ESG SECURITIES FRAUD

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As investors have become more concerned about the risk that corporate wrongdoing will impact a company's stock price, the SEC and private plaintiffs are increasingly bringing cases alleging that a company misrepresented a risk relating to an Environmental, Social, and Governance (ESG) matter. The courts have been skeptical of such claims because of the perception that the scope of securities fraud liability would be too broad if it policed disclosure relating to the myriad of ESG risks facing public companies. They have thus often used the puffery doctrine to find that broadly worded statements concerning ESG risk are not misrepresentations.

This Article argues for a different focus in the evaluation of ESG securities fraud cases. The key question in such cases is whether the ESG risk at issue was sufficiently material so that the company's disclosures that failed to acknowledge such risk were misleading. Courts should assess the materiality of ESG risk by applying the probability-magnitude test set forth by the Supreme Court in Basic Inc. v. Levinson. *In doing so, they should consider facts relating to whether the probability of the risk at issue is subject to reasonable calculation or whether it is an uncertainty. Screening cases primarily based on the materiality of ESG risk would be a more effective way for courts to identify meritorious cases than rigid application of the amorphous puffery doctrine.*

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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 also prompted the filing of a securities fraud 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 disaster.[2] 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.[3] The government lawsuit

1. Complaint at 2, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022). Private plaintiffs also filed a securities class action that is still pending. *See* Consolidated Class Action Complaint at 1–2, *In re* Vale S.A. Sec. Litig., 19-cv-526-RJD-SJB (E.D.N.Y. Oct. 25, 2019).

2. Complaint at 2, *Vale*, No. 22-cv-2405.

3. *Id.* at 3. The collapse of that dam in 2015 also prompted the filing of a securities class action that resulted in a $25 million settlement. *See In re* Vale S.A. Sec. Litig., 1:15-cv-9539-GHW, 2017 WL 1102666, at *39–40 (S.D.N.Y. Mar. 23, 2017) (granting in part and denying in part motion to dismiss the case). The SEC did not bring a case.

argued that Vale misled investors about the risk of its 2019 dam collapse in "Environmental, Social, and Governance (ESG) disclosures" contained in both periodic reports it must file with the SEC as a public company and sustainability reports that it had voluntarily provided to investors.[4] 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 both prohibit securities fraud.[5]

The *Vale* case, which resulted in the payment of $55 million by the company to settle the SEC's action,[6] 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.[7] Such enforcement has coincided with the growing importance of ESG matters to the modern public corporation.[8] Investors are more concerned about the economic risks of corporate misconduct, which can result in reputational harm and

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4. Complaint at 6, 10, *Vale*, No. 22-cv-2405.

5. 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 (2023).

6. Sec. & Exch. Comm'n, *Brazilian Mining Company to Pay $55.9 Million to Settle Charges Related to Misleading Disclosures Prior to Deadly Dam Collapse* (Mar. 28, 2023), https://www.sec.gov/news/press-release/2023-63.

7. More generally, a significant percentage of securities class actions appear to target conduct that does not directly harm shareholders. Emily Strauss reports that 16.5 percent of cases filed from 2010–2015 involved allegations of misconduct that primarily impacted non-shareholders. *See* Emily Strauss, *Is Everything Securities Fraud?*, 12 U.C. IRVINE L. REV. 1331, 1334 (2022). Such cases are less likely to be dismissed and settle for larger amounts than the average case. *Id.* at 1346. Some cases are also brought as state corporate law derivative claims. *See, e.g.*, Daniel Hemel & Dorothy Shapiro Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1641–50 (2018).

8. *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.

governmental sanction.[9] An ESG scandal can wipe out a significant portion of a public company's market capitalization almost instantly. In certain circumstances, public companies can commit ESG securities fraud by deceiving investors about an ESG matter in a way that affects the company's stock price.

Partly to reassure investors, public corporations are increasingly issuing ESG disclosures.[10] Many of these disclosures are voluntary and provide representations about a company's efforts to manage ESG risk.[11] The SEC has also recently proposed and passed significant mandatory disclosure requirements relating to ESG issues such as climate change and cybersecurity.[12] Companies with stock trading in public markets will have to disclose more information on how they manage the risks of environmental disaster and invasions of customer privacy.[13]

As corporations increasingly make representations about their management of ESG risk, there will be more opportunities to contend that they misrepresented such risks. Some commentators have described ESG securities fraud cases as event litigation,[14] where any corporate event that causes a significant stock price decline could potentially violate Rule 10b-5. If "everything is now securities

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9. *See, e.g.*, Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 657 (2016) (noting that ESG risk encompasses "the negative effect of poor ESG practices").

10. *See, e.g.*, Lisa M. Fairfax, *Dynamic Disclosure: An Exposé on the Mythical Divide Between Voluntary and Mandatory ESG Disclosure*, 101 TEX. L. REV. 273, 277 (2022) (describing dramatic increase in voluntary ESG disclosure).

11. *See id.*

12. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21388 (proposed Apr. 11, 2022) (climate change); Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 88 Fed. Reg. 51896 (Aug. 4, 2023) (cybersecurity).

13. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. at 21365–66 (environmental disaster); Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 88 Fed. Reg. at 51896 (customer privacy).

14. *See, e.g.*, Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation*, 78 BUS. LAW. 1, 1 (2022); 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., *Securities Litigation in 2017: "It Was the Best of Times, It Was the Worst of Times"*, COLUM. L. SCH.: THE CLS BLUE SKY BLOG (Mar. 19, 2018), https://clsbluesky.law.columbia.edu/2018/03/19/securities-litigation-in-2017-it-was-the-best-of-times-it-was-the-worst-of-times/ (noting in discussing "event-driven" class actions that "an adverse event (whether a criminal misdeed or a 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 the limit").

fraud,"[15] securities regulation would essentially police virtually all forms of corporate misconduct. Public companies like Vale that destroy the environment and neglect worker safety will not only be punished by environmental and labor regulators but will also be routinely investigated and sanctioned by securities regulators.[16] There is concern that ESG securities fraud litigation will increase the costs of new mandatory disclosure requirements.

The criticisms of ESG securities fraud cases in many ways mirror longstanding concerns about Rule 10b-5 litigation arising out of business failures. Whenever a business suffers a significant setback that prompts its stock price to fall, there is an opportunity for investors to argue that corporate managers misrepresented the risk of such a setback. The cases they file often turn on the extent to which the corporate defendant and its agents had knowledge about such risk and issued misleading statements denying the existence of the risk. A concern in adjudicating such cases is that hindsight bias will make it more likely for a factfinder to erroneously conclude that the risk of failure was higher than it actually was at the time the disclosure was made. Like cases involving the misrepresentation of a business risk, cases alleging the misrepresentation of an ESG risk are complicated partly because they involve assessing knowledge about the *risk of* failure rather than a setback that was *known*.

ESG securities fraud cases differ from business failure risk cases because they relate to deceptions concerning a wider range of risks that can be more difficult for corporate managers to predict. Investors have long expected corporate managers to constantly evaluate the risk of a business setback. Expectations about the ability of corporations to manage the myriad of ESG risks are still evolving. Broadening the scope of securities fraud liability to cover a daunting number of ESG issues could impose significant litigation costs on public companies and perhaps distract them from focusing on core business matters.[17]

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15. Bloomberg columnist Matt Levine has often highlighted examples of such cases. *See* Matt Levine, Opinion, *Everything Everywhere Is Securities Fraud*, BLOOMBERG (June 26, 2019, 12:01 PM), www.bloomberg.com/opinion/articles/2019-06-26/everything-everywhere-is-securities-fraud.

16. 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).

17. *See, e.g.*, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21443–44 (proposed Apr. 11, 2022) (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, *Analysis: ESG Litigation – Poised for an*

Because they are wary of adjudicating ESG fraud theories, courts have often dismissed ESG securities cases brought by private plaintiffs.[18] They have done so primarily by applying the puffery doctrine, a longstanding presumption that rosy statements of optimism should not be taken literally.[19] When a statement is considered puffery, it is not a material misrepresentation to investors, a prerequisite to liability under Rule 10b-5 and other securities fraud rules.[20] Disclosures relating to ESG risk tend to be broadly worded and can be characterized as aspirational statements that investors will view skeptically. For example, in the *Vale* case, the SEC pointed to statements that the company complied "strictly" with "rigorous" standards and that the dams were of "impressive" quality and in an "impeccable" state.[21] ESG securities fraud cases often turn on difficult determinations of whether a statement relating to the strength of a company's risk management is specific enough to be misleading. As Donald Langevoort observed in an article analyzing cases applying Rule 10b-5 to corporate disasters, courts have come to opposite conclusions in cases involving similar statements relating to ESG compliance.[22] Moreover, excusing companies when they issue vague statements on ESG issues creates incentives to avoid disclosing specific information to investors about ESG risk.

This Article argues that the current approach taken by courts in deciding ESG securities fraud cases, which emphasizes the puffery doctrine, misses the core issue raised by these cases, and should be replaced by a more holistic approach that emphasizes assessment of the materiality of the ESG risk at issue. Rather than arbitrarily screening cases by measuring the specificity of statements relating to ESG risk, courts should closely examine whether a material ESG risk

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Increase?, BLOOMBERG L. (June 14, 2022, 8:53 AM), news.bloomberglaw.com/bloomberg-law-analysis/analysis-esg-litigation-poised-for-an-increase.

18. SEC cases tend to settle, so the courts usually do not have an opportunity to review the agency's legal theories.

19. *See, e.g.*, *In re* Petrobras Sec. Litig., 116 F. Supp. 3d 368, 381 (S.D.N.Y. 2015) (discussing the puffery doctrine).

20. 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 Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).

21. Complaint at 10, 59, 62, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

22. *See* Donald C. Langevoort, *Disasters and Disclosures: Securities Fraud Liability in the Shadow of a Corporate Catastrophe*, 107 GEO. L.J. 967, 972–73 (2019). One example cited by Langevoort was a securities class action filed against Vale arising out of the earlier collapse of a dam it co-owned with another company. *Id.*

exists. If the court did engage in such an analysis, it would be more likely to find that statements obscuring risk were misleading, managers acted with fraudulent intent, and investors will have a plausible argument that they paid too much for the company's stock.

In evaluating the materiality of an ESG risk, courts should apply the well-established test set forth by the U.S. Supreme Court in *Basic Inc. v. Levinson*.[23] This probability/magnitude test, which has not been cited by courts widely outside of the merger context, instructs courts to assess the materiality of a contingent event by weighing both the probability of the event occurring and the magnitude of the event.[24] Like the possibility of a transformative merger, the possibility of an ESG scandal is a contingent event that is only material if its probability and magnitude are sufficiently high.

For the *Basic* test to apply, it must be possible to generate meaningful probabilities about the contingent event, what economists refer to as Knightian risk. For example, in the *Vale* case, there was evidence that Vale had calculated the probability that the dam would collapse and thus knew that the risk the dam would fail was unacceptable under international standards.[25] Its prediction that a collapse would cause 240 deaths was very close to the actual toll.[26] The risk of dam collapse was of sufficient concern so that it was included in a "Business Risk Matrix" available to the company's board.[27] Because the probability of dam collapse was knowable and known, it was possible for the SEC to argue that the ESG risk was material and that Vale's obfuscation of that risk was fraudulent.[28] The fact that Vale's statements about dam safety and environmental compliance were somewhat vague should not by itself immunize Vale from securities fraud liability.

In contrast, when meaningful probabilities with respect to an ESG risk cannot be generated by a company, when there is Knightian uncertainty, securities fraud liability relating to that risk should not be triggered. When a risk is essentially unknowable, there would be no meaningful asymmetry between the corporation and its investors with respect to the risk.[29] The probability/magnitude test can thus be

23. 485 U.S. 224 (1988).

24. *Id.* at 238 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

25. Complaint at 16–17, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

26. *Id.* at 48.

27. *Id.* at 48–49.

28. *Id.* at 6.

29. There are doctrines recognizing 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).

used as a way of limiting the costs of such litigation by assisting courts in separating good cases from bad.

