Navigating the Disclosure Dilemma: Corporate Illegality and the Federal Securities Laws

ALISON B. MILLER*

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* Georgetown University Law Center, J.D. 2014; Dartmouth College, A.B. 2010. © 2014, Alison B. Miller. I would like to thank Professor Donald Langevoort for his guidance in developing this Note and Professor Sonya Bonneau for introducing me to legal writing. Thank you also to the editors of The Georgetown Law Journal for their assistance. Lastly, thank you to my parents, Kenneth and Toby Miller, for their constant encouragement and support.
INTRODUCTION

On September 21, 2005, the general counsel of Wal-Mart received an e-mail from a former executive of Wal-Mart de Mexico alerting her to “irregularities” condoned “by the highest levels” of the company’s Mexican subsidiary. The e-mail alleged that Wal-Mart de Mexico executives had been bribing Mexican officials to obtain construction permits for at least the past three years to speed expansion throughout the country. The whistleblower was credible: he had worked in the division involved in obtaining the permits and described specific bribes, names, and dates. At the behest of the general counsel that received the e-mail, Wal-Mart initiated an internal investigation that substantiated the e-mail’s claims, uncovering a paper trail of nearly $24 million worth of suspicious payments likely in violation of the Foreign Corrupt Practices Act (FCPA) and Mexican law.

Despite this strong evidence and the general counsel’s advice to expand the scope of the investigation, Wal-Mart’s board of directors ended the preliminary inquiry and kept quiet. The incident might have been swept under the rug entirely, but the New York Times eventually uncovered the bribery scheme and subsequent coverup. Reporters notified Wal-Mart of their findings in December 2011, and, within a matter of days, Wal-Mart confidentially shared the findings of its 2005 internal investigation with the Department of Justice (DOJ) and Securities and Exchange Commission (SEC). It also disclosed the existence of the investigation to shareholders in a Form 10-Q filed with the SEC. The New York Times published a two-part exposé revealing extensive details about the

2. Id.
3. Id.
5. Barstow, supra note 1.
6. Id.
7. Wal-Mart Stores, Inc., Quarterly Report (Form 10-Q), at 26 (Dec. 8, 2011) (“During fiscal 2012, the Company began conducting a voluntary internal review of its policies, procedures and internal controls pertaining to its global anti–corruption compliance program. As a result of information obtained during that review and from other sources, the Company has begun an internal investigation into whether certain matters, including permitting, licensing and inspections, were in compliance with the U.S. Foreign Corrupt Practices Act. The Company has engaged outside counsel and other advisors to assist in the review of these matters and has implemented, and is continuing to implement, appropriate remedial measures. The Company has voluntarily disclosed its internal investigation to the U.S. Department of Justice and the Securities and Exchange Commission. We cannot reasonably estimate the potential liability, if any, related to these matters. However, based on the facts currently known, we do not believe that these matters will have a material adverse effect on our business, financial condition, results of operations or cash flows.”).
scandal a few months later,\textsuperscript{8} causing Wal-Mart’s share price to fall by roughly 5\% and Wal-Mart de Mexico’s by nearly 12\%.\textsuperscript{9}

The Wal-Mart bribery scandal is unique in that the company only came clean to enforcement agencies and shareholders when pressured by the media six years later.\textsuperscript{10} But the scandal is otherwise unextraordinary. It simply illustrates a dilemma routinely faced by publicly traded companies: when management learns of violations that could result in corporate criminal liability, must and should that information be disclosed to shareholders, and if so, when?

Corporate counsel and executives are confronting this “disclosure dilemma” with growing frequency as they take monitoring more seriously in response to new legal mandates.\textsuperscript{11} The Sarbanes–Oxley Act of 2002 (SOX) strengthened internal compliance requirements, establishing the corporate audit committee as a gatekeeper responsible for policing accounting and financial reporting fraud.\textsuperscript{12} Under SOX, audit committees must be authorized to receive complaints and retain outside, independent counsel in the event an investigation is warranted.\textsuperscript{13} DOJ\textsuperscript{14} and SEC\textsuperscript{15} memoranda have also emphasized that a company’s willing-

\begin{itemize}
\item \textsuperscript{11} From 2001 to 2009, over 2500 public companies have retained outside counsel to conduct internal investigations into suspected wrongdoing by executives and employees, and there is no reason to think that the surge in internal investigations has ebbed. See Am. Coll. of Trial Lawyers, Recommended Practices for Companies and Their Counsel in Conducting Internal Investigations, 46 AM. CRIM. L. REV. 73, 73 (2009). Commentators agree that the internal investigation has become a de facto requirement in the business world when misconduct surfaces. See, e.g., Sarah Helene Duggin, Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview, 2003 COLUM. BUS. L. REV. 859, 886 (“[T]he internal investigation has become the standard of care whenever credible allegations of significant misconduct are raised in organizational settings.”).
\item \textsuperscript{13} Id. For an overview of internal investigation practice following the enactment of the Sarbanes–Oxley Act, see Robert S. Bennett et al., Internal Investigations and the Defense of Corporations in the Sarbanes–Oxley Era, 62 BUS. LAW. 55 (2006).
\item \textsuperscript{15} Following the DOJ’s lead, the SEC issued its first memorandum outlining a departmental policy on the impact of cooperation on enforcement decisions in 2001, commonly referred to as the “Seaboard
ness to cooperate with regulators—such as by taking remedial actions or voluntarily disclosing wrongdoing—is a crucial factor that influences agency enforcement decisions. The United States Sentencing Commission’s guidelines for sentencing business organizations also recommend that judges reduce sanctions for companies that have robust compliance programs and have assisted prosecutors.16

Figuring out whether and when to disclose is a difficult decision that can have significant legal, business, and reputational consequences for a company, its executives, and its employees.17 Keeping quiet like Wal-Mart might enable a company to skirt enforcement proceedings and collateral consequences to company reputation and stock price. But an avoidance approach only succeeds if the violations remain undetected, and it therefore can be quite risky.

To facilitate the disclosure decision, much has been written on how to conduct internal investigations,18 the efficacy of government leniency programs in deterring corporate misconduct,19 and privilege issues arising when a company voluntarily discloses misconduct to enforcement agencies.20 In the aggregate, these questions address whether a company should disclose wrongdoing in hopes of obtaining leniency. But there has been comparatively little attention paid to the more fundamental question of whether the securities laws ever require companies to disclose uncharged criminal wrongdoing to shareholders.

Perhaps the oversight reflects that, at first glance, broad and conclusive language in many cases seemingly settles the matter in favor of nondisclosure.

16. See U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2012); see also Bennett et al., supra note 14, at 418–21 (summarizing key provisions rewarding corporate cooperation).


In 1979, the Southern District of New York held that “the [federal] proxy rules simply do not require management to accuse itself of antisocial or illegal policies.”\(^{21}\) A few years later, the Second Circuit pronounced in *United States v. Matthews* that “so long as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution.”\(^{22}\) More recent cases have likewise commented that the federal securities laws “do not require a company to accuse itself of wrongdoing”\(^{23}\) or “illegal policies,”\(^{24}\) to “publicly admit the culpability of their actions,”\(^{25}\) or to “disclose uncharged illegal conduct.”\(^{26}\) But despite this decisive language, the nondisclosure norm is not absolute. Courts have frequently found criminal wrongdoing material, and have identified a duty to disclose it where its omission would make a company’s statement misleading.\(^{27}\) However, they have done so inconsistently, creating a difficult web for issuers to navigate that may chill disclosure to shareholders.\(^{28}\)

In a regime that creates liability whenever a company chooses to speak, the natural reaction in the face of uncertainty is for companies to not speak at all.\(^{29}\) This Note demonstrates that courts have frequently but unpredictably circumvented the nondisclosure norm embodied in *Matthews*, creating confusion for issuers attempting to figure out whether and when to disclose uncharged criminal conduct. Greater clarity is needed. To alleviate the problem, this Note proposes a template courts can use to more reliably determine whether company statements trigger a duty to disclose uncharged criminal conduct. In addition to providing more guidance to issuers, certainty in disclosure obligations will also benefit shareholders. Companies would be less likely to withhold material information solely because they are uncertain whether the statement would trigger a duty to disclose.

