risk, that may influence companies to take measures to reduce such risk. In doing so, the hope is that public companies can be profitable and increase shareholder value while also respecting the interests of a broader range of stakeholders. Whether or not ESG disclosure can achieve such goals is still an open question, but it is clear that for such disclosure to work, there must be regulation of ESG securities fraud.

CONCLUSION

ESG securities fraud reflects the growing importance of ESG risk to the valuations of public companies. Corporations are increasingly calculating the probability of a broader range of events that could affect their business. When management can estimate meaningful probabilities of an ESG risk and become aware of a risk with sufficiently significant probability and magnitude, they should not deceive investors about that risk. On the other hand, courts should be aware that some risks are not subject to meaningful calculation. If managers and investors are on the same footing with respect to a risk, it is more difficult to argue that investors are deceived when managers do not anticipate an ESG event in advance.

Far from fundamentally changing securities fraud litigation, ESG securities fraud should be viewed as a subset of the Rule 10b-5 cases where a risk relating to the development of important products is not fully revealed to investors. These types of cases have been litigated in federal court for decades. Some of the most important examples of securities fraud have involved misstatements relating to the risk that a product would not become viable. It can be difficult to adjudicate the issues raised in products fraud and ESG fraud actions, but courts are capable of sorting good cases from bad.

ESG securities fraud cases will often turn on careful evaluation of the relevant facts. But at their essence, they all raise the issue of whether an ESG risk was material. The Supreme Court's probability/magnitude test offers a good starting point for assessing whether an ESG securities fraud case has merit. The strongest ESG securities fraud cases have uncovered evidence that probabilities of an ESG risk were actually calculated by a company and were known to be significant. As investors increasingly push companies to calculate ESG risk, it will be more difficult for companies to contend that they did not appreciate such risk. Mandatory disclosure requirements will also influence public companies to prioritize ESG risk. In order to do so, they must make efforts to gather information on such risk and understand it.

Securities fraud is not a static concept. It has evolved over time as the public corporation has changed. The rise of ESG securities fraud may partly reflect the efforts of public and private enforcers to develop innovative liability theories. But they likely also reflect the reality that ESG disasters can shatter a company's reputation and market value. Corporate managers must understand that they must not only provide accurate information about a company's financial performance. They must also be forthright about ESG risk.