In assessing the materiality of an ESG risk, courts should require the plaintiff to describe allegations and produce evidence that meaningful probabilities of an ESG risk were calculable. Such a showing could be supported by the fact that the corporation actually calculated the ESG risk at issue and relied upon it to some extent. In addition, plaintiffs should produce evidence on the validity of such calculation. They might demonstrate that the risk calculation was performed by experts pursuant to industry standards or that the risk calculation was widely disseminated and utilized within the company. In turn, defendants could argue that the ESG risk was not calculated, or if it was, that such calculations were not viewed as generating reliable estimates of Knightian risk.

Rather than applying the puffery doctrine in isolation, courts should evaluate the specificity of ESG risk statements and the materiality of the ESG risk together using a sliding scale approach. For example, when there is a very specific representation about ESG risk, the burden of establishing the materiality of the risk under the probability/magnitude test would be more modest than when there is only a generic representation of ESG risk. On the other hand, plaintiffs would have a much higher burden to establish that general statements of ethics or compliance are misleading. They would need to prove more convincingly that there was a known or highly probable ESG risk of substantial magnitude.

The impact of shifting to a more holistic assessment of ESG securities fraud cases is likely to be positive. While there is a danger that some companies will avoid calculating ESG risks to avoid liability, such a course of action is unrealistic for public companies that are being pressured to generate ESG risk disclosure by investors and regulation. By making it clear that the puffery doctrine will not automatically shield companies, a holistic approach would somewhat reduce the incentive to avoid specific statements relating to ESG risk and encourage better disclosure to investors. Rather than making arbitrary decisions based on the specificity of disclosures, judges adjudicating ESG securities fraud cases should thoroughly assess whether managers are deceiving investors about their knowledge of material information about a company's value.

It is worth noting at the outset some of the limits of the scope of this Article. This Article only addresses securities fraud liability for public corporations when their statements about ESG risk significantly distort their stock price. This Article does not address potentially broader claims that representations of ESG compliance deceived investors who based their decision to purchase a company's stock on ethical considerations. It is unclear whether securities fraud prohibitions would apply in such circumstances. Moreover, this Article does not offer a precise definition of the scope of ESG obligations. This Article recognizes that there is debate about what

qualifies as an ESG issue and that the meaning of ESG is continually evolving.

When ESG matters were of limited concern for public companies, it was difficult to argue that high-level corporate managers deceived investors about the risk of an ESG event. However, as investors have increasingly pushed companies to manage ESG risk, there is a stronger case that corporate managers should be accountable for truthfully disclosing their assessments of such risk. To the extent that companies are able to generate meaningful probabilities of an ESG-related loss, they should be held accountable when their public portrayals substantially diverge from their internal analysis of ESG risk.

Part I of the Article begins by discussing the similarities and differences between ESG securities fraud cases and cases where a company allegedly deceives investors about the risk of a business failure. Part II describes the current approach taken by courts in adjudicating ESG securities fraud cases, which relies heavily on the puffery doctrine as a screening device. Part III argues that the primary consideration in adjudicating securities fraud cases involving ESG risk is whether it is possible to generate reasonable probabilities relating to the risk. Part IV argues that courts should use a holistic approach in evaluating whether an ESG securities fraud case alleges a material misrepresentation.

I. SECURITIES FRAUD AND RISK

One view is that ESG securities fraud cases involve radically different theories than traditionally asserted under Rule 10b-5. This Part disagrees and shows that ESG securities fraud cases involve similar questions as standard claims alleging a material misrepresentation concerning a business failure or a risk of business failure. Liability for misrepresenting ESG risk is often difficult to assess because securities fraud claims relating to the *risk of* failure are generally more complicated to adjudicate than claims involving the misrepresentation of a *known* failure. ESG securities fraud cases are controversial because until recently, there was less expectation that high-level corporate managers should monitor ESG risk.

A. Business Failure Risk

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.[30] Such

30. 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

disclosure must be truthful. Statutes and rules permit the SEC to bring suit if there is a material misrepresentation in the company's public disclosures.[31] The most significant sanctions tend to be reserved for misstatements that are issued with an intent to deceive investors, a wrongful state of mind that courts often refer to as scienter.[32]

A common corporate motivation to mislead investors is to hide a significant business failure. For example, if a company knows that demand for an important product has declined significantly, it may fear that its stock price will fall if this fact is made public. The company may attempt to hide the weak demand by fabricating sales of the product or applying accounting rules aggressively to move future sales earlier to offset any shortfall.[33] Because the company has reported stronger sales than warranted, the company's stock price will remain stable or even rise. At some point, if the truth is revealed and investors realize that the company's sales were inflated to hide a decline, the stock price will fall to adjust for the reality that the company's economic prospects have worsened.[34]

If a company knows a fact about its economic condition and issues disclosure that misstates the fact, there is a misrepresentation to investors. If demand for a product is clearly weak but the company claims it is clearly strong, that statement is not true. Such a misstatement is a prerequisite for any securities fraud claim. If sales of the product are important for the company's financial performance, the misstatement will also be material in that it will be important to investors in valuing the stock, satisfying another condition for a viable securities fraud action.

Securities fraud cases involving business failures are more complicated when they involve statements about the *risk of* failure as opposed to a failure that is *known*. Consider a product that is performing well but there is a risk that such performance will falter. If a company states that demand for the product is strong without

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reports are filed on Form 10-K. Interim reports of certain events must be filed on Form 8-K. *See* 15 U.S.C. § 78m (2018).

31. 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. *See* 15 U.S.C. § 78j (2018); *see also* 15 U.S.C. § 77q (2018).

32. Such cases are typically brought pursuant to SEC Rule 10b-5. *See* 17 C.F.R. § 240.10b-5 (2023).

33. In a securities fraud case that reached the U.S. Supreme Court, Tellabs, a manufacturer of telecommunications equipment, claimed that "demand" for its "flagship networking device . . . was continuing to grow, when, in fact, demand for that product was waning." Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 315 (2007).

34. When the truth was revealed about the demand for Tellabs' product, its stock price, which had reached a high of $67, plunged to $15.87. *Id.* at 316.

revealing that there is a risk that demand may fall, it is not clear that there was a misrepresentation. If the risk of failure is trivial, then there is an argument that it is not misleading to claim that demand for the product is strong. There is always some risk that a product will fail and not every risk needs to be spelled out to the investor. When there is an allegation of a misrepresentation relating to a risk, it is thus important to establish that the risk is a material one.

The importance of the issue of materiality in cases involving the risk of a business failure was highlighted by the U.S. Supreme Court in *Matrixx Initiatives v. Siracusano*.[35] That case involved a pharmaceutical company with stock traded on the Nasdaq Stock Market.[36] One of Matrixx's major products was a cold medicine that contained zinc.[37] The company received a number of reports from doctors and customers that users of the medicine had lost their sense of smell.[38] It was also informed of a number of studies linking zinc and the medicine to the loss of smell.[39] In addition, nine patients who had taken the cold medication filed products liability lawsuits against Matrixx alleging it affected their ability to smell.[40]

Despite knowing of reports that the product had an adverse side effect, Matrixx represented to investors that demand for its cold medicine was strong.[41] It issued a generic disclosure acknowledging the risk that it could be subject to claims for product defects, but did not disclose that lawsuits alleging a defect had already been filed.[42] After the Food and Drug Administration announced it would investigate the reports of loss of smell, Matrixx's stock price fell by about twenty-five percent.[43]

When the representations scrutinized in *Matrixx* were made, it was not yet clear that demand for the company's product had fallen or would ever fall. There was only the possibility that there was a side effect that could affect sales at some point. In order to determine whether Matrixx misled investors when stating that demand for the medicine was strong, there would need to be a finding that the risk of such a side effect was material enough so that a reasonable investor would view information about the risk as significant.

The Supreme Court concluded that the complaint described sufficient allegations that "Matrixx had information indicating a significant risk to its leading revenue-generating product."[44] The

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35. 563 U.S. 27 (2011).
36. *Id.* at 31, 31 n.1.
37. *Id.* at 31.
38. *Id.* at 32.
39. *Id.* at 32–33.
40. *Id.* at 33.
41. *Id.*
42. *Id.* at 34.
43. *Id.* at 34–35.
44. *Id.* at 47.

Court rejected the defendant's argument that the lack of a study establishing a statistically significant relationship between the medicine and the loss of smell meant that the risk of such a side effect was not material.[45] The Court instructed that the materiality of a risk should depend on a fact-intensive inquiry rather than a bright-line rule.[46] The numerous customer complaints were sufficient to create a factual issue about whether there was a substantial risk that the product would suffer a setback, so Matrixx's statements that demand for the medicine was strong were material misrepresentations that could support a claim under Rule 10b-5.[47]

B. ESG Risk

ESG securities fraud cases can be understood to be a subset of securities fraud cases relating to a business failure. ESG issues often affect a company's financial performance. A corporate scandal can drive away customers, destroy employee morale, and trigger harsh regulatory penalties. ESG problems can effectively have the same economic impact as the failure of an important product, which could reduce the company's credibility with customers and affect the company's ability to attract talent. Just as it makes sense to distinguish between securities fraud cases where there is a *known* business failure from cases where there is a *risk of* business failure, it is important to distinguish between securities fraud cases involving a *known* ESG failure and cases involving a *risk of* ESG failure. The strongest complaints alleging ESG securities fraud will describe misrepresentations concerning an ESG problem that has already been realized. The more difficult cases involve misrepresentations relating to the *risk of* an ESG failure that may or may not occur.

Companies often issue misstatements about *known* ESG problems. For example, a company that knows it has a culture of sexual harassment could deceive investors by conveying that it has a strong commitment to complying with anti-discrimination laws.[48] When the truth is revealed, the stock market will reassess the company's valuation to take into account the impact of such a culture on the company's business. The company will find it more difficult to attract qualified workers, bad publicity about its problems will drive away customers, and legal violations will attract the attention of government enforcers and increase litigation costs.

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45. *Id.* at 39–40, 45.
46. *Id.* at 30, 43.
47. *Id.* at 47, 49.
48. A recent example of a misrepresentation relating to a *known* ESG issue involved the CEO of McDonald's, who failed to disclose improper sexual relationships with employees, which resulted in the filing of a misleading disclosure by McDonald's. *See* Stephen J. Easterbrook & McDonald's Corp., Securities Act Release No. 11144, Exchange Act Release No. 96610, File No. 3-21269 2–3 (Jan. 9, 2023).

The SEC recently filed a case against Boeing that alleged a misstatement about a *known* ESG problem.[49] After the first tragic crash of one its 737 MAX planes, the company's safety engineers identified a flaw in the 737 MAX's software that caused it to erroneously tilt the plane's nose downwards.[50] Despite knowing of this safety issue, Boeing's CEO ordered the company's communications office to issue a statement that the 737 MAX was "as safe as any airplane that has ever flown the skies."[51] Boeing's stock price rallied after that statement was made.[52] The SEC alleged that Boeing knew the crash was likely caused by a safety issue it needed to address but chose not to reveal that issue to investors.[53]

ESG securities fraud cases will also scrutinize the truth of corporate disclosures issued before an ESG risk has been actualized. The defendant will typically argue that its representations were accurate because they were made when it did not know of a substantial risk. For example, in the *Vale* case, the company might have argued that at the time it assured investors that its dam was safe, the probability of collapse was so low that it could not have predicted that the dam would fail at the time that it did. It could claim that it was just as surprised by the failure of the dam as investors (though that argument might not be convincing as discussed below). ESG securities fraud litigation prompted by another corporate disaster, the explosion of British Petroleum (BP)'s Deepwater Horizon rig, prompted one prominent commentator to observe: "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."[54] For a large company with sprawling global operations, there are dozens if not hundreds of places where an accident could take place. Investors would be overwhelmed with information if they received specific disclosures about the risk of disaster at each and every one of a company's facilities.

In addition to involving the misrepresentation of a *known* issue, the Boeing case could be understood as misrepresenting the *risk of* an additional tragedy. Less than six months after the first 737 MAX crash, a second 737 MAX plane crashed.[55] The second crash amplified Boeing's crisis and caused greater damage to its business because it

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49. Boeing Co., Securities Act Release No. 11105, File No. 3-21140 1–2 (Sept. 22, 2022).

50. *Id.* at 7–8.

51. *Id.* at 9.

52. *Id.*

53. *Id.*

54. Coffee, *supra* note 14; *see also* MENDOZA & LUBITZ, *supra* note 14, 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").