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22. 787 F.2d 38, 49 (2d Cir. 1986).
27. See infra Part III.
28. See 2 JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES § 5:22 (2013) (“[T]he law in this area (to the extent it exists) is remarkably unclear. . . . [T]here is as yet no generally accepted rule for a corporation to follow in making its disclosure decision until the jurisprudence is clarified.”); Stuart & Wilson, supra note 17, at 973 (“There is no statute, regulation, or rule that explicitly imposes a duty to disclose the existence of an investigation to investors and caselaw does not provide much guidance.”).
29. See Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (suggesting that one way for companies to avoid liability for misleading statements is simply to say “[n]o comment,” because “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.”).
Part I describes the theory behind the federal securities laws and outlines the disclosure framework, which generally does not require companies to disclose information to investors unless the information is material and there is a duty to disclose it. The next two Parts use the Second Circuit’s opinion in Matthews as a springboard for understanding arguments courts have made on both sides of the disclosure divide. Part II explores the four justifications for nondisclosure set forth in Matthews and related cases, which collectively form the backbone of the pervasive nondisclosure norm. Part III then examines how other courts have rebutted these justifications and required disclosure. Although courts have found disclosure appropriate in numerous instances, the contours of these requirements are imprecise and there are few clear rules to guide issuers. Finally, Part IV considers how to clarify disclosure obligations for issuers. Proposals for the SEC to implement a new line item are rejected in favor of a decisional framework courts can use to apply the half-truth doctrine more consistently. Unlike a line item, clarifying the half-truth doctrine enables companies to retain control over when uncharged criminal conduct is disclosed.

I. THE DISCLOSURE FRAMEWORK OF THE FEDERAL SECURITIES LAWS

Congress enacted the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) to protect investors by promoting transparency in the marketplace. To that end, a complex set of statutes, regulations, and SEC rules now require issuers to disclose information about the company, its business, and its management periodically and upon the occurrence of specified events. One goal of the federal securities laws is to deter corporate misconduct by placing corporate practices under the societal microscope. The logic is that requiring reporting companies to periodically disclose information about their operations and business deters misconduct. However, the primary goal of disclosure is to promote informed investment decision-making. The securities laws seek to provide investors with the information necessary to make smart investment choices. Without this information, investors

32. See Eric D. Roiter, Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws, 50 FORDHAM L. REV. 781, 785 (1982) (citing 1969 S.E.C. Disclosure Policy Study which, quoting Louis Brandeis’s famous remarks in Other People’s Money, noted a secondary goal of the securities laws is to bring corporate wrongdoing to light on the theory that “[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants”); see also Cynthia A. Williams, The Securities and Exchange Commission and Corporate Social Transparency, 112 HARV. L. REV. 1197, 1210 (1999) (“One of the major purposes of disclosure was to prevent fraud by corporate issuers and underwriters in the initial sale and subsequent trading of securities.”).
33. Roiter, supra note 32, at 784 (“[F]ostering informed investment decision-making is the fundamental purpose of the securities laws.”). Congress also intended the mandatory disclosure framework to furnish the market with information needed to accurately value the security. See H.R. REP. No. 73-85, at 4 (1933) (noting that mandatory disclosure would “bring into the full glare of publicity those elements of real and unreal values which may lie behind a security”); see also Williams, supra note 32,
would lack “an intelligent basis for forming [a] judgment as to the value of the securities [they buy or sell].” Although too little disclosure can undermine investor protection, too much disclosure can also be problematic. The more information made publicly available, the more difficult it becomes for investors to weed out the potentially useful information from the unsubstantiated, trivial, or duplicative. A glut of information can be just as blinding as no information at all.

The federal securities laws attempt to strike the right disclosure balance by imposing two conditions. Issuers are only required to share information with investors if the information is important to investment decisions (“material”) and there is a duty to disclose it. This Part introduces these two fundamental requirements and explains how uncharged criminal conduct could conceivably be construed as (A) material and (B) subject to a duty to disclose. The question of how courts have actually interpreted the materiality and duty questions in the corporate illegality context is discussed infra in Part II.

A. MATERIALITY

Rule 10b-5 makes it unlawful to, among other things, “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made...not misleading.” Similar language in Rule 14a-9 prohibits making misleading statements on proxy statements. In broad strokes, information is material if a reasonable investor would be substantially likely to view it “as having significantly altered the ‘total mix’ of information made available [to investors].” Throughout the 1970s, the SEC argued that all

at 1210 (citing one purpose of the securities laws as ensuring the price of the security matches its underlying value in order to promote market efficiencies).


36. 17 C.F.R. § 240.10b-5(b) (2013). Rule 10b-5 is promulgated under Section 10(b) of the Exchange Act, which makes it unlawful for any person to “use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j(b) (2012).

37. 17 C.F.R. § 240.14a-9(a) (2013) (“No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.”). Rule 14a-9 is promulgated under Section 14(a) of the Exchange Act, which prohibits using one’s name to solicit a proxy “in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78n(a)(1) (2012).

information bearing on management integrity was material. However, courts have since rejected this position and required that information have some quantitative impact on a company’s bottom line to be material. Uncharged criminal conduct seemingly toes the line between qualitative and quantitative materiality. A violation is immaterial insofar as it bears on management integrity, but that same violation might be found material if a plaintiff demonstrates that criminal liability would somehow damage the company’s financial status, either through reputational loss or the fines imposed. Although Rule 10b-5 specifies that only misleading material facts are actionable, Basic Inc. v. Levinson recognized that speculative, forward-looking information might be material if the balance of probability and magnitude suggest that the event in question will impact the company. That is, uncharged criminal conduct might be material at some point before criminal liability is imposed if liability is likely and the expected sanction is significant. Under this analysis, the crucial inquiry becomes: at what point is criminal liability sufficiently certain to render the conduct material to shareholders, and does the answer depend on the size of the potential criminal sanction?

B. DUTY TO DISCLOSE

Although material information is, by definition, important to investors, an issuer has no affirmative duty to disclose material information as it occurs. Issuers need only disclose material information to: (1) fill out line items in a registration statement, proxy solicitation, or periodic report as required by Regulation S-K; (2) disclose an event that must be disclosed promptly in a Form 8-K; and (3) make any statement, whether required or voluntary, complete and not misleading

The first two categories consist of specific line item disclosures that the SEC has required through rulemaking, and these regulations are summarized in Table 1. With respect to the first, several Regulation S-K line items that companies must fill out periodically could be construed to create a duty to disclose uncharged criminal conduct. The closest that the regulatory framework comes to explicitly requiring disclosure is Item 103, which compels disclosure of “material pending legal proceedings” or proceedings “known to be contemplated” against the company. In a similar fashion, Item 401(f) compels disclosure of criminal proceedings that are pending or transpired in the past ten

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40. See infra section III.A.
41. See infra section III.A.
43. Stuart & Wilson, supra note 17, at 977.
44. Id. at 977–78.
45. 17 C.F.R. § 229.103 (2013) (“Item 103”).
Table 1: SEC Regulations that Might Create a Duty to Disclose Uncharged Criminal Conduct

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Title</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reg. S-K Item 103</td>
<td>“Legal Proceedings”</td>
<td>“Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. ... Include similar information as to any such proceedings known to be contemplated by governmental authorities.”</td>
</tr>
<tr>
<td>Reg. S-K Item 401(f)</td>
<td>“Involvement in Certain Legal Proceedings”</td>
<td>Describe if any director, person nominated to be director or executive officer “was convicted in a criminal proceeding [within the past ten years] or is a named subject of a pending criminal proceeding (excluding traffic violations and other minor offenses).”</td>
</tr>
<tr>
<td>Reg. S-K Item 303</td>
<td>“Management’s Discussion and Analysis of Financial Condition and Results of Operations” (MD&amp;A)</td>
<td>“Discuss registrant’s financial condition, changes in financial condition, and results of operations” as provided in Item 303(a).</td>
</tr>
<tr>
<td>Reg. S-K Item 503(c)</td>
<td>“Risk Factors”</td>
<td>“[P]rovide ... a discussion of the most significant [risk] factors that make the offering speculative or risky.”</td>
</tr>
<tr>
<td>Form 8-K Item 4.02</td>
<td>“Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Report”</td>
<td>If a company’s board of directors, a committee of the board of directors, or its officers “concludes that any previously issued financial statements ... should no longer be relied upon because of an error in such financial statements ... disclose ... (2) a brief description of the facts underlying the conclusion to the extent known to the registrant at the time of filing.”</td>
</tr>
<tr>
<td>Form 8-K Item 1.01</td>
<td>“Entry into a Material Definitive Agreement”</td>
<td>“If the registrant has entered into a material definitive agreement not made in the ordinary course of business of the registrant ... disclose [a description of the agreement].”</td>
</tr>
</tbody>
</table>

years where an officer, director, or person nominated for those positions was a “named subject” or was convicted.\(^\text{46}\) Item 303, “Management’s discussion and analysis of financial condition and results of operations,” might also require disclosure of uncharged criminal conduct.\(^\text{47}\) The so-called “MD&A” requires issuers to describe “changes in financial condition and results of operations” that the issuer reasonably expects will materially negatively impact the net sales, revenues, or income from continuing operations.\(^\text{48}\) Item 503(c), which

\(^{46}\) 17 C.F.R. § 229.401(f) (2013) (“Item 401(f)").

\(^{47}\) 17 C.F.R. § 229.303(a) (2013) (“MD&A”).

\(^{48}\) Id.
requires companies to discuss the “most significant [risk] factors” the company faces,49 might also necessitate disclosing uncharged criminal conduct that materially impacts the business.

Second, companies might also need to submit a Form 8-K when they identify potential violations. For example, a Form 8-K must be filed when a company discovers significant financial statement errors suggesting that previous financial statements “should no longer be relied upon.”50 In addition to pointing out such an error, the company would also be required to include “a brief description of the facts underlying the conclusion to the extent known . . . at the time of filing.”51 A Form 8-K must also be filed when a company enters into a “material definitive agreement” outside the ordinary course of business.52 This encompasses settlements with government agencies investigating the wrongdoing.

Unlike the first two categories, which created regulatory duties to disclose upon specified filings or events, the third category involves situations where a company acquires a duty to disclose information in order to make its own statement not misleading. This “half-truth” doctrine applies both to statements companies are required to make in their regulatory filings with the SEC, such as the requirements listed in Table 1, as well as to statements issuers voluntarily make to the public.53 Under the half-truth doctrine, any statement of a company could trigger a duty to disclose uncharged criminal conduct if the statement would be misleading without the disclosure.

II. **Matthews and the Nondisclosure Norm**

Matthews54 was the first case in which the DOJ argued that qualitative information bearing on management integrity is material to investors.55 The

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49. 17 C.F.R. § 229.503(c) (2013) ("Item 503(c)"). The enumerated examples of risk factors that might be significant are (1) lack of an operating history, (2) lack of profitable operations in recent periods, (3) financial position, (4) business or proposed business, and (5) lack of a market for equity securities. *Id.*

50. SEC FORM 8-K, Item 4.02 (2012) ("Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review”).

51. *Id.* at 4.02(a)(2).

52. See SEC FORM 8-K, Item 1.01 (2012) ("Entry into a Material Definitive Agreement").

53. Rule 12b-20 imposes the half-truth doctrine on required SEC filings. See 17 C.F.R § 240.12b-20 (2013) ("In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."). Rule 10b-5 applies more generally to any statement made by an issuer, whether required or not. See 17 C.F.R. § 240.10b-5(b) (2013) (stating that it is unlawful to “omit to state a material fact necessary in order to make the statement made . . . not misleading.”).


55. Fedders, *supra* note 39, at 79. The SEC had advocated for a qualitative materiality standard throughout the 1970s and met judicial resistance, *see infra* section II.A, but the DOJ did not coordinate with the SEC in drafting the indictment against Matthews. Fedders, *supra* note 39, at 79 n.201. The Second Circuit chided the DOJ for not seeking the SEC’s expertise, which presumably would have questioned the wisdom of proceeding on a qualitative materiality theory. *See Matthews*, 787 F.2d at 45
complaint alleged that Clark Matthews, an officer of Southland Corporation running for election to the company’s board of directors, violated Section 14(a) of the Exchange Act and Rule 14a-9 by failing to disclose that he was the subject of a grand jury investigation for actions taken while serving as Southland’s general counsel. In the late 1970s, Matthews had conducted an internal investigation of Southland’s financials that revealed an employee had bribed a New York state tax commissioner adjudicating Southland’s pending tax matters. After interviewing several employees who denied wrongdoing, Matthews opted to not mention the bribe in the internal report summarizing the investigation’s findings.

Matthews was later named a “subject” of a grand jury proceeding investigating tax corruption because he excluded the bribe from the internal investigation report. Southland’s board of directors was aware of this investigation, but nonetheless recommended Matthews run for the board of directors. He was elected, but on the basis of a proxy statement that did not mention the grand jury investigation or his involvement in the original bribery investigation. A jury later acquitted Matthews of tax evasion conspiracy, but convicted him of proxy fraud.

A proxy statement violates Rule 14a-9 if it “omits to state any material fact necessary in order to make the statements therein not false or misleading.” Southland’s contested proxy statement gave “basic information” concerning each candidate, such as age, current position in the company, salary, and equitable holdings in the company. The government argued that Matthews’s status as subject of the grand jury investigation and alleged participation in the bribery scheme were facts “material to an evaluation of the ability or integrity of any director” and thus their omission made the proxy statement false and misleading in violation of Rule 14a-9. The government further contended that the grand jury investigation should have been disclosed under Item 401(f), which requires that candidates in board elections disclose if they have been “convicted in a criminal proceeding or... named [a] subject of a pending

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56. 787 F.2d at 39.
57. Id. at 40–41.
58. Id. at 41.
59. Id. at 44.
60. Id.
61. Id. at 39.
63. Matthews, 787 F.2d at 45.
64. 17 C.F.R. § 229.401(f) (2013).
65. Matthews, 787 F.2d at 45.
criminal proceeding” in the past ten years, excluding minor offenses.66

On appeal, the Second Circuit reversed Matthews’s conviction of securities fraud.67 Assuming the term “pending criminal proceeding” applied only once criminal charges had been filed, the court focused its inquiry on whether Item 401(f) nonetheless created an implicit duty for “Matthews to state to all the world that he was guilty of the uncharged crime of conspiracy.”68 The court held for Matthews and offered four primary justifications for rejecting the government’s theory that Item 401(f) compelled disclosure of Matthews’s uncharged criminal conduct: (A) criminal conduct is solely qualitatively material and the SEC did not implicitly intend to mandate disclosure of qualitatively material information in Regulation S-K; (B) uncharged criminal conduct might never be material because the conduct amounts to unproven allegations, not facts; (C) requiring disclosure of uncharged criminal conduct would raise fairness and due process concerns for issuers; and (D) requiring disclosure of uncharged criminal conduct would mandate self-incrimination.69 This Part examines how Matthews and like-minded cases have relied on these four lines of reasoning to hold uncharged criminal conduct immaterial and not subject to a duty to disclose. Together, these cases have created the nondisclosure norm—that is, the presumption that the securities laws never compel issuers to disclose uncharged criminal conduct.