55. Boeing Co., No. 3-21140, at 11.

required grounding all of the company's 737 MAXs for twenty months.[56] Boeing's earlier misstatement that its planes were "safe" could be interpreted as not only denying that its first crash reflected a *known* issue, but also obscuring the *risk of* additional crashes that could adversely affect its business.[57] Investors who believed that the first crash was due to pilot error would not have incorporated the appropriate risk of a second crash when purchasing the company's stock.

The distinction between *known* ESG problems and ESG risk is also evident in the context of cybersecurity, which has generated a significant amount of securities enforcement and private litigation. Cyberattacks that steal customer data or disrupt company operations now frequently cause substantial economic losses to public companies. The failure to prevent such attacks can result in reputational harm and regulatory sanction.[58] A company that knows it has been subject to a major cyber breach but denies such a breach in its regulatory filings has clearly issued a misrepresentation. A more complicated case would involve a claim that a company knew there was a substantial risk of a breach but represented that it had a system in place that would likely prevent such a breach. If a breach actually occurs and causes the stock price to decline, investors may claim that the risk of the breach was misrepresented. Resolving whether there was a misrepresentation will require assessing whether the risk was sufficiently material so the denial of the risk was a misstatement.

The economic loss associated with an ESG failure will often reflect the costs of resolving enforcement brought by regulators and lawsuits by private parties.[59] This adds another layer of contingency in resolving whether the company adequately represented the risk of ESG loss. It is difficult to anticipate the probability that a government agency will bring an enforcement case and impose a substantial penalty on a company for the failure to comply with ESG regulations. Not all investigations of corporate wrongdoing will necessarily result in the filing of a case.[60] The company will often

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56. *Id.*

57. The SEC also alleged that Boeing issued additional misrepresentations after the second crash relating to flaws in its design and certification issues. *Id.* at 11–13.

58. For an overview of this issue, see Commission Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. 8166, 8166–72 (Feb. 26, 2018).

59. *See, e.g.*, Frank Partnoy & Adam Badawi, *Social Good and Litigation Risk*, 12 HARV. BUS. L. REV. 315, 321 (2022) (arguing that ESG risk is essentially litigation risk).

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

vigorously defend its actions in the hope of persuading the enforcer not to bring a case or abandon a case that has been filed, and a disclosure acknowledging the merit of a possible investigation could undermine that effort. The secrecy and unpredictability of the governmental decision-making process 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.[61] The impact of private litigation arising out of a corporate scandal is also difficult to estimate. Some cases may be dismissed with little cost while others will require substantial payment to resolve.

C. Challenges in Adjudicating Securities Fraud Claims Involving ESG Risk Misrepresentations

To the extent that an ESG securities fraud case involves misrepresentations relating to ESG risk, it will face similar challenges in court as cases involving misrepresentations of the risk of a business failure. At the same time, ESG risk cases raise distinctive issues that are not seen in cases involving the company's core financial performance.

1. General Challenges

a. Hindsight Bias

Assessing whether a statement misleads investors about a risk is complicated by the well-known cognitive challenge of hindsight bias. When a risk is actualized, there is a tendency to conclude after the fact that the risk was high ex ante. Knowledge that the Vale dam actually collapsed will bolster the belief that the risk of collapse was significant when a prior disclosure was made, regardless of the actual risk of collapse.

Courts have thus often warned against finding "fraud by hindsight."[62] A significant business failure by itself does not mean the risk of that failure was high, corporate managers knew that the risk was high, and yet misrepresented that risk to investors. A plaintiff must thus present specific evidence relating to the risk establishing that it was actually high and known to be high by corporate officers before the actual disaster.

Because securities fraud enforcement and litigation are often spurred by a decline in the company's stock price, some critics contend that companies are targeted for regulatory action in a way that

61. 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, 973–75 (2009).

62. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir. 1990) (quoting Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978)).

essentially punishes misfortune. Courts thus often view securities fraud cases that target misstatements relating to risk with skepticism.

b. Costs of Litigation

Assessing whether a corporation misrepresented a risk of business failure is inherently more costly than assessing whether a corporation misrepresented an ongoing business failure. A court will not only have to assess evidence on whether the failure was significant, it will also have to assess whether the risk of failure was significant enough so that its misrepresentation was material to investors.

Securities fraud litigation has been criticized for decades because of the burdens it imposes on public companies. Concerns about the costs of adjudicating securities fraud claims became prominent during the 1980s, when investors began to frequently file securities class actions against companies that were developing computers and related technologies.[63] Entrepreneurs in the computer industry formed public corporations that often focused on developing a single new product. Because of the willingness to speculate on the success of computer technology, the market value of such companies was often higher than warranted by their current profitability. 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. Because products often did not live up to their promise, there were hundreds of cases filed against technology companies alleging that they issued statements about a product that did not acknowledge that the product had failed or that did not acknowledge a significant risk that the product would fail.

Adjudicating a company's true knowledge of a risk can generate high litigation costs. It is difficult to determine the intent of managers working in a complex corporate bureaucracy where there are differing viewpoints and information flows are imperfect. A plaintiff will often request all documents, including e-mails, that relate to a corporation's assessment of a risk. Corporate 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 often are conducted long 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 an unpredictable jury unless it settles.

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63. 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).

2. *ESG Risk Challenges*

Cases involving ESG risk are particularly controversial because they can expand the scope of a company's monitoring and disclosure obligations. Investors have always expected that competent corporate managers will assess and monitor risks relating to their core business operations. The expectation that corporate managers will actively evaluate ESG risks is more recent and still contested.

ESG risks are generated by a wider range of sources than the risk of a business failure. Because ESG scandals can come from many parts of a company's business operations, it is more challenging for corporate management to assess, evaluate, and address such risks.[64] While public corporations and their management can be expected to have a comparative advantage in assessing whether a core product will fail,[65] it is less clear that they can predict when various ESG problems will arise.

Because courts do not have as much experience evaluating ESG risk, they will find it more difficult to decide ESG securities fraud cases.[66] In contrast to litigation involving financial misstatements and misrepresentations about products where there is significant case law, the law governing misstatements about ESG risk is less developed. Some courts may be cautious in extending liability to cover disclosure relating to newer risks that they are not as familiar with.

II. THE LAW OF ESG SECURITIES FRAUD

Courts have been wary about permitting ESG securities fraud cases to proceed, partly because of the perception that they often involve statements about risks that are ancillary to a company's core business.[67] They have frequently dismissed Rule 10b-5 claims arising out of ESG events on the ground that disclosures relating to ESG risk are puffery and are thus not material misstatements. Decisions in this area reveal the lack of a principled approach to determining whether an ESG statement is sufficiently specific to qualify as a

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64. *See, e.g.*, Roy Shapira, *Mission Critical ESG and the Scope of Director Oversight Duties*, 2022 COLUM. BUS. L. REV. 732, 799 (2022) (describing difficulty of assessing reputational risk).

65. *See, e.g.*, Michael Simkovic, *Limited Liability and the Known Unknown*, 68 DUKE L.J. 275, 280 (2018) (observing that managers generally have an informational advantage over investors).

66. For an argument that the increase in ESG disclosure will make the costs of Rule 10b-5 securities class actions unmanageable, see Kevin S. Haeberle, Fraud-on-the-Market Liability in the ESG Era 1 (Aug. 21, 2022) (unpublished manuscript) (available at https://ssrn.com/abstract=4198386).

67. Ann Lipton has argued that courts may also be generally skeptical of securities class actions advancing Rule 10b-5 claims because such class actions do not require a strict showing of reliance by individual investors. *See* Ann M. Lipton, *Reviving Reliance*, 86 FORDHAM L. REV. 91, 94–95 (2017).

misstatement. ESG risk cases have also raised tricky questions about whether a disclosure about a risk, if the risk has been actualized, can be misleading, and when an ESG misstatement is issued with fraudulent intent. This Part reviews these various doctrinal issues.

A. Puffery

One of the difficulties of bringing an ESG securities fraud case is identifying a clear misstatement by the corporation.[68] Corporate managers generally spend less effort disclosing specific information about ESG risk than conveying a company's financial performance. Corporate disclosure often discusses ESG risk in the context of general statements assuring investors that a company has high ethical standards and complies with regulatory rules.

Plaintiffs in ESG securities fraud cases thus often point to vague statements of corporate ethics and compliance in arguing that a company misrepresented the risk of an ESG scandal. As noted earlier, in the *Vale* case, the SEC argued that the company's claim that its reviews of its dams were "rigorous" and based on "best practices" was false because it manipulated various audits of the dams.[69] A serious workplace accident could trigger a lawsuit arguing that a company's representation that it was committed to workplace

68. The failure to disclose an ESG risk by itself is not actionable because there is no general duty to continually disclose material information under Rule 10b-5. This point has been well-established in the caselaw. *See* Basic Inc. v. Levinson, 485 U.S. 224, 239, 239 n.17 (1988); *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d. Cir. 1993); *see also* Langevoort, *supra* note 22, 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 Fam. P'ship LLLP 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." *Id.* 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). When a defendant issues information relating to the risk, it has a "duty to speak the full truth." Lormand v. US Unwired, Inc., 565 F.3d 228, 249 (5th Cir. 2009) (quoting Rubinstein v. Collins, 20 F.3d 160, 170 (5th Cir. 1994)); *see also* SEC v. Johnston, 986 F.3d 63, 71–72 (1st Cir. 2021) (noting that duty to disclose was not an issue because the defendant "chose to make statements"). As another court has noted, when a defendant chooses to speak on a risk, it "must disclose material, firm-specific adverse facts that affect the validity or plausibility of that prediction." *Rubinstein*, 20 F.3d at 170.

69. Complaint at 64, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

safety was untrue. A substantial regulatory violation that results in the imposition of a large fine by the government could indicate the company's assertion that it has an ethical culture was misleading. A corporation that touts its rigorous measures to prevent cyber breaches could be accused of misleading investors when such a breach actually occurs and there is evidence that its managers knew that the company's controls were weak.

Courts often dismiss ESG securities fraud actions when they are based mainly on such broad statements of ESG compliance. They do so by applying the longstanding puffery doctrine, which precludes liability for vague statements that are not meant to be literally true.[70] Such imprecise statements may not be misrepresentations because it is obvious that they are not verifiable.[71] A customer cannot win a fraud claim against a pizza parlor that advertises its pizza as the "best in the world," even if the pizza tastes terrible, because a reasonable customer would not believe that the statement is literally true. The statement would thus not be a misrepresentation and would also not materially affect the investor's decision to purchase the pizza. In one representative case, a federal appellate court found that a corporate statement by the auto manufacturer Ford expressing its "commitment to quality, safety, and corporate citizenship" was not made misleading by a major tire recall.[72] The court 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."[73] Other judges have often rejected claims directed at statements on issues ranging from a commitment to comply with regulations, general codes of ethics, and efforts to

70. *See, e.g.*, Xia Bi v. McAuliffe, 927 F.3d 177, 183 (4th Cir. 2019) (observing that "immaterial boasting and exaggerations" are generally not misstatements); *see also* Lipton, *supra* note 67, at 114 (noting that "claims based on ESG statements, such as ethics codes and risk mitigation strategies, are particularly attractive targets for dismissal on puffery grounds").

71. *See, e.g.*, Ind. Pub. Ret. Sys. v. SAIC, Inc., 818 F.3d 85, 97–98 (2d Cir. 2016) (holding that statements in a company's Annual Report about its commitment to ethics and integrity were not actionable because their generality "prevent[ed] them from rising to the level of materiality required to form the basis for assessing a potential investment") (quoting City of Pontiac Policemen's & Fireman's Ret. Sys. v. UBS AG, 752 F.3d 173, 183 (2d Cir. 2014)).

72. *In re* Ford Motor Co. Sec. Litig., 381 F.3d 563, 569–70 (6th Cir. 2004); *see also* City of Monroe Emps. Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 671 (6th Cir. 2005) (finding statements too vague to support securities fraud case arising out of tire recall).