A. UNCHARGED CRIMINAL CONDUCT AS QUALITATIVELY MATERIAL

The principal reason Matthews held Item 401(f) did not implicitly require disclosing the bribe and grand jury investigation was that the DOJ had not shown either harmed Southland’s financial condition.70 In fact, government counsel had conceded at oral argument that the government had not proven adverse economic impact, instead arguing that materiality was “not a matter of dollars and cents, it was morality looked at through the eyeglasses of someone with economic interest.”71 If the SEC had intended its regulations to require disclosure of qualitative information for shareholders to “determine the morality of [directorial] conduct,” so reasoned the court, it likely would have done so explicitly.72 In the court’s view, Item 401(f)’s explicit requirement to disclose convictions and postcharging criminal proceedings was not a wholesale endorsement of the qualitative materiality standard.

66. 17 C.F.R. § 229.401(f) (2013). At the time Matthews was decided, Item 401(f) only required disclosure of convictions and proceedings in the past five years as opposed to the ten years currently required. See Matthews, 787 F.2d at 44.
67. Matthews, 787 F.2d at 50.
68. See id. at 46 (emphasis added).
69. See id. at 45–50.
70. See id. at 49.
71. Id.
72. See id. at 47–49.
On the contrary, the court reasoned that the Commission did not intend to draft a qualitative disclosure requirement because the release accompanying the final rule stated, “[I]nformation reflecting on management ability and integrity is, in part, subjective.” Interpreting Item 401(f) to require full ethical and social disclosure would burden issuers with assessing whether information was subjectively important to investors and, absent clearer guidance from the SEC, the court declined to inject this uncertainty into the line item. Accordingly, it held, “[A]t least so long as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution” for securities fraud.

The Second Circuit’s rejection of qualitative materiality in *Matthews* is emblematic of a general consensus that, without more, uncharged criminal conduct is immaterial under the securities laws. The need for an objective, quantitative way to measure what is important to investors derives from the diversity of the investor base. Although the SEC advocated a qualitative standard of materiality throughout the 1970s as discussed in section I.A *supra*, the Commission’s October 1975 release acknowledged that investors’ primary investment interest is to turn a profit:

> [T]he primary interest of investors is economic. After all, the principal, if not the only, reason why people invest their money in securities is to obtain a return. A variety of other motives is probably present in the investment decisions of numerous investors but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed.

In other words, the SEC recognized that although shareholders may invest with social and ethical interests in mind, these interests are varied and subordinate to the economic motive common to all investments. The following year, the Supreme Court emphasized that “[t]he question of materiality . . . is universally . . . an objective one.” A materiality standard that sought to accommodate all investors’ interests would significantly overreach to the point of unworkability. The Northern District of Illinois took note of this problem in *SEC v. Chicago Helicopter Industries, Inc.*, reasoning that although investors might agree on the point at which conduct affects the profitability of the company, ethics are a more “nebulous” matter involving investors’ subjective

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74. See id. at 48–49.
75. Id. at 49.
interests. In light of the multiplicity of viewpoints surrounding what is “ethical,” a materiality standard grounded in ethics would result in a “stream of ad hoc determinations of materiality which would provide little guidance as to the required disclosure from one case to the next.” Accordingly, the court rejected the SEC’s theory that an illegal loan transaction entered into by a bank’s employee was material information that the bank needed to disclose to its shareholders. Other courts have similarly noted that uncharged illegal conduct cannot be considered material by dint of its relevance to management integrity.

B. UNCHARGED CRIMINAL CONDUCT AS NONFACTUAL

In addition to holding that Matthews’s participation in the bribery scheme and grand jury investigation were not material because they lacked financial relevance, the Matthews court also discussed whether the unproven nature of uncharged criminal conduct barred materiality. For a statement to be actionably misleading under Rules 10b-5 and 14a-9, it must somehow distort or omit a material fact. Interpreting the word “fact” quite literally, the Second Circuit held that “[l]iability under Rule 14a-9 is predicated upon a showing that an allegedly omitted fact is true.” The need to hew closely to the omitted “fact” language was especially poignant in Matthews because the defendant was ultimately acquitted. But these same concerns would arguably surface in any case involving allegations of criminal conduct, even if the government had not yet tried and failed to convict. Before criminal conduct is adjudicated, there is always doubt as to whether the underlying allegations of wrongdoing are true. A contrary rule would place courts passing on the materiality of allegedly illegal conduct in a difficult position by requiring them to first determine the conduct’s lawfulness.

79. Id.
80. Id. at *9.
81. See, e.g., Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987) (“Management cannot be expected to disclose information that some may find distasteful but that does not alter ‘the “total mix” of information made available’ to the investor.” (quoting TSC Indus., 426 U.S. at 449)).
82. See United States v. Matthews, 787 F.2d 38, 46–47 (2d Cir. 1986).
83. See 17 C.F.R. § 240.10b-5(b) (2013); 17 C.F.R. § 240.14a-9(a) (2013); see also supra section II.A (discussing materiality requirements of 10b-5 and 14a-9).
85. Id. at 46.
86. See In re Teledyne Def. Contracting Derivative Litig., 849 F. Supp. 1369, 1383 (C.D. Cal. 1993) (reasoning that because the securities laws require disclosures of “material facts,” an issuer need not disclose its culpability “until it is at least charged (in which case the charge is material) or proven (in which case the proven conduct is material”).
87. See SEC v. Chicago Helicopter Indus., Inc., No. 79-C-0469, 1980 U.S. Dist. LEXIS 17214, at *9 (N.D. Ill. Jan. 18, 1980) (“Subject matter jurisdiction of this action is premised on a violation of the
Not only is the underlying conduct speculative, but so too is the likelihood that the conduct will actually result in criminal liability. Accordingly, just as the Second Circuit in Matthews declined to require Southland to disclose the existence of the grand jury investigation, several courts have similarly not required companies to disclose that they have been contacted by enforcement agencies. In Browning-Ferris Industries the Southern District of Texas concluded that a corporate manager’s receipt of a “target letter” sent by the DOJ in connection with an investigation of collusion in the waste management industry did not have to be disclosed under Item 401(f) as a “pending legal proceeding” because it merely signaled the preliminary stages of an investigation, not an indictment. 88

Similarly, in Richman v. Goldman Sachs Group, Inc., the Southern District of New York held that receipt of a “Wells Notice”—in which the SEC notifies companies that the Enforcement Division is considering prosecution and invites them to submit a “Wells Submission” in their defense—is not a “pending legal proceeding” nor one “known to be contemplated” within the meaning of Item 401(f). 89 Rejecting the assertion that a Wells Notice signals likely liability, the court viewed the Wells Notice as only reflecting the “contingency” of litigation or “the desire of the Enforcement staff to move forward.” 90 Accordingly, it held that “[a]n investigation on its own is not a ‘pending legal proceeding’ until it reaches a stage when the agency or prosecutorial authority makes known that it is contemplating filing suit or bringing charges.” 91 Building off of Richman’s conclusion that Item 401(f) did not require disclosure of an investigation, Houston American Energy Corp. likewise held that a company’s statement in its 10-K avowing it faced no pending or threatened litigation was not misleading even though the company knew it was being investigated by the SEC. 92

C. FAIRNESS TO ISSUERS

Courts embracing the nondisclosure norm also frequently note that holding issuers liable for not disclosing uncharged criminal conduct would be unfair because there is no clear indication from the SEC alerting them that such a disclosure is required. In criminal securities fraud prosecutions, this unfairness principle can rise to the level of a due process violation: where an individual has no fair notice that specific conduct is forbidden or compelled, prosecution for

90. See id. at 274. The nonauthoritativeness of a Wells Notice was especially clear in Richman because one of the Goldman Sachs employees who received one was ultimately not sued by the SEC. See id. at 272–74.
91. Id. at 272 (quoting Stuart & Wilson, supra note 17, at 982).
that conduct deprives him of due process. In *Matthews*, the Second Circuit noted that criminal prosecutions based on a qualitative materiality theory might threaten due process because the standard’s subjectivity creates inherent uncertainty regarding what must be disclosed. Constitutional issues aside, the court was wary of expansively interpreting the SEC’s regulations and imposing liability on unsuspecting companies and officers in such an ad hoc manner.

In *United States v. Crop Growers Corp.*, the District Court for the District of Columbia invoked the *Matthews* due process concerns to narrowly construe the disclosure duties created by several Regulation S-K line items. In *Crop Growers*, the Office of Independent Counsel alleged that company executives made illegal campaign contributions and then covered their tracks by falsifying records submitted to various federal agencies. Although the directors were being prosecuted under 18 U.S.C. § 1001 for making false statements to the federal government and not for securities fraud, the court analyzed the securities disclosure framework because false statement liability hinged on whether Crop Growers had a legal duty to disclose the concealed information at the time of the alleged cover-up.

The *Crop Growers* court extended the Second Circuit’s due process-based reasoning to find that other Regulation S-K line items did not create a duty to disclose the misconduct. The court first discounted Item 103, which requires issuers to disclose any proceedings “known to be contemplated by governmental authorities.” At the time of the filings at issue, Crop Growers had no knowledge that the government was contemplating an enforcement action. Moreover, the plain language of Item 103 did not explicitly and “unambiguously” require disclosure of uncharged criminal conduct such that the directors would have fair notice of their obligation to disclose. Items 303 and 503(c)—which respectively require issuers to disclose “any known trend or uncertainty” likely to influence liquidity or operational results, and “the principal factors that make the offering speculative or one of high risk”—similarly created no disclosure duty. Terms like “risk,” “trend,” and “uncertainty,” the court rea-

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93. See United States v. Harriss, 347 U.S. 612, 617 (1954) (“The constitutional requirement of definiteness is violated by a criminal statute that fails to give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden by the statute. The underlying principle is that no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.”).

94. See United States v. Matthews, 787 F.2d 49 (2d Cir. 1986).

95. See id.


97. Id. at 339–40.

98. See id. at 344–45; see also Fedders, supra note 39, at 85 (describing how court reached the securities law duty-to-disclose question in *Crop Growers*).


100. Id. at 347.

101. Id.

102. Id.

103. Id. at 347–48.
soned, were simply “too vague and amorphous to give fair notice, required by the Due Process clause.”

D. SELF-INCRIMINATION CONCERNS

In Matthews, the Second Circuit also perceived that compelling Matthews to disclose the bribery and grand jury investigation under Item 401(f) might yield self-incrimination. Although Matthews was not compelled to run for Southland’s board, the court reasoned that the coercion associated with livelihood, professional standing, and reputation can be sufficient to implicate the Fifth Amendment. One commentator has gone so far as to suggest that the “Fifth Amendment alarm” was the motivating factor behind the Matthews decision. In framing the issue as whether a director would be forced to disclose his own “guilt” as opposed to the underlying conduct, James Redwood argues the Second Circuit entirely subordinated the materiality and duty analysis to Fifth Amendment concerns. This argument might stretch a little too far given that the court made clear the Fifth Amendment concerns only “buttressed” its reading of the securities laws. Nevertheless, the self-incrimination risk was certainly a factor that tipped the scales towards nondisclosure.

Setting aside the constitutional consequences of a rule requiring self-incrimination, courts have also identified the practical difficulties of requiring self-reporting. In Amalgamated Clothing, union shareholders argued that a company’s statement in its proxy materials that “all nominees for the Board of Directors were qualified to serve as fiduciaries” was misleading because it omitted that the incumbents had allegedly violated federal labor laws. The court dismissed the complaint because Item 401(f) did not create a duty to disclose. As in Matthews, the court feared upholding the union’s theory of the proxy rules would require companies to accuse themselves of wrongdoing. But rather than sounding the “Fifth Amendment alarm” featured in Matthews, the court here was more troubled by the common-sense problem of requiring companies to disclose their illegal conduct and intentions:

104. Id. at 348.
106. Id. at 50.
108. Id. at 354.
109. See Matthews, 787 F.2d at 49.
111. Id. at 333.
112. Id. at 331.
No matter how the proxy rule is construed, indeed even if it explicitly stated such a duty, corporate management would not announce in proxy literature an intention to violate laws. It is simply contrary to human nature. The rule, if it were construed to require this, would never succeed in its purpose of bringing such disclosure to the shareholders. It would do nothing more than license retrospective litigation, casting doubts on the results of shareholder elections and the legitimacy of management.\(^{113}\)

In short, Judge Leval thought reading Rule 14a-9 to require corporations to disclose wrongdoing to shareholders would make for a “silly, unworkable rule”: no rational director would disclose his potentially illegal conduct, but the omission would nonetheless create a cause of action and engender strike suits.\(^{114}\) *Amalgamated Clothing*’s pragmatic self-incrimination reasoning stands to catch more in its net than *Matthews*’s Fifth Amendment concerns. Such practical considerations apply globally to all misconduct that paints one unfavorably, whereas the Fifth Amendment only pertains to misconduct that could have criminal ramifications.\(^{115}\) Subsequent decisions have often grounded their reasoning in some combination of *Matthews*’s formalistic Fifth Amendment concerns and *Amalgamated Clothing*’s more practical ones.\(^{116}\)

### III. The Erosion of the Nondisclosure Norm

Despite strong rhetoric in several cases suggesting that the securities laws never require uncharged criminal conduct to be disclosed to shareholders,\(^ {117}\) the nondisclosure norm has been steadily eroding as courts revisit the concerns underpinning the Second Circuit’s aversion to disclosure in *Matthews*.

This Part discusses how courts addressing the key justifications underlying the nondisclosure norm have reached a different outcome. Section A proves that, contrary to arguments that uncharged criminal conduct is only ethically important or too speculative to be material, courts have routinely found that such conduct can be material if a plaintiff alleges it resulted in an adverse economic impact. Section B discusses how courts have found that the self-incrimination concerns raised in *Matthews* and *Amalgamated Clothing* do not bar disclosure. First, most courts have found the Fifth Amendment self-

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113. *Id.* at 332.
114. *Id.*
115. See U.S. Const. amend. V (“No person . . . shall be compelled in any criminal case to be a witness against himself.” (emphasis added)).
116. See, e.g., SEC v. Chicago Helicopter Indus., Inc., No. 79-C-0469, 1980 U.S. Dist. LEXIS 17214, at *9–10 (N.D. Ill. Jan. 18, 1980) (reasoning that requiring disclosure of uncharged criminal conduct would raise “troubling issues as to whether the philosophy of disclosure may supervene the *fifth amendment* protection against self-incrimination” if criminal penalties attached to the securities fraud, but that even if only civil penalties were appropriate, management would still never disclose allegedly illegal conduct because, as observed in *Amalgamated Clothing*, “it is simply contrary to human nature”).
117. See supra notes 21–26 and accompanying text.
incrimination concerns inapposite because corporations cannot invoke the Fifth Amendment, and the applicability of the Fifth Amendment to heavily regulated areas like the securities laws is questionable at best. Second, courts have doubted that mandatory disclosure would be a “silly unworkable rule” because the securities laws require disclosure of criminal conduct, not incriminating narratives. Lastly, section C documents how courts have required disclosure of the information under the half-truth doctrine.