73. *Ford*, 381 F.3d at 570; *see also* Longman v. Food Lion, Inc., 197 F.3d 675, 685 (4th Cir. 1999) (concluding that statement describing company's stores as "clean and conveniently located" was "the kind of puffery . . . that reasonable investors could not have relied upon when deciding whether to buy the stock").

protect customer information.[74] Indeed, Vale itself won dismissal on puffery grounds of part of a securities class action that arose out of an earlier collapse of a dam it owned through a joint venture.[75]

The U.S. Supreme Court recently highlighted a form of the puffery doctrine in a securities class action alleging Rule 10b-5 violations against Goldman Sachs.[76] Prior to the financial crisis of 2008, the investment bank sold securities backed by a pool of mortgages selected by a fund manager who wanted to bet that the value of those securities would fall. The purchasers of these securities would want to know that they were backed by assets selected by someone with an interest in the assets failing, but that fact was not disclosed. When this questionable transaction came to light, it triggered an SEC investigation and sanction of $550 million.[77] Investors who purchased Goldman Sachs stock during the period of the misconduct sued, alleging that they too were defrauded. They essentially argued that representations in Goldman's SEC filings that the company had "extensive procedures and controls that are designed to identify and address conflicts of interest" were shown to be misleading by the scandal.[78]

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74. *See, e.g.*, Singh v. Cigna Corp., 918 F.3d 57, 63 (2d Cir. 2019) (finding that "statements in Cigna's Code of Ethics are a textbook example of 'puffery'"); Emps.' Ret. Sys. v. Whole Foods Mkt., Inc., 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 & Dep't Store Union Loc. 338 Ret. Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1276 (9th Cir. 2017) (finding that code of ethics was aspirational); Ind. State Dist. Council of Laborers & HOD Carriers Pension & Welfare Fund v. Omnicare, Inc., 583 F.3d 935, 944 (6th Cir. 2009) (finding that representation about compliance with Medicare rules was too vague to be actionable); Metzler Inv. GMBH v. Corinthian Colls., 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"); Order Granting Defendants' Motion to Dismiss, *In re* First Am. Fin. Corp. Sec. Litig., CV 20-9781, 2021 WL 4807648, at *9 (C.D. Cal. Sept. 22, 2021) (finding that statement that a company was "committed to safeguarding customer information" was puffery); Constr. Laborers Pension Tr. for S. Cal. v. CBS Corp., 433 F. Supp. 3d 515, 533 (S.D.N.Y. 2020) (finding that code of ethics was too broad to be misleading); *In re* Braskem S.A. Sec. Litig., 246 F. Supp. 3d 731, 754–56 (S.D.N.Y. 2017) (holding that code of ethics was aspirational); Strougo v. Barclays PLC, 105 F. Supp. 3d. 330, 343–44 (S.D.N.Y. 2015) (finding general statements relating to compliance and risk controls to be puffery).

75. *In re* Vale S.A. Sec. Litig., 1:15-cv-9539-GHW, 2017 WL 1102666, at *21–22 (S.D.N.Y. Mar. 23, 2017).

76. Goldman Sachs Grp., Inc. v. Ark. Tchr. Ret. Sys., 141 S. Ct. 1951, 1960–61 (2021).

77. Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), https://www.sec.gov/news/press/2010/2010-123.htm.

78. *Goldman Sachs Grp.*, 141 S. Ct. at 1957.

The Supreme Court noted that an obstacle to the class action plaintiff's theory in the *Goldman Sachs* case was that the disclosures they pointed to were "generic" statements of good governance that may not have impacted the company's stock price.[79] Investors will discount boilerplate language when they value a company's stock. Even if Goldman's controls were extremely weak and there was in fact a high risk it would enter into questionable transactions that would harm its reputation, investors might not have been misled because they never believed Goldman's statement meant it would prevent every conflict of interest.[80]

A securities fraud plaintiff might respond that the puffery doctrine is misguided because the reasonable investor will believe and rely upon general representations about a commitment to ESG standards.[81] 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 Goldman's controls were in fact systematically weak?[82]

The practice of dismissing claims based on puffery is best justified on the ground that making such broad statements actionable would mean that too many ESG events would 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.

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79. A defendant in a securities class action case alleging a violation of Rule 10b-5 can defeat certification of the class by showing that a misstatement did not impact the company's stock price. *Id.* at 1959. Though not technically an inquiry on materiality, the price impact inquiry essentially evaluates whether a misstatement was material to the marketplace. *See, e.g.*, Ark. Tchr. Ret. Sys., v. Goldman Sachs Grp., 77 F.4th 74, 108-09 (2d Cir. 2023) (Sullivan, J., concurring) (discussing difficulty of distinguishing materiality and price impact tests).

80. The Supreme Court remanded the case to the district court to consider the generic nature of the misstatements. *Goldman Sachs Grp.*, 141 S. Ct. at 1963.

81. A number of scholars have found evidence that ordinary investors would rely upon statements that courts have classified as puffery. *See* David A. Hoffman, *The "Duty" to be a Rational Shareholder*, 90 MINN. L. REV. 537, 586–87 (2006); *see also* Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 372 (2008).

82. 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 such statements. *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 Supreme Court remanded the *Goldman Sachs* case to the district court,[83] which considered whether the company's disclosures relating to its governance of conflicts of interest were too generic to impact the company's stock price.[84] On remand, the lower court concluded that the statements were specific enough so that they may have played a role in maintaining the company's stock price over time (a fact that would support a finding of materiality).[85] The court questioned why these types of disclosures "would have achieved such ubiquity in the first place were they incapable of influencing (including by maintaining) a company's stock price."[86] While the U.S. Court of Appeals for the Second Circuit later reversed the district court's decision,[87] the lower court made a plausible point about the market impact of generic representations.

Plaintiffs in other ESG securities fraud cases have been successful when they persuade courts that ESG statements are sufficiently specific to be misleading.[88] For example, in a case

83. *Goldman Sachs Grp.*, 141 S. Ct. at 1963.

84. *See In re* Goldman Sachs Grp., Inc. Sec. Litig., 579 F. Supp. 3d 520, 533–36 (S.D.N.Y. 2021).

85. *Id.* at 535–38.

86. *Id.* at 536.

87. Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., 77 F.4th 74, 105 (2d Cir. 2023).

88. *See, e.g.*, *In re* Synchrony Fin. Sec. Litig., 988 F.3d 157, 167–70 (2d Cir. 2021) (finding statement denying pushback from business partners to be sufficiently specific to mislead investors about deteriorating client relationship that resulted in litigation); *In re* Signet Jewelers Ltd. Sec. Litig., 389 F. Supp. 3d 221, 231 (S.D.N.Y. 2019) (finding 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 word"); *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"); Hall v. Johnson & Johnson, No. 18-1833 (FLW), 2019 WL 7207491, at *19–24 (D.N.J. Dec. 27, 2019) (finding statements about quality assurance and that products were "asbestos free" to be misleading while dismissing claims relating to statements about general commitments to corporate values); Edgar v. Anadarko Petroleum Corp., No. CV H-17-1372, 2019 WL 1167786, at *6, *14, *17 (S.D. Tex. Mar. 13 2019) (finding that an affirmative statement regarding a company's compliance with laws and regulations, included in its Health, Safety, Environmental, and Sustainability Overviews, was sufficiently specific to be actionable); *see also* Constr. Laborers Pension Tr. for S. Cal. v. CBS Corp., 433 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").

involving the collapse of another dam in Brazil (which was jointly owned by Vale), 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.[89] In adjudicating ESG securities fraud cases relating to cybersecurity 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 cybersecurity risk.[90]

In the BP securities litigation discussed earlier, a court found that representations relating to safety in a sustainability disclosure by BP were actionable under Rule 10b-5 because they were meant to address investor concerns after prior accidents.[91] After a number of problems at its oil rigs, BP made efforts to regain investor trust in its commitment to safety.[92] 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 evaluated its safety measures.[93] Investors argued that these disclosures 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.[94] Rather than arguing that a general commitment to safety was misleading, the plaintiffs successfully argued that more specific statements which were meant to address particular investor concerns were actionable.[95]

The specificity of a company's disclosure on an ESG issue may indicate that the issue is of particular importance to investors and that the reasonable investor would rely on that disclosure. When a company takes the trouble to address a specific area of concern in its

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89. *See, e.g.*, *In re* BHP Billiton 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, when 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").

90. *See, e.g.*, *In re* Zoom Sec. Litig., No. 20-cv-02353-JD, 2022 WL 484974, at *3 (N.D. Cal. Feb. 16, 2022) (concluding that claim alleging company provided "end-to-end encryption" was actionable); *In re* Solarwinds Corp. Sec. Litig., 595 F. Supp. 3d 573, 589 (W.D. Tex. 2022) (holding that company's statements falsely describing security measures as sufficient were actionable).

91. *In re* BP P.L.C. Sec. Litig., 843 F. Supp. 2d 712, 762–64 (S.D. Tex. 2012).

92. *Id.* at 757–60.

93. *Id.* at 757.

94. *Id.* at 744.

95. *Id.* at 757–59.

public communications, that could be evidence that corporate managers are aware of a risk that could affect the company's valuation. Their failure to adequately disclose adverse developments relating to the ESG issue could be motivated by the fear 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 court's main focus in assessing whether there is a material misrepresentation to investors. There is no precise test for determining when a representation avoids classification as puffery.[96] As a result, the application of the doctrine will depend on the arbitrary discretion of district court judges.[97] A rigid requirement that a company can only be liable for specific statements on a particular ESG risk may unfairly immunize companies from securities fraud scrutiny, even when they obscure substantial risks to investors. The puffery doctrine could also create incentives for companies to limit specific disclosure and instead rely on general assurances about a company's ethics and commitment to social responsibility.[98] In doing so, it would undermine the securities law policy of encouraging useful disclosure to investors.[99]

B. *Risk Disclosure*

Courts have also expressed concerns about ESG securities fraud claims in the context of risk disclosures. Plaintiffs have filed cases alleging that a disclosure of an ESG risk was misleading because the

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96. *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").

97. *See, e.g.*, Langevoort, *supra* note 22, at 972–93 (comparing differing results in cases and asking if "wordplay" should be determinative).

98. *See, e.g.*, Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821, 1847–48 (2021) (noting that "some law firms recommend that companies phrase ESG disclosures" "in aspirational or vague terms" to "reduce liability risk"). There may also be situations where broad statements are not necessarily motivated by the desire to avoid liability. For example, 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.'" Constr. Laborers Pension Tr. for S. Cal. v. Marriott Int'l, 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 risk disclosures necessarily lead to more attacks." *See, e.g.*, Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 88 Fed. Reg. 51896, 51932 (Aug. 4, 2023).

99. *See, e.g.*, Strauss, *supra* note 7, at 1367 (arguing that more specific disclosures of risk induce better monitoring and put investors on notice).

risk was actualized when the disclosure was issued.[100] A disclosure that describes a potential risk to the business without revealing that the risk is in the process of actually occurring seems to be misleadingly incomplete.[101] But courts have differed in how they treat these cases. Some courts have concluded that a risk disclosure cannot be misstated, even when it does not acknowledge an actualized risk, because it provided investors sufficient warning about the risk that allowed them to take that risk into account in their decision to purchase a stock.[102] Several decisions by courts in the Ninth Circuit have held 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.[103] In one case, the U.S. Court of Appeals for 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."[104]

The hesitancy to impose Rule 10b-5 liability for misleading risk disclosures can be explained by the concern that such liability could create disincentives to warn about risk. While securities regulation requires public companies to file disclosures on risks, this requirement is limited to "material" risks.[105] A corporation concerned that its risk disclosures could trigger securities fraud liability might choose to apply a narrow definition of materiality and disclose fewer risks.[106]

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100. The SEC requires issuers to disclose material risks to investors in registration statements and periodic disclosure. *See* 17 C.F.R. § 229.105 (2023).

101. The SEC has consistently taken this position. *See, e.g.*, Complaint at 11, SEC v. Mylan N.V., No. 1:19-CV-2904 (D.D.C. 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").

102. *See* Plevy v. Haggerty, 38 F. Supp. 2d 816, 830–32 (C.D. Cal. 1998) (noting that "abundant and specific disclosures[,]" put investors "on notice of these risks[,]" even when those adverse facts "were actually impacting [defendant's] business").

103. *See, e.g.*, *In re* Volkswagen "Clean Diesel" Mktg., Sales Pracs., & Prods. Liab. Litig., 480 F. Supp. 3d 1050, 1061 (N.D. Cal. 2020) (quoting *In re* LeapFrog Enters., Inc. Sec. Litig., 527 F. Supp. 2d 1033, 1048 (N.D. Cal. 2007)).

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

105. 17 C.F.R. § 229.105.

106. Corporations have incentives to issue risk disclosure as well. They have an incentive to make cautionary statements about disclosures relating to their future performance to qualify for the PSLRA safe harbor, which protects them from Rule 10b-5 litigation if such predictions are not actualized. *See* 15 U.S.C. §§ 77z-2(c), 78u-5(c) (2018); *see also* James J. Park, *Do the Securities Laws Promote Short-Termism?*, 10 U.C. IRVINE L. REV. 991, 1009–10 (2020) (describing history of safe harbor).

On the other hand, there is a concern that without some policing, risk warnings could become meaningless.[107] The risk disclosure section of SEC filings should not just recite boilerplate that stays static even as risks come to fruition. There must be some obligation to ensure that risk disclosures are updated to reflect material developments.

Many courts are thus reluctant to find that risk disclosures are misleading but leave the door open to finding liability, instructing that "under certain circumstances, cautionary statements can give rise to Section 10(b) liability."[108] 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.[109] The U.S. Court of Appeals for the Fourth Circuit 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."[110] The U.S. Court of Appeals for the First Circuit has held that a risk disclosure can be misleading when the risk at issue was "a near certainty" and known to corporate management.[111]

Notably, the SEC has taken the position that an actualized risk can make a prior disclosure on that risk misleading. In its 2019 case against the social media company Facebook, the SEC alleged that "Facebook misleadingly presented the potential for misuse of user 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."[112] That case was not litigated but settled for a substantial sum.[113] In 2021, the SEC brought a case against Pearson, an educational publishing company, on the ground that its

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107. *See, e.g.*, Langevoort, *supra* note 22, 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").

108. *In re* Van Der Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388, 400 (S.D.N.Y. 2005).

109. *Id.*

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

111. Karth v. Keryx Biopharmaceuticals, Inc., 6 F.4th 123, 137–38 (1st Cir. 2021).

112. *See* Complaint at 2, SEC v. Facebook, Inc., No. 3:19-cv-04241 (N.D. Cal. Aug. 22, 2019).

113. *See* Press Release, SEC, Facebook to Pay $100 Million for Misleading Investors About the Risks it Faced from Misuse of User Data (July 24, 2019), https://www.sec.gov/news/press-release/2019-140. Facebook won dismissal of a securities class action alleging that the company made misleading statements about its privacy policies. *In re* Facebook, Inc. Sec. Litig., 405 F. Supp. 3d 809, 849 (N.D. Cal. 2019).

risk disclosure of the possibility of a major data breach was misleading because it was unchanged after such a breach occurred.[114]

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 federal district court in California refused to dismiss a Rule 10b-5 class action against Volkswagen (VW) 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.[115] The court found that while VW'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 researching clean technologies.[116] 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.[117] Such an approach would encourage companies to go beyond boilerplate 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 under Rule 10b-5, it must have been made with fraudulent intent, that is, scienter.[118] If a corporation and its managers mistakenly describe a risk, even if they do so negligently,

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114. *See* Pearson plc, Securities Act Release No. 10963, Exchange Act Release No. 10963, File No. 3-2042, at 3–4 (Aug. 16, 2021).

115. *See, e.g.*, *In re* Volkswagen Clean Diesel Mktg., Sales Pracs., Fed. Sec. L. Rep. P 99817 (CCH), 2017 WL 3310179, at *3, *18 (N.D. Cal. July 19, 2017).

116. *See, e.g.*, *id.* at *8–9 (finding risk disclosure misleading in light of other disclosures).

117. *Compare In re* Alphabet, Inc. Sec. Litig., 1 F.4th 687, 703–04 (9th Cir. 2021) ("[R]isks 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.'") (alterations in original) (citations omitted), *with* Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1207 (9th Cir. 2016) (concluding that 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 a warning of future writeoffs).

118. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

they would not violate Rule 10b-5. Corporate disclosures cannot be perfect and only misstatements that are meant to deceive investors are actionable as securities fraud. As ESG securities fraud filings become more frequent, courts will have to grapple with the question of whether misrepresentations relating to ESG risk were made with fraudulent intent, especially in cases by private investors who typically must bring suit under Rule 10b-5.

Early securities class actions filed against technology companies highlighted the costs of determining whether misstatements relating to a business failure reflected securities fraud. If corporate managers did not have knowledge of the risk of product failure in a high percentage of cases, requiring companies to expend significant amounts to defend their mistaken disclosures might not be justified. Congress in 1995 thus passed the Private Securities Litigation Reform Act (PSLRA) on the premise that the costs of securities litigation were on average greater than the benefits.[119] 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.[120]

There are two tests that courts typically apply in determining whether corporate managers acted with scienter.[121] The first looks at whether there was a motive and opportunity for a manager to defraud investors.[122] The second asks essentially whether managers acted with a high degree of recklessness.[123]

The first test is not often used in the ESG securities fraud context. It can be 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 incentive to defraud investors. A general motive to increase or maintain the company's stock price is

119. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737.

120. *See* 15 U.S.C. § 78u-4(b)(2)(A) (2018) (requiring that plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

121. *See, e.g.*, Novak v. Kasaks, 216 F.3d 300, 307–08 (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, 974 (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 misconduct").

122. *See Novak*, 216 F.3d at 307 (quoting Acito v. IMCERA Grp., Inc., 47 F.3d 47, 52 (2d Cir. 1995)).

123. *Id.* at 307 (quoting *Acito*, 47 F.3d at 52).

insufficient.[124] Plaintiffs often establish motive by showing that managers personally profited in some way through the fraud.[125] In a financial fraud case, this is often established through evidence of unusual amounts of stock sales by managers during the period when the misrepresentation affected the stock price.[126]

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.[127] 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 through fraud, there is 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.[128] 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 engage in case-by-case analysis focusing on the severity of the risk that was not disclosed.[129] They often look to whether there were "red flags"

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124. *See, e.g.*, *id.* at 139 ("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).

125. *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").

126. *See* Goldman v. Belden, 754 F.2d 1059, 1070–71 (2d Cir. 1985).

127. *See, e.g.*, James J. Park, *Shareholder Wealth Maximization and Securities Fraud*, 72 DEPAUL L. REV. 395, 405–08 (2023) (observing that securities fraud in cases relating to corporate wrongdoing is often motivated by the desire to maximize shareholder wealth rather than individual enrichment).

128. *See, e.g.*, Plotkin v. IP Axess Inc., 407 F.3d 690, 697 (5th Cir. 2005) (citing Mercury Air Grp., Inc. v. Mansour, 237 F.3d 542, 546 n.3 (5th Cir. 2001)) (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").

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

that corporate managers knew of but ignored.[130] 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.

For example, in the *Matrixx* case, the Supreme Court briefly discussed whether the complaint sufficiently alleged scienter.[131] The Court noted that the company made substantial efforts to counter the reports of side effects, which could support the claim that they knew that the reports raised a significant problem.[132] Rather than inform investors about what they knew of the problem, the company attempted to prevent an adverse market reaction to the reports.[133] The Supreme Court thus concluded that there were sufficient allegations relating to scienter to proceed past the motion to dismiss stage.[134]

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.[135] At the same time, it has insisted on substantial penalty payments to settle such cases,[136] signaling it viewed such corporate conduct as reflecting substantial misconduct. In doing so, the SEC has left the concept of fraudulent intent in ESG securities fraud cases undefined.

III. MATERIALITY AND 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 often unduly focused on the wording of corporate statements in screening which cases may proceed past a motion to dismiss.[137] This Part proposes an alternative emphasis. The key

130. *See, e.g.*, *In re* Van der Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388, 404–05 (S.D.N.Y. 2005) (concluding that managers were reckless in ignoring red flags relating to rule violations).

131. Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 48 (2011).

132. *Id.* at 49.

133. *Id.* at 50.

134. *Id.*

135. *See, e.g.*, Complaint at 2–3, SEC v. Facebook, Inc., No. 3:19-cv-04241-JD, 2019 WL 3318599 (N.D. Cal. July 24, 2019); Complaint at 4, SEC v. Volkswagen Aktiengesellschaft, No. 3:19-cv-01391-SK, 2019 WL 1224720 (N.D. Cal. Mar. 14, 2019).

136. 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. Final Judgment at 4, *Facebook, Inc.*, 3:19-cv-04241-JD.

137. 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

issue in a securities fraud case relating to a misrepresentation of ESG risk is whether the risk at issue was material. Such a finding will often turn on whether reasonable probabilities concerning a particular ESG risk can be calculated. If they can be, and the probability/magnitude of the ESG risk is sufficiently high, it is then often possible to establish other elements of a viable Rule 10b-5 claim such as scienter. In contrast, public companies should not be liable under Rule 10b-5 when the risk of an ESG failure 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.[138] The materiality requirement follows from the fact that securities fraud prohibitions are meant to protect investors. If a misstatement does not impact the company's stock price, an investor will not have suffered a recoverable loss. As discussed earlier, for a statement about a risk to be misleading, the risk itself must be material.[139] In the ESG risk context, the materiality inquiry would ask whether an ESG risk was significant enough so that statements that obscured such risk would affect the total mix of 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 or other provisions that prohibit material misstatements relating to a security.[140]

Courts have not developed a coherent approach to assessing materiality in ESG securities fraud cases. The materiality inquiry tends to be made in passing based on a vague sense of whether a piece of information was important. The SEC's complaint in *Vale* is typical, cursorily noting that "[i]t mattered to Vale's investors whether this

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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.

138. *See, e.g.*, Basic Inc. 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*, 563 U.S. at 43.

139. *Matrixx Initiatives*, 563 U.S. at 38 (citing *Basic Inc.*, 485 U.S. at 238).

140. Materiality will also be a consideration in determining whether there is a duty to disclose a risk. *See, e.g.*, Richman v. Goldman Sachs Grp., 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).

dam was safe."[141] 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.[142] 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 economic loss from an ESG failure. The question is whether the risk of a consequential ESG loss was high when misleading statements were made to investors.

Because they often involve contingent events that may or may not occur, assessing the materiality of an ESG risk is challenging but can be analyzed under existing doctrine. In its 1988 decision in *Basic Inc. v. Levinson*,[143] the U.S. Supreme Court set forth a test that courts can use to assess the materiality of "contingent or speculative information or events."[144] In *Basic*, a corporation publicly lied about whether it had been approached by another company with an acquisition offer.[145] It was in merger talks with a potential acquirer 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.[146] Such a price movement would make the transaction more expensive for the bidder and increase the risk it would abandon the merger.[147] Investors who sold their stock before news of the merger was publicly acknowledged sued under Rule 10b-5, arguing that the lie kept the stock price artificially low, causing them damage because they sold their stock for too little.[148]

Basic Inc. argued that the lie was not material because it was far from certain that the acquisition would occur.[149] 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.[150] Instead of following the lower appellate court, which had adopted a bright line

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141. Complaint at 70, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

142. 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." City of Westland Police & Fire Ret. Sys. v. Metlife, Inc., 928 F. Supp. 2d 705, 719 (S.D.N.Y. 2013).

143. 485 U.S. 224 (1988).

144. *Id.* at 238.

145. *See id.* at 227.

146. *See id.* at 228.

147. *See id.* at 233–34.

148. *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.

149. *See id.* at 229.

150. *See id.*

rule governing when merger discussions are material, the Court adopted a more fact intensive approach.[151] It explained that in determining whether a contingent event such as an acquisition was material, it would weigh both probability and magnitude.[152] 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."[153] An acquisition possibility would only be material to investors if its combined probability and magnitude were sufficiently high.[154]

The probability/magnitude test presumes that a corporation can assess the probability of a contingent event. Without the ability to calculate the probability of an event, it will be difficult to conclude that information about the event is material to investors. If the company cannot evaluate the probability of a contingent event, it does not have an informational advantage over investors. They are both equally in the dark. 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 happen.[155] But for

151. *See id.* at 231–32.

152. *Id.* at 238–39.

153. *Id.* at 238 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)). The test originated in an earlier decision by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*, 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. *Texas Gulf Sulphur*, 401 F.2d at 839–42. The court observed that "whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the events will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Id.* at 849. 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*, Judge Hand explained that the probability and magnitude of the accident should be compared with the cost of the precautionary measures. 159 F.2d 169, 173 (2d Cir. 1947). If the probability/magnitude of the accident is greater than the cost of such measures, it would be negligent not to implement them. *Id.* Similar inquiries are made in the context of criminal punishments. *See, e.g.*, Miriam H. Baer, *Law Enforcement's* Lochner, 105 MINN. L. REV. 1667, 1719 (2021).