A. THE RESURRECTION OF QUALITATIVE MATERIALITY?

Following on the heels of Matthews, many observers colorfully commented that the qualitative materiality standard had “died” and been consigned to “a premature grave” at the hands of the Second Circuit. In the past twenty years since Matthews, however, the standard has been resurrected. Although the Matthews rule that uncharged criminal conduct is immaterial still officially stands, it can be easily circumvented if the plaintiff specifically demonstrates how the misconduct threatens investors’ ability to receive a return.

Courts have embraced two variations on this theme. First, uncharged criminal conduct is generally material if the individual profited at the expense of the corporation, whatever the degree of the self-dealing. In Maldonado v. Flynn, the Second Circuit held that while allegations of corporate mismanagement were immaterial, instances of corporate abuse involving self-dealing—cheating the corporation for personal gain—would be material because the reasonable investor would value such information as bearing on the ability of management to lead the company. The Ninth Circuit likewise upheld the corporate management/self-dealing dichotomy in Gaines v. Haughton, finding “‘mere’ bribes” to be immaterial but “bribes coupled with kickbacks” to be material. Although these cases predate Matthews, they are still good law.

Second, uncharged criminal conduct may also be quantitatively material if it stands to negatively affect the financial position of the issuer. Under this theory, the key inquiry is whether the penalties attaching to the criminal conduct would create significant liability for the company, even though the conduct might be economically immaterial on its own. In analyzing this question, courts

118. See, e.g., Fedders, supra note 39, at 86 (“The qualitative materiality standard has come and gone. It died at the bar of common sense.”).
119. See, e.g., Redwood, supra note 107, at 351.
120. See Sauer, supra note 35, at 332 (noting that “the death of ‘ethical materiality’ is subject to various qualifications that are growing in number and significance” because, although the standard has been officially disregarded, current legal requirements often demand disclosure of information whose chief importance is primarily normative rather than economic).
121. 597 F.2d 789, 796 (2d Cir. 1979).
122. 645 F.2d 761, 777–78 (9th Cir. 1981).
essentially apply the test established in Basic Inc. for assessing the materiality of speculative events, which calls for balancing the probability of the event occurring against the magnitude of its potential financial impact. The issuer’s liability is a speculative event because the allegations might not be true and, even if they are, it is unclear before disclosure whether the wrongdoing would ever be discovered or successfully prosecuted. Under this standard, courts often find materiality if the potential sanctions would significantly damage the company’s ability to conduct business or the conduct would otherwise cause significant financial loss. These cases are strikingly at odds with those holding that the initiation of a government investigation is not material because it carries a low risk of ultimate liability.

Additionally, after years of retreating from the position that information with ethical consequences is material, the SEC endorsed a more searching theory of materiality in a 1999 release concerning the materiality of accounting misstatements. Staff Accounting Bulletin 99 (SAB 99) purports to merely clarify a company to substantial fines or require substantial expenditures in order to continue operations.”); Sauer, supra note 35, at 332–33 (explaining that courts often find bribes to foreign officials material because of the extraordinary penalties for violating the FCPA even though the payments themselves are in relatively small dollar amounts and therefore immaterial on their own). 124. 485 U.S. 224, 238 (1988).

125. See, e.g., Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987) (“Illegal payments that are so small as to be relatively insignificant to the corporation’s bottom line can still have vast economic implications. Even small illegal payments can seriously endanger a corporation’s business, especially when it relies heavily on government contracts, because such activity can result in the corporation being barred from obtaining future government contracts or subcontracts. Such a bar would be devastating to Alpha; it relied on defense-related contracts for sixty to sixty-five percent of its sales. Disclosure of the illegal conduct in obtaining government subcontracts, therefore, could have had a very significant impact on the ‘total mix of information made available’ to Alpha’s investors.” (citations omitted)); Jos. Schlitz Brewing Co., 452 F. Supp. at 830 (finding payment of bribes to distributors material because the violation posed a “substantial threat” to brewing company’s license to sell beer); Cooke v. Teleprompter Corp., 334 F. Supp. 467, 473–74 (S.D.N.Y. 1971) (holding proxy materials advising shareholders that a director convicted of bribery had resigned were materially misleading for omitting his continued involvement in running the company, a material fact given such involvement could cost the company its FCC licenses).

126. See, e.g., Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 640 (3d Cir. 1989) (rejecting motion to dismiss 10b-5 claim because company’s failure to disclose that the success of its advertising and promotional practices was attributable to illegal conduct could be material); Rahman v. Kid Brands, Inc., No. 11-1624 (JLL), 2012 WL 762311, at *8–11 (D.N.J. Mar. 8, 2012) (denying motion to dismiss 10b-5 claim because a company’s statements describing its effective internal controls, compliance with the law, and financial health omitted the material fact that the company was engaging in ongoing customs violations); Greenfield v. Prof’l Care, Inc., 677 F. Supp. 110, 113 (E.D.N.Y. 1987) (denying motion to dismiss 10b-5 claim because failure to disclose in 10-K that part of company’s earnings were obtained through Medicaid fraud and subject to forfeiture was directly related to company’s earnings and, thus, was material); In re Occidental Petroleum Corp., Exchange Act Release No. 16,950, 1980 WL 121345 (July 2, 1980) (finding environmental violations that were likely to be prosecuted and carried substantial potential liability material). But see Acito v. IMCERA Grp., Inc., 47 F.3d 47, 52–53 (2d Cir. 1995) (finding fact that corporation’s manufacturing plant was not up to code immaterial because plant only made ten of one thousand products that corporation manufactured, FDA took no action based on inspections, and plant was only one of corporation’s more than thirty locations).

127. See discussion supra section II.B.

128. SAB 99, supra note 38.
existing doctrine on the materiality of financial misstatements—perhaps in recognition that an interpretive guidance cannot overturn extant judicial precedent—but the release signaled a return to the qualitative theory of materiality. 129 SAB 99 takes as its starting premise that materiality cannot be determined exclusively based on quantitative metrics such as the percent of earnings or revenue affected by the misstatement. 130 Rather, issuers must also consider “qualitative factors,” which in some circumstances “may cause misstatements of quantitatively small amounts to be material.” 131 One of the suggested qualitative factors is “whether the misstatement involves concealment of an unlawful transaction.” 132 While SAB 99 falls short of creating an ever-present obligation for companies to self-report illegal conduct, the SEC’s inclusion of this qualitative factor indicates corporate illegality is not unequivocally immaterial like Matthews suggests.

B. SELF-INCRIMINATION CONCERNS DISPELLED

Many courts assessing whether companies must disclose uncharged criminal conduct have not been troubled by the constitutional and practical self-incrimination concerns identified in Matthews and Amalgamated Clothing. Some do not address the Fifth Amendment because they involve private litigation or civil enforcement actions with no criminal implications. 133 But even cases stemming from criminal prosecutions have outright rejected Fifth Amendment claims. Two primary arguments are typically advanced.