154. In the merger context, it is a given that the magnitude of a transaction on the future of the acquired 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." *Basic Inc.*, 486 U.S. at 238 (quoting SEC v. Geon Indus., Inc., 531 F.2d 39, 47–48 (2d Cir. 1976)).

155. The Court listed a number of factors to consider in assessing the probability of a merger. *See, e.g.*, *Basic Inc.*, 485 U.S. at 239 (noting that "board

many other contingent events, it is not always clear that a corporation can calculate a meaningful probability. Courts have thus differed in their willingness to apply the probability/magnitude test outside of the merger context.[156] Notably, the SEC did not explicitly discuss the test in its *Vale* complaint.[157]

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 in that context. Assuming that the magnitude of an ESG event is substantial,[158] the main question will be whether the probability of the event was sufficiently high when a disclosure downplaying the risk of the event was made.

The critical issue in ESG cases is thus whether corporate managers can meaningfully predict the risk of an ESG failure. If they can, then there is a basis for evaluating the materiality of the risk by applying the probability/magnitude test. 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 difficult for managers to argue that they were simply negligent in denying an ESG risk when they calculated that the risk is high. In contrast, when the risk of an ESG event cannot

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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.*, United States 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).

156. One setting outside the merger context where the probability-magnitude test is often applied is in cases relating to whether a company should disclose a government investigation. *See, e.g.*, Lewis v. YRC Worldwide Inc., No. 19-CV-0001, 2020 WL 1493915, at *12 (N.D.N.Y. Mar. 27, 2020) (applying probability/magnitude test to materiality of ongoing government investigation); *see also* Stuart & Wilson, *supra* note 61, at 974 ("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."); Milton v. Van Dorn Co., 961 F.2d 965, 970 (1st Cir. 1992) (assessing whether possibility that seller of business might build competing plants was material through probability-magnitude test).

157. Complaint at 29–30, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022). The district courts that evaluated claims arising out of the 2015 collapse of the dam co-owned by Vale also did not apply the test. *See In re* BHP Billiton Ltd. Sec. Litig., 276 F. Supp. 3d 65, 78–79 (S.D.N.Y. 2017).

158. It is possible that managers will also have an advantage over investors in assessing the magnitude of an ESG risk. To simplify the analysis, this Article will focus on those situations where the magnitude of a risk is known to be high.

be calculated, it will be less likely that corporate managers can be liable under Rule 10b-5 for shareholder losses caused by the event.

B. Assessing the Probability of ESG Events

Courts may be reluctant to apply the probability/magnitude test because 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 cited in judicial opinions outside of the merger context.[159] However, an examination of recent ESG cases shows that public companies often calculate probabilities with respect to ESG events. These cases show how it is possible for plaintiffs to establish a material ESG risk by pointing to corporate calculations of such 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.[160] This basic dichotomy, though somewhat imprecise, can serve as a rough guide in determining whether an ESG risk is material. A contingent event can 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.[161] The main task of corporate managers is to understand their businesses so that they can be managed. Assessing risk within the corporation is essential to allocating resources to promising projects.[162] Investors expect public company managers to accurately forecast revenues, costs, 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.

On the other hand, corporate managers do not have perfect knowledge of all potential risks. For example, in the aftermath of the financial crisis of 2008, questions were raised about why more securities fraud cases were not brought against the financial

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159. 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." Rizzo v. The MacManus Grp., Inc., 158 F. Supp. 2d 297, 303–04 (S.D.N.Y. 2001).

160. FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 233 (Houghton Mifflin Co. ed. 1921) (observing that a "risk" is a "measurable uncertainty" while "uncertainty" is "immeasurable").

161. *See, e.g.*, James J. Park, *Investor Protection in an Age of Entrepreneurship*, 12 HARV. BUS. L. REV. 107, 116 (2022).

162. *See, e.g.*, OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 43–44 (1975) (discussing internal capital markets).

institutions that were driven to the brink of collapse by massive losses in their housing-related investments.[163] 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.[164] They could not have adequately warned stock markets about the uncertain prospect of an unprecedented financial storm because they were also surprised by these events.

Courts in applying the probability/magnitude test must thus carefully evaluate whether a risk is calculable.

1. The Calculation of Risk

The main question courts should assess in deciding ESG cases is whether Knightian probabilities can be generated for ESG risks.[165] One way a plaintiff can establish a prima facie case that an ESG risk was calculable is to demonstrate that the defendant actually calculated such risk.

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 anticipate them all. Companies might also contend that ESG risk is not the sort of information that they understand how to assess. They simply do not have the ability to calculate such risk and their efforts would be better spent on normal business operations. Corporations may protest that they are unfairly blamed for deceiving investors about ESG risk. The actual occurrence of a significant ESG disaster can influence factfinders to conclude ex post that the risk was predictable ex ante. As noted earlier, such hindsight bias can result in a finding that a risk was predictable even when it was not.[166]

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163. *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), https://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions/ (noting lack of criminal prosecutions would be a travesty if the crisis was the result of intentional fraud).

164. For an example of a decision 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, 238 (S.D.N.Y. 2010).

165. 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, 53–55 (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").

166. 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).

The problem with these arguments 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-related probabilities, it is difficult to argue that such probabilities cannot be calculated. Hindsight bias can be checked to some extent by examining the probabilities that were actually calculated ex ante. The probability/magnitude test for materiality will thus be more important as norms evolve to prompt public companies to generate additional risk information internally.

There are numerous examples of ESG securities fraud cases that point to 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.[167] The mining company's own internal reports calculated that the risk of a collapse was higher than international norms.[168] Rather than acknowledge this possibility, Vale affirmatively represented to investors that its dams were safe.[169] Given that it had actually calculated the probability of collapse, it was 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.[170] It alleged that BP "materially misrepresented and understated the estimated range of flow rate of oil leaking from the well."[171] The company's public statements were at odds with several 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.[172] It was difficult for BP to argue that it could not have anticipated the ultimate extent of the spill when it had its own internal analysis predicting its size.

Finally, the SEC's case against 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.[173] 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

167. Complaint at 3, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

168. *Id.* at 16–17.

169. *Id.* at 55–62.

170. Complaint at 1, SEC v. BP p.l.c., No. 2:12-cv-02774 (E.D. La. Nov. 15, 2012).

171. *Id.* at 2.

172. *Id.* at 8–11.

173. *See* Complaint at 4–5, SEC v. Volkswagen Aktiengesellschaft, No. 3:19-cv-01391 (N.D. Cal. Mar. 14, 2019).

the fraud exceeded $20 billion."[174] Even knowing of this substantial risk, VW sold billions of dollars in bonds to U.S. investors without acknowledging the high probability of a costly scandal 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."[175]

Even when a company cannot generate a precise probability of a risk, it can be guided by past experience in determining 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.[176] 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 likelihood of suit."[177] 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.

2. *When are Risk Assessments Reliable?*

In addition to showing that a risk calculation was made, plaintiffs should also be required to provide evidence that the calculation was viewed by the corporation as sufficiently reliable. Not all risk calculations will affect management's assessment of a risk. Risk assessment can involve guesswork and may be viewed skeptically by corporate managers. At a minimum, courts should evaluate the evidence to determine whether a particular risk calculation was reliable enough that it influenced a corporation's understanding of the risk. While it is difficult to comprehensively describe the factors that could be relevant, examination of recent cases suggests some relevant considerations.

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174. *Id.* at 5.

175. *Id.* at 34. 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, 591 (2015).

176. *See* Richman v. Goldman Sachs Grp., Inc., 868 F. Supp. 2d 261, 273 (S.D.N.Y. 2012). For descriptions of the Wells process, see U.S. SEC. & EXCH. COMM'N, ENFORCEMENT MANUAL 19–22 (2017); Joshua A. Naftalis, Note, *"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).

177. *Richman*, 868 F. Supp. 2d at 274.

The replicability of a risk assessment supports the conclusion that it is reliable. For example, in the *BP* case, the SEC showed that BP had generated multiple estimates of the extent of the spill that were higher than the estimate that it shared publicly.[178] While a single estimate might not be sufficiently reliable to affect corporate decision-making, when multiple estimates come to the same general conclusion, the argument that a risk can be calculated is more compelling.

When a risk analysis is widely disseminated within an organization and there is additional evidence that it was credited, that fact could indicate it is sufficiently reliable to put managers on notice of a risk. In the *VW* case, estimates of the impact of a scandal were described in "multiple internal memos" that were circulated to numerous employees. One court has cited the fact that information about a particular risk was "widely known within the company" in determining that an internal assessment of risk was reliable.[179] The fact that a risk analysis is only credited by a contrarian minority may indicate that the analysis was not viewed as reliable, but the fact that "the entire management team of the company" credited a risk can be evidence that a risk analysis was viewed as credible.[180] In the *Vale* case, the risk of a dam collapsing was included in a "Business Risk Matrix" that was presented to the company's board.[181] It would be difficult to cabin such risk as an ancillary compliance issue that would not be a corporate priority.

Finally, the extent to which a risk analysis is performed pursuant to a widely adopted industry standard can indicate that it is reliable. For example, in the *Vale* case, the calculations relating to the collapse of the dam were performed by an expert who evaluated the risk in reference to international standards.[182] To the extent that there are accepted industry practices with respect to the calculation of an ESG risk, that would be evidence that the risk calculation is valid.

3. Disclosure Mandates and Risk Calculation

One possible objection to vigorous ESG securities fraud enforcement is that it would create a disincentive to assess ESG risks. If liability hinges on a showing that a probability was calculated, companies could avoid securities law obligations by not performing such calculations. It is likely, though, that for public companies the benefits of assessing ESG risk will be substantial enough to outweigh the costs. Good companies will understand that they can avoid losses

178. Complaint at 2–3, SEC v. BP p.l.c., No. 2:12-cv-02774 (E.D. La. Nov. 15, 2012).

179. *In re* Cabletron Sys., Inc., 311 F.3d 11, 27 (1st Cir. 2002).

180. *See, e.g.*, Lormand v. US Unwired, Inc., 565 F.3d 228, 250 (5th Cir. 2009).

181. Complaint at 48–49, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

182. *Id.* at 47–52.

by better understanding the risks of their business. Moreover, if it becomes clear that companies are deliberately ignoring a risk that can be calculated, courts could find that such willful blindness to material ESG risk supports a finding of deceptive intent. For example, the Supreme Court's decision in *Matrixx* could be read as faulting the company for failing to adequately follow up on various consumer reports of side effects.[183]

Not only will companies calculate risks on their own, the SEC has prompted them to focus on particular risks. Consider the subject of cybersecurity. Until recently, cyber breaches were not viewed as an issue within the purview of high-level management. As the value of consumer data has increased and the consequences of compromising such data are greater, data breaches have become an issue of significant corporate concern. The SEC thus issued guidance in 2018 on disclosure relating to such breaches.[184] In doing so, it signaled that companies should be mindful of informing investors when appropriate about such events.[185] The SEC supplemented its cyber guidance in 2023 with a rule requiring disclosure about cybersecurity breaches and the risk of such breaches.[186] The rule requires filings relating to a company's policies and procedures to identify cybersecurity risks.[187] Such a mandate creates incentives for public companies to do more to evaluate the probability of cybersecurity risk, and in doing so, will 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.

It is worth highlighting a telling statement in the SEC's cyber disclosure proposal about the concept of materiality. 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."[188] This statement rests too easily on the assumption that a reasonable probability of a cyberattack can actually be calculated. The SEC should have

183. *See* Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 32–34 (2011).

184. *See, e.g.*, Commission Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. 8166, 8169 (Feb. 26, 2018) ("The materiality of cybersecurity risks and incidents also depends on the range of harm that such incidents could cause.").

185. The SEC's guidance was cited by a court in concluding that a public company's statements about the risk of cyber privacy breaches were materially misleading. *See, e.g.*, *In re* Alphabet, Inc. Sec. Litig., 1 F.4th 687, 703 (9th Cir. 2021).

186. Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 88 Fed. Reg. 51896, 51896 (Aug. 4, 2023).

187. *Id.* at 51912.

188. Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, 87 Fed. Reg. 16590, 16596 (proposed Mar. 23, 2022).

recognized that even if the magnitude of a cyber event is very high, if its probability is shrouded in uncertainty, it is less clear that disclosure would be warranted.

The SEC has also recently signaled that there are obligations to assess the risk of worker abuse within a public company. In an enforcement action against the video game developer Activision Blizzard, the SEC fined the company $35 million for its failure to maintain sufficient controls relating to its ability to retain personnel.[189] The company had noted the risk of employee retention in its SEC filings, but "lacked controls and procedures designed to ensure that it captured and assessed . . . employee complaints of workplace misconduct."[190] The Activision settlement shows how the SEC can not only encourage risk assessment by requiring disclosure, it can fault companies for failing to construct internal controls that apprise managers of ESG risk.

As noted earlier, the SEC has proposed rules requiring more disclosure about the risks associated with global warming on a company's business.[191] Notably, in its discussion of these 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."[192] If adopted, companies would have to devote more resources to computing the probability of climate-related losses. If companies do so, they will generate more material information about ESG risk.[193] To the extent that Rule 10b-5 suits arise out of climate-related damages, the question will be whether the damages relate to climate risks for which meaningful probabilities were calculated.

The SEC has not been the only regulator that has moved to improve ESG risk assessment by corporations. Delaware corporate law has increased expectations that corporate boards have systems in

189. Activision Blizzard, Inc., Exchange Act Release No. 96796, 2023 WL 1765354, at *5 (Feb. 3, 2023).

190. *Id.* at *3.

191. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21349–51 (proposed Apr. 11, 2022).

192. *Id.*

193. Notably, early efforts to characterize the failure to disclose climate risks as fraudulent failed because the projections of such risks were too speculative. As the New York Supreme Court explained after trial in a case brought by the New York Attorney General against ExxonMobil, "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 v. Exxon Mobil Corp., 452044/2018, 2019 WL 6795771, at *19 (N.Y. Sup. Ct. Dec. 10, 2019).

place to monitor "mission critical" risks.[194] If a company were to simply stop gathering risk information to minimize its securities fraud liability, the company would increase its vulnerability to a derivative suit against the board arguing that it did not fulfill its duty to monitor. Corporate and securities law are thus working together to encourage public companies to assess ESG risk.[195]

There are questions about whether efforts to mandate that all public companies focus on ESG risk are warranted. Corporate law has traditionally given boards wide discretion in how they operate. Securities regulation has been careful not to directly regulate corporate governance.[196] The SEC has generally couched these new proposed mandates as disclosure provisions meant to protect investors,[197] but they will also 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. Notably, in Vale's case, an executive signed a certification that there were sufficient internal controls in place to ensure its sustainability report was not misleading.[198] 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.[199] 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

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194. For an overview and analysis of these cases, see Roy Shapira, *Max Oversight Duties: How* Boeing *Signifies a Shift in Corporate Law*, 48 J. CORP. L. 121, 123 (2022).

195. For another example of the synergy between federal and state law, see Geeyoung Min, *The SEC and the Court's Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663, 691–96 (2014).

196. 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, 479–80 (1977).

197. *See* James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 163 (2017).

198. Complaint at 67, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

199. *See* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1410, 1423 (2020).

every ESG risk. Courts will have to be careful to distinguish between ESG failures for which reasonable probabilities can be generated and those characterized by uncertainty. Courts will have to be mindful of the real challenge of predicting a wide range of contingent events that could generate shareholder losses.

C. *Evaluating the Combined Probability/Magnitude of ESG Risk*

A significant ambiguity with respect to the probability/magnitude test is that the Supreme Court did not provide any guidance in *Basic* about the level of combined probability/magnitude that would make a contingent event material.[200] Lower courts have not clarified 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 light of a company's market capitalization. The advantage of this approach is that the company's stock price reflects a wide range of potential costs. An ESG event will not only directly affect current period revenue and profits, it will 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 presumptively material, while a loss less than that threshold would be presumptively immaterial. For example, in the context of financial statements, the rule of thumb at one time was five percent.[201] A financial misstatement of revenue or profits that did

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200. Litigants and courts tend to make superficial inquiries into the materiality of a risk. *See, e.g.*, *In re* BHP Billiton 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").

201. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45152 (Aug. 12, 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 id.*; *see also* James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 524–28 (2009).

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 ten percent of market capitalization.

If it were judged in terms of its expected impact on market capitalization, it is not completely clear that the risk of Vale's dam collapsing 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.[202] In the wake of the disaster, the company's securities on the New York Stock Exchange declined by 25 percent, an amount of over $4 billion.[203] While this decline in market value was substantial, a kitchen table calculation of the expected value of the market decline is only about $400,000 per year.[204] For a multi-billion dollar company, it's unclear that investors would be concerned about such a modest expected decline.

Rather than applying an inflexible numerical threshold, there is an argument that courts should consider the probability/magnitude of the ESG risk in relation to the probability/magnitude of other risks. For example, if a $400,000 per year expected loss in market capitalization was significantly greater than the expected value of other losses, there would be a stronger case that the risk from the dam collapse should have been acknowledged in the company's disclosures.

D. *Materiality and the Evaluation of ESG Securities Fraud Claims*

The *Basic Inc. v. Levinson* probability/magnitude test offers a framework for evaluating the legal viability of ESG securities fraud cases. It provides both a basis for dismissing questionable claims and a way of identifying cases that are meritorious.[205] A plaintiff can construct a credible claim of ESG securities fraud by establishing that an ESG risk was calculated, and such calculation was reliable. A defendant can establish a defense by demonstrating that the ESG risk at issue was shrouded in Knightian uncertainty and could not have been calculated.

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202. Complaint at 48, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. April 28, 2022). Vale also knew of additional estimates that were two to three times higher. *See id.* at 30, 45. There was one estimate that a dam could fail every five years. *Id.* at 4–5.

203. *Id.* at 2.

204. This would reflect a 1 in 10,000 chance per year of a $4 billion market loss. The expected value of a $1.4 billion loss in any given year would be even less.

205. *See* Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77, 100 (2017) (arguing that courts should utilize materiality more effectively as a screening device).

As companies increasingly evaluate ESG risk, it will be more difficult for them to argue that such ESG risks are unknowable. Recent SEC enforcement actions demonstrate that evidence on the probability of ESG risks is obtainable and can be the basis for securities enforcement. On the other hand, not all ESG risks are knowable and thus there will be a wide range of ESG risks that will not be material under the probability/magnitude test.

The courts will need to develop standards for assessing how the probability/magnitude test would interact with other elements of Rule 10b-5. For example, there may be situations where there was a clear methodology that would have shown that an ESG risk was material, but the company did not calculate the risk. One view might be that in such a situation, the company did not know the probability of the ESG risk and so could not have acted with scienter when it issued statements denying the risk. Another view might be that a company was willfully blind to the ESG risk and acted recklessly.

The probability/magnitude test may also have broader application outside of the ESG context. Courts could assess the materiality of standard business risks under this framework. To the extent that a business risk is calculated and known to be substantial, there is a stronger case that it is material.

At a minimum, the probability/magnitude test should play a significant role in deciding ESG securities fraud cases. Resolving the materiality of an ESG risk will often be the key consideration in determining whether there is a violation of Rule 10b-5 and other securities fraud provisions in such cases.

IV. A SLIDING SCALE APPROACH TO ASSESSING ESG SECURITIES FRAUD CLAIMS

An implication of this paper's analysis is that courts should adopt a holistic approach to adjudicating ESG securities fraud cases. Rather than arbitrarily screening cases based on the specificity of a statement or its status as a risk disclosure, courts should carefully assess whether the corporation and its agents knew there was a high probability of a significant ESG-related loss yet chose to obscure that risk through misleading disclosures. Courts should utilize a sliding scale approach in evaluating ESG securities fraud cases. The more generic a statement is with respect to ESG risk, the higher the burden to establish the risk was material under the probability/magnitude test. This approach would permit courts to screen cases that are unlikely to involve meritorious claims at an early stage while permitting stronger cases to move forward. To the extent that there are close calls relating to the materiality of an ESG risk, it may be more appropriate for a public enforcer to bring a case than a private enforcer.

A. *Specificity and Materiality*

Rather than evaluate the specificity of corporate statements in isolation to determine whether a company issued a material misrepresentation, courts should evaluate specificity and materiality together. When only generic statements relating to an ESG risk have been issued, courts should require plaintiffs to do more to show a meaningful probability of a substantial ESG risk. When there are specific statements about an ESG risk, the burden on plaintiffs to establish a material ESG risk at an early stage of the case should be lower. The basic idea can be summarized in a simple chart:

Specificity of Statement on ESG Risk	**Plaintiff's Burden to Establish Probability/Magnitude**
Generic	Higher
Specific	Lower

Consider a company with a $5 billion market value that represents it has a strong commitment to preventing sexual harassment. Such a statement implies there is a minimal probability of a substantial market loss due to a workplace where such harassment is prevalent. If a corporate review finds 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 for a $5 billion company. It would be possible for the company to assert that its assurances, at least to the extent they convey there are sufficient measures in place to prevent a major loss, 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 for a $5 billion company. Such knowledge would make the assertion that the company's commitment to preventing sexual harassment is high enough to avoid a significant scandal misleading. Even though the company's statement was generic, at the very least, it should be read as representing that corporate management does not know of a substantial risk of a sexual harassment scandal that could have a significant impact on the company's stock price.

Some courts have already linked the specificity and materiality inquiries when adjudicating Rule 10b-5 claims. For example, the U.S. Court of Appeals for the Second Circuit has instructed 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."[206] While general statements of ESG risk are not misleading when a risk is uncertain, companies should not be permitted to avoid liability because their disclosures are vague when they have evidence of a very high probability of a substantial risk. Other courts should follow the Second Circuit's approach. Broadening the inquiry to consider the extent of the risk at issue could help courts better determine whether investors were misled.

In adjudicating an ESG securities fraud class action involving Arconic, an aluminum manufacturer, a federal district court in Pennsylvania evidenced the view that even generic statements can be misleading when there is sufficient evidence that the company knew of a substantial ESG risk.[207] Arconic sold aluminum used in the exterior walls of a public housing building in London that caught on fire, killing numerous individuals.[208] Media outlets alleged that defects in Arconic's product contributed to the rapid spread of flames.[209] After these reports, the company's stock price fell by about ten percent.[210] Investors filed a claim of securities fraud against Arconic alleging it had misrepresented the safety of its product and thus misled investors of the risk of a substantial scandal.[211] Initially, Arconic successfully won dismissal of most of the complaint on the ground that its statements about its "commitment to safety, development of safety-related processes and procedures, values and ethics, and compliance program" were puffery.[212] The court relied on the fact that a single scandal was insufficient to show that this general statement was misleading.[213] However, the plaintiffs were permitted to amend their complaint to add more specific allegations that the company knew its aluminum did not meet safety standards.[214] Put another way, there was evidence that the company knew of risk calculations indicating a significant probability of a substantial accident. This time, the court concluded that given the new evidence of such material risk, there were sufficient allegations for a securities fraud claim to proceed.[215]

The district court's decisions in *Arconic* exemplify a holistic approach to adjudicating ESG securities fraud cases. Rather than viewing the wording of a corporate statement in isolation, the court evaluated such statements in light of the ESG risks at issue. Such an

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206. Meyer v. Jinkosolar Holdings Co.,761 F.3d 245, 251 (2d Cir. 2014).
207. *See* Howard v. Arconic Inc., 395 F. Supp. 3d 516, 553 (W.D. Pa. 2019).
208. *Id.* at 530–31.
209. *Id.* at 531.
210. *Id.*
211. *Id.* at 537–38.
212. *Id.* at 546.
213. *Id.* at 548.
214. *See* Howard v. Arconic Inc., No. 2:17-cv-1057, 2021 WL 2561895, at *1–3 (W.D. Pa. June 23, 2021).
215. *Id.* at *13.

approach would recognize that the question of whether a "representation is 'mere puffery' depends, in part, on the context in which it is made."[216] Even when "statements, viewed in isolation, may be mere puffery," further facts can indicate that they were part of a scheme to deceive investors.[217]

Such a sliding scale approach could apply to a case like *Vale*, where many of the alleged misstatements were arguably puffery.[218] Even vague statements of "rigorous" and "strict" safety measures can be misleading given specific knowledge of a high probability of a significant disaster.