The first recognizes that the securities laws regulate disclosure by issuers, not individual directors, and corporate entities do not have Fifth Amendment rights. 134 The Eastern District of New York held in Ballan v. Wilfred American Educational Corp, that even if the defendant for-profit educational institution and its management had timely asserted their Fifth Amendment rights, the Fifth Amend-
ment would not have shielded them from having to disclose a scheme to defraud the Department of Education’s financial aid fund because “[a] corporation has no privilege against self-incrimination.” 135 Rather than eschewing the securities laws, the company’s directors could presumably address their fear of incrimination by appointing an authorized agent to make the disclosures. 136 Along the same lines, in SEC v. Joseph Schlitz Brewing Co., the court held a brewing company charged with failing to disclose illegal payments to alcohol retailers could not invoke the Fifth Amendment privileges of its management as justification for not disclosing the scheme to shareholders. 137 Since the corporation itself lacked Fifth Amendment rights, it could not “take advantage of an allegedly unconstitutional burden placed on its individual employees” to evade the securities laws. 138

A second reason for rejecting the “Fifth Amendment alarm” is that the privilege does not apply in regulatory self-reporting contexts. In California v. Byers, the Supreme Court held that regulatory disclosure frameworks only violate the Fifth Amendment if the possibility of self-incrimination is “substantial.” 139 The Ninth Circuit considered whether the securities reporting requirements entailed such a risk in SEC v. Fehn. 140 Applying a three-factor test that weighed the individual’s Fifth Amendment interest against the government’s interest in requiring disclosure, 141 the court concluded that the securities laws do not sufficiently threaten self-incrimination because they aim to further investor protection and apply to many businesses generally, not only to those suspected of criminal activity. 142

Many courts are similarly not concerned that requiring disclosure of uncharged criminal conduct would make for a “silly, unworkable rule” because no rational director would self-incriminate himself. 143 As one commentator noted in the context of the Matthews case, the question of whether disclosure requires

135. 720 F. Supp. at 248 (citing United States v. Kordel, 397 U.S. 1, 7 (1970)).
136. Id.
138. Id. at 829.
140. 97 F.3d 1276 (9th Cir. 1996).
141. The three factors considered were:
   (1) whether the disclosure requirement targets a highly selective group inherently suspect of criminal activities, rather than the public generally; (2) whether the requirement involves an area permeated with criminal statutes, rather than an essentially noncriminal and regulatory area of inquiry; and (3) whether compliance would compel disclosure of information that would surely prove a significant link in a chain of evidence tending to establish guilt.
142. Id. at 1291–92 (citations omitted) (internal quotation marks omitted).
self-accusation turns on how the issue is framed. Amalgamated Clothing and Matthews framed the disclosure question in terms of whether the securities laws required the corporation to “accuse” itself of criminal conduct. But the proper framing of the issue is not whether corporations should be required to declare their own guilt, but rather whether they should be required to disclose the underlying facts or conduct at issue.

Noting the subtle distinction, the court in Ballan agreed it would be impracticable for the securities laws to require issuers to release statements impugning their corporate culture (e.g., “The Company promotes a corporate culture in which violations of government regulations are bound to occur”) or revealing that the company routinely breaks the law (e.g., “The Company is in flagrant violation of numerous governmental regulations”). However, in contrast to Judge Leval’s conclusion in Amalgamated Clothing, the Ballan court observed that the securities laws could still require some disclosure even if requiring mandatory confessions was impractical. Nothing in the securities laws, the court reasoned, would protect defendants from having to disclose the underlying facts showing that the alleged scheme to defraud federal funds took place.

Other cases have drawn a similar line between confessions of guilt and the underlying facts or conduct suggesting guilt. In Roeder v. Alpha Industries, Inc., for example, the First Circuit held that a company’s practice of paying bribes to obtain defense subcontracts could be material even before indictment. Although the legal consequences stemming from the bribe were only contingencies, the bribe itself was a “fact” that investors would consider material. Likewise, in Menkes v. Stolt-Nielsen S.A., the District of Connecticut concluded that a shipping company’s price-fixing agreement with a competitor in violation of the antitrust laws could be a material fact requiring disclosure.

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144. See Redwood, supra note 107, at 354 (describing the Matthews court’s framing of the issue—whether the securities laws required Matthews to pronounce himself “guilty”—as “melodramatic” because such loaded language all but preordained a Fifth Amendment problem).

145. See United States v. Matthews, 787 F.2d 38, 46 (2d Cir. 1986) (framing the issue as whether the proxy rules “required Matthews to state to all the world that he was guilty of the uncharged crime of conspiracy”); Amalgamated Clothing, 475 F. Supp. at 331 (“[T]he proxy rules simply do not require management to accuse itself of antisocial or illegal policies.”).

146. See, e.g., Galati v. Commerce Bancorp, Inc., No. Civ. 04-3252(RBK), 2005 W.L. 3797764, at *6 (D.N.J. Nov. 7, 2005) (“[W]hile omissions regarding criminal conduct are material, omissions relating to ‘the attendant risks’ or unsustainability of criminal conduct are not. Even if a corporation is engaging in illegal practices, predictions of future events such as criminal indictments are too speculative to be material.”); see also infra notes 156–63 and accompanying text.


148. Id.

149. Id.

150. 814 F.2d 22, 25 (1st Cir. 1987).

151. Id. at 25 n.1.

C. FINDING A DUTY TO DISCLOSE

Although Matthews and related cases settled that the line items of Regulation S-K do not create an affirmative duty to disclose uncharged criminal conduct, the language in these decisions suggesting that the federal securities laws never require disclosure cannot be read for all it is worth. Issuers ought not to rely on these sweeping statements because courts have, with some frequency, required disclosure of this information under the half-truth doctrine.

Once a company speaks, whether in a public filing or informally as in a press release, the half-truth doctrine provides that the company must include all additional information necessary to make the statement not misleading. A statement misleads, and thus violates Rule 10b-5 if it would give reasonable shareholders a “false impression” of the facts at hand. Contrary to the rhetoric of the nondisclosure norm, many cases have found that the duty to complete a half-truth exists even where the omitted information is uncharged criminal conduct. It is unclear what types of statements qualify as half-truths, however. In other words, how close must the nexus between the statement and the concealed illegality be in order to trigger a duty to disclose? This question typically arises with respect to four types of statements, explored in turn below: (1) earning statements; (2) legal compliance statements; (3) statements describing prior success; and (4) future rosy projections. And, perhaps given the fact-specific nature of the inquiry, there are few clear-cut answers. Issuers therefore find themselves in an unsettling position: while line items themselves do not create an affirmative duty to disclose uncharged criminal conduct, the way in which issuers fill out the line items can independently trigger disclosure.