A contextual approach to evaluating ESG securities fraud cases would be consistent with the Supreme Court's decision in *Omnicare*,[219] which provided guidance on when statements of opinion can be misleading.[220] In that case, the defendant issued a registration statement when selling securities that expressed belief in its compliance with applicable regulation.[221] The Court instructed that such statements of belief can be misleading if they were completely baseless.[222] For example, if Omnicare issued its statement of compliance without any prior investigation, such statement could be deceptive because it did not disclose that Omnicare had no reasonable basis for the statement.[223] Similarly, to the extent that companies issue general statements of ESG compliance while aware of a material ESG risk, a factfinder could conclude that such representations were without basis and misleading.

There will be cases that can move forward under a sliding scale approach, but there will also be many cases that do not. If the plaintiffs in *Arconic* had not produced evidence relating to a high ESG risk, their case would rightly have been dismissed. Administered correctly, a holistic approach would permit courts to manage the costs of strike suits.

To the extent that plaintiffs protest it will be too difficult to establish that companies calculated ESG risks, plaintiffs can lower their burden in establishing materiality by linking an ESG risk to a

216. *In re* Petrobras Sec. Litig., 116 F. Supp. 3d 368, 381 (S.D.N.Y. 2015) (citing line of cases in the Southern District of New York).

217. *Id.*

218. *In re* Vale S.A. Sec. Litig., 1:15-cv-9539-GHW, 2017 WL 1102666, at *21–22 (S.D.N.Y. Mar. 23, 2017).

219. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 190 (2015).

220. *See id.* at 194.

221. Because *Omnicare* involved a registration statement governed by the heightened liability of Section 11 of the Securities Act, there is a question as to whether its analysis applies generally to Rule 10b-5 litigation. Some courts have held that *Omnicare* applies outside of the Section 11 context. *See, e.g.*, City of Dearborn Heights v. Align Tech., Inc., 856 F.3d 605, 616 (9th Cir. 2017).

222. *See Omnicare*, 575 U.S. at 190.

223. *See id.*

specific corporate statement. Because public companies are increasingly issuing ESG disclosures, they are increasingly taking clearer stands on ESG compliance. In doing so, they will often acknowledge a particular ESG risk is material to their business.

In cases where a material risk has already been actualized, the probability of the risk is known and is essentially one hundred percent. In such a case, the court should only have to determine the magnitude of the risk in determining whether the risk was material. Under the sliding scale framework, even a generic statement can be misleading if materiality is definitively established. Courts should thus make clear that even broad risk disclosures can be misleading when the defendant has knowledge a risk covered by the disclosure has been actualized.[224] At the very least, a risk disclosure should be understood to mean such risk has not materialized to the extent that it will certainly affect the company's market value when disclosed. The Ninth Circuit or Supreme Court should overrule or minimize the line of Ninth Circuit decisions that imply there is a bright line rule that risk disclosures can never be misleading.[225]

One way of thinking of this approach is that it imposes a duty to disclose that a company's prior disclosures are no longer valid because the company knows of a substantial ESG risk or that a prior acknowledged risk has been actualized.[226] Rather than maintain its

224. This approach would be consistent with law relating to whether a risk disclosure is a meaningful cautionary statement that would shield a statement from liability under the PSLRA's safe harbor for forward-looking statements. Courts have found that the failure to update a boilerplate disclosure in light of new developments may mean that the disclosure is not meaningful. *See, e.g.*, Asher v. Baxter Int'l Inc., 377 F.3d 727, 734–35 (7th Cir. 2004).

225. 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, 703–04 (9th Cir. 2021).

226. There is an argument that a general duty to disclose is set forth by Item 303 of Regulation S-K, which requires that an issuer provide a Management Discussion & Analysis of "material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." 17 C.F.R. § 229.303 (2023). Courts have been unclear as to whether this section creates an independent duty to disclose material information to investors enforceable by Rule 10b-5. *See, e.g.*, *In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1054–55 (9th Cir. 2014) (implying that plaintiff must establish independent duty to disclose information that was allegedly omitted from Item 303 to proceed under Rule 10b-5). Some commentators have argued that Item 303 creates a duty to disclose that can be enforced by Rule 10b-5. *See, e.g.*, Langevoort, *supra* note 22, at 993–94 (arguing there would be an enforcement gap without Rule 10b-5 liability); Matthew C. Turk & Karen E. Woody, *The* Leidos *Mixup and the Misunderstood Duty to Disclose in Securities Law*, 75 WASH. & LEE L. REV. 957, 990 (2018) (arguing that duty to disclose under Item 303 exists so long as other elements of Rule 10b-5 such as materiality have been

generic statements of compliance, a company would have to issue a specific statement warning of the ESG risk to avoid securities fraud liability. Such a duty would be somewhat of a departure from the general rule that companies do not have a general affirmative duty to disclose all material information.[227] However, there is a line of cases indicating there is a duty to update disclosures that have become materially misleading.[228] Not all circuits have adopted such a duty because of concerns that it would be too burdensome for companies to continually update their disclosures.[229] To the extent that such a duty is limited to situations where risks are calculable and known to be high, such a duty to update should be manageable. The case for such a duty is strongest when a substantial risk has actually emerged. As one court has noted, when a "risk approaches a certainty, courts have no difficulty in finding a duty of disclosure."[230]

B. Enforcement

When it is difficult to determine whether the probability/magnitude of an ESG risk is sufficient to trigger securities fraud liability, it might be more appropriate for a public enforcer than a private plaintiff to bring an action.[231] The SEC can initiate cases under a wider range of provisions than private enforcers. It can even file cases against public companies for misleading statements that are not material under the books and records provision of Section 13 of the Securities Exchange Act.[232] By doing so, it could avoid making close calls about whether a combined probability/magnitude is material,[233] 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

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met). If such a duty to disclose under Item 303 exists, this Article's approach to materiality could provide guidance on whether an omitted item is sufficiently material to trigger liability under Rule 10b-5.

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

228. *See* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1664–71 (2004) (listing cases).

229. *See, e.g.*, *id.* at 1667–68.

230. Hill v. Gozani, 638 F.3d 40, 60 (1st Cir. 2011).

231. *See, e.g.*, Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923, 964 (2019) (describing advantages to relying primarily on SEC enforcement); *see also* James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115 (2012) (describing different enforcers).

232. 15 U.S.C. § 78m(b)(2)(A) (2018).

233. The SEC has been known to apply the materiality standard broadly when protecting investors. *See, e.g.*, Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 478–89 (2006).

been passive relative to private enforcers,[234] the SEC has not taken a narrow view of securities fraud in bringing cases against companies like Vale, BP, Facebook, and VW.[235] Some of these cases have alleged securities fraud pursuant to Section 10(b) and Rule 10b-5,[236] while others have relied on provisions that do not require a showing of fraudulent intent such as Section 17(a)(2) and (3) of the Securities Act.[237] In doing so, the SEC has given credibility to ESG securities fraud theories.

While private securities litigation is subject to more obstacles that may make it 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 be viable when knowledge of a significant ESG risk was fraudulently denied and it is apparent that investors paid too much for a stock given such risk.[238] There are additional doctrinal barriers to private suits such as the element of loss causation, which requires that an investor loss be linked to a material misstatement.[239] Merritt Fox and Joshua Mitts argue that courts should rigorously screen securities class actions to ensure the inflationary impact of a misstatement is sufficiently high to warrant the costs of adjudicating such claims.[240] The *Goldman Sachs* case is an example of an ESG securities fraud case where it was difficult to establish a link between the alleged

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234. *See, e.g.*, PARK, *supra* note 63.

235. *See, e.g.*, Complaint at 1, 6, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022); Complaint at 1, 3, SEC v. BP p.l.c., No. 2:12-cv-02774 (E.D. La. Nov. 15, 2012); Complaint at 3, SEC v. Facebook, Inc., No. 3:19-cv-04241 (N.D. Cal. Aug. 22, 2019); Complaint at 2, SEC v. Volkswagen Aktiengesellschaft, No. 3:19-cv-01391 (N.D. Cal. Mar. 14, 2019).

236. *See, e.g.*, Complaint, *Vale*, No. 1:22-cv-02405, at 72; Complaint, *BP*, No. 2:12-cv-02774, at 19.

237. 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 Section 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, 697 (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.

238. 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 they purchased the stock, which would reflect the inflation from the ESG risk that was not forthrightly revealed. For an extensive analysis of this point, see Fox & Mitts, *supra* note 14, at 37; *see also* Haeberle, *supra* note 66 (manuscript at 29).

239. As noted earlier, there is an initial inquiry on the similar issue of price impact at the class certification stage of a Rule 10b-5 class action.

240. Fox & Mitts, *supra* note 14, at 37.

misstatement and investor losses.[241] However, to the extent that there is a misrepresentation relating to an ESG risk with sufficiently high probability-magnitude, investor plaintiffs should be able to establish the requirement of loss causation necessary for a viable Rule 10b-5 claim. If the ESG risk is clearly material, then such risk would have affected the price an investor would have been willing to pay for the stock.

In addition to loss causation, private plaintiffs in ESG securities fraud cases will need to establish scienter (fraudulent intent), because they typically must bring suit under Rule 10b-5. When the probability of an ESG risk is high and calculable, it is more likely that a plaintiff can demonstrate that there were red flags corporate management ignored, permitting the plaintiff to establish the requisite scienter under Rule 10b-5.[242] They can point to risks set forth in internal reports that corporate managers were aware of but obfuscated.[243] It is notable that in the *Vale* case, the company responded to reports establishing the risk of a dam collapse by manipulating and deceiving its auditors, conduct that would help support a finding of scienter.[244] 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 will find scienter.[245] When an ESG

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241. *See* Ark. Tchr. Ret. Sys., v. Goldman Sachs Grp., 77 F.4th 74 (2d Cir. 2023) (denying class certification of securities class action on price impact grounds). One of the difficulties of establishing that a misrepresentation affects a company's stock price is that bad news may be bundled with good news to offset its impact on a company's stock price. *See, e.g.*, James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After* Dura Pharmaceuticals, 95 GEO. L.J. 653, 677 (2007). Rather than looking at market price to resolve whether a misstatement impacted a company's stock price, courts might use discounted cash flow analysis to assess the various ways in which a misstatement can impact a company's valuation. *See, e.g.*, Frank Partnoy, *Market Prices vs. Fundamental Value: The Case for Using Discounted Cash Flow Analysis in Securities Class Actions*, 77 BUS. LAW. 1059, 1062 (2022).

242. *See, e.g.*, No. 84 Emp.-Teamster Joint Council Pension Tr. Fund v. Am. W. Holding Corp., 320 F.3d 920, 941–43 (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).

243. *See, e.g.*, City of Monroe Emps. Ret. 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").

244. *See, e.g.*, Complaint at 5–6, SEC v. Vale S.A., No. 22-cv-2405 (E.D.N.Y. Apr. 28, 2022).

245. *See, e.g.*, *In re* PXRE Grp., 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).

misrepresentation is clearly motivated by deceptive conduct, investors should be permitted to exercise their right to recover damages.

CONCLUSION

The prioritization of ESG securities fraud enforcement by the SEC and investor-plaintiffs reflects the growing importance of ESG risk to the valuations of public companies. Investor pressure and mandatory disclosure have prompted corporations to increasingly calculate the probability of a broader range of events that could affect their market value. When managers estimate meaningful probabilities of an ESG risk of sufficient 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 defrauded.

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 a business failure is deceptively obscured. 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 an important product will fail. It can be difficult to adjudicate the issues raised in securities fraud actions relating to the risk of business and ESG setbacks, but courts are capable of sorting good cases from bad.

ESG securities fraud cases will often turn on careful holistic evaluation of the relevant facts. They should not be judged solely on whether they involve statements that are puffery. Courts should adopt a sliding scale approach in assessing ESG securities fraud claims. The more generic the disclosure, the greater the burden for plaintiffs to establish that an ESG risk was material because it was calculable and high. In deciding these cases, judges should focus on whether an ESG risk was material and managers deceptively obfuscated that risk.

Securities fraud is not a static concept. It has evolved over time as the environment within which the public corporation operates has changed. The rise of ESG securities fraud may partly reflect the efforts of public and private enforcers to develop innovative liability theories. But it also reflects 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.