153. See supra section II.C.  
154. See supra notes 21–26 and accompanying text.  
155. See supra notes 21–26 and accompanying text.  
156. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968).  
158. See Donald C. Langevoort, Half-Truths: Protecting Mistaken Inferences by Investors and Others, 52 Stan. L. Rev. 87, 88–89 (1999) (“Because half-truth claims are so frequently made in litigation, this leaves an unfortunate risk of confusing precedent. Such confusion, in turn, causes people a good deal of trouble in knowing how to act (or advise their clients) free of legal risk, something particularly problematic given how often we are all tempted to be evasive. The law’s murkiness should not be surprising. Half-truths trigger a high level of both moral and social ambiguity.” (footnote omitted)).
1. Earning Statements

Courts struggle with whether and to what degree earning statements trigger a duty to disclose illegal conduct that materially impacts the depicted earnings. Although the Eastern District of New York held in Greenfield v. Professional Care, Inc. that earning statements are materially misleading if they fail to disclose that earnings derived from illegal conduct,\textsuperscript{159} the majority view is that, absent more, revenue figures themselves cannot trigger a duty to disclose illegal sources of the earnings. Greenstone v. Cambex Corp.\textsuperscript{160} is emblematic of the majority perspective. In Greenstone, the District of Massachusetts rejected a claim that a firm’s revenue figures triggered a duty to disclose illegal revenue sources because “the reports would have been more accurate and complete if the defendants had revealed their improper activities” on the balance sheet.\textsuperscript{161} Although the revenue statements might have artificially inflated profits, the plaintiff’s vague references to “false portrayal” of revenue were insufficient to create a duty to disclose the source of the revenue and amounted to an incorrect assertion that there was an independent affirmative duty to disclose the information.\textsuperscript{162} The Sixth Circuit likewise held in Sofamor Danek Group that “a violation of federal securities law cannot be premised upon a company’s disclosure of accurate historical data.”\textsuperscript{163}

A related question is whether a misleading statement about a company’s earnings triggers the duty to correct not only the misstatement itself, but also the revenue figures writ large.\textsuperscript{164} Although some cases indicate that the revenue figures themselves must be corrected,\textsuperscript{165} later courts have not adopted such an expansive interpretation. In Marsh, the Southern District of New York rejected precedent suggesting that misleading statements about revenue made the numbers themselves misleading.\textsuperscript{166} The court considered this rule “inequitable” because it would permit a company that stayed silent to escape 10b-5 liability but would punish a company that chose to make a misleading statement two times for the underlying illegal conduct.\textsuperscript{167} Consequently, the court limited the

\textsuperscript{159}. See Greenfield v. Prof’l Care, Inc., 677 F. Supp. 110, 113 (E.D.N.Y. 1987). The Greenfield approach presumes that because the numbers in earning statements themselves create a presumption of legality and GAAP-compliance, they are materially misleading to the extent that the earnings were not legally obtained. This view has not been popular, perhaps because it blurs the line between duty and materiality. See In re FBR Inc. Sec. Litig., 544 F. Supp. 2d 346, 356 n.6 (S.D.N.Y. 2008).
\textsuperscript{161}. Id. at 91.
\textsuperscript{162}. Id.
\textsuperscript{163}. In re Sofamor Danek Group, Inc., 123 F.3d 394, 401 n.3 (6th Cir. 1997).
\textsuperscript{164}. See In re FBR, 544 F. Supp. 2d at 356 (noting split in Second Circuit).
\textsuperscript{165}. See In re Van der Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388, 400–01 (S.D.N.Y. 2005).
\textsuperscript{167}. Id.
half-truth doctrine to the misleading statement itself, an outcome later praised in *FBR*.169

2. Legal Compliance Statements

Statements expressing full compliance with the law may also trigger a duty to disclose illegal conduct, although not universally. In *Craftmatic*, the company’s statement that it was “presently in compliance with consumer protection requirements” was sufficient to trigger a duty to disclose its violation of FCC consent decrees and consumer protection laws.170 The Eastern District of New York reached a similar result in *Ballan*, concluding that a private school’s assurance that its policy was “to comply with all applicable laws and regulations” was misleading because the school was defrauding the federal higher education loan system.171

On the other hand, the Sixth and Eighth Circuits have found that general statements of legal compliance are only actionable if a plaintiff pleads with particularity that a defendant actually knew he or she was speaking falsely at the time of the statement.172 This approach arguably confuses the duty issue with the heightened pleading standard for securities fraud173 and the 10b-5 scienter requirement,174 but its effect is to make it considerably more difficult to prove that a statement concerning legal compliance is an actionable half-truth. Thus, in stark contrast to the Third Circuit and Eastern District of New York’s willingness to consider legal compliance statements half-truths, the Sixth Circuit held in *Omnicare* that a “generic claim of lawfulness, in the absence of any specifics” did not trigger a duty for a healthcare company to disclose that various practices for processing drugs were unlawful.175

168. *Id.*

169. *See In re FBR*, 544 F. Supp. 2d at 356 (finding reasoning in *Marsh* “convincing” but finding no need to reach the question on present facts).


173. *Compare Fed. R. Civ. P. 9(b)* (“In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.”), and 15 U.S.C. § 78u-4(b)(2) (2012) (“[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”), *with Fed. R. Civ. P. 8(a)* (“A pleading that states a claim for relief must contain . . . a short and plain statement . . . showing that the pleader is entitled to relief.”), and *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007) (interpreting Fed. R. Civ. P. 8(a) to require plaintiff to plead “enough facts to state a claim to relief that is plausible on its face”).

174. *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (holding the SEC must also prove scienter because “scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (holding private plaintiffs suing under Section 10(b) must prove scienter).

175. *Omnicare*, 583 F.3d at 946–47. One reason generic statements do not trigger a duty to disclose is that they are mere corporate puffery. *See In re Marsh & McLennan Cos. Sec. Litig.*, 501 F. Supp. 2d
3. Statements Describing Prior Success

The misleading nature of a statement describing prior success hinges on whether the statement attributes its success to an advantage the company gained illegally or to a cause wholly unrelated to the wrongdoing. Statements that attribute prior success to specific company practices without disclosing their illegal nature are misleading by virtue of the omission. The Third Circuit established this point in *Craftmatic*, concluding that a prospectus crediting a company’s financial success to its advertising and marketing practices triggered the duty to disclose that these practices violated an FCC consent order and other consumer laws.\(^{176}\) In *Par Pharmaceuticals*, the Southern District of New York similarly found misleading a pharmaceutical company’s statements touting its success in gaining FDA approval of new drugs and devices.\(^{177}\) The statement created the impression that the company had a particular expertise in obtaining FDA approvals over its peer companies when in fact the company had been routinely bribing FDA officials to gain approvals.\(^{178}\) More recently, in *Sotheby’s Holdings*, the Southern District of New York found Sotheby’s statement in its 10-K describing “intense” competition in the auction market to be misleading absent disclosure that it had entered into a price-fixing agreement with Christie’s that removed much, if not all, of the competition.\(^{179}\)

A statement that falsely attributes past success to a cause wholly unrelated to the misconduct may not be a half-truth, however, depending on the jurisdiction. In *Menkes*, the District of Connecticut drew the line based on the specificity of the attribution.\(^{180}\) A statement attributing increased shipping volume over the past five years primarily to “improved demand” in the company’s dominant regions was not specific enough to mislead with respect to the company’s anticompetitive conduct.\(^{181}\) This statement was not a half-truth because it was too attenuated from the root of the misconduct and did not specifically attribute the gains to an illusory competitive market.\(^{182}\) The Third Circuit takes a more liberal tack. Instead of focusing on whether the statement specifically touts an unrelated cause of success, the Third Circuit considers whether the statement generally put the source of the company revenue “in play.”\(^{183}\) In *Providian Financial*, for example, the court found statements attributing a lender’s past

\(^{176}\) See *Craftmatic Sec. Litig.* v. Kraftsow, 890 F.2d 628, 640 (3d Cir. 1989).


\(^{178}\) See id.


\(^{181}\) Id. at *2,*8.

\(^{182}\) Id. at *8.

successes to its “customer focused approach” put the cause of the company’s success in play, triggering a duty to disclose that fraudulent credit card practices drove its success.184

4. Future Rosy Projections

With respect to forward-looking statements, the majority perspective is that future rosy projections about company growth are not misleading if they omit potentially illegal conduct. One reason that courts generally do not find projections to be half-truths is that future statements are on somewhat unsure footing when it comes to materiality. That is, reasonable investors are presumed to place less stock in such inherently uncertain statements.185 Courts also eschew a duty to disclose here on the theory that companies should not be “obligated to speculate as to the myriad of consequences, ranging from minor setbacks to complete ruin, that might . . . [befall] the company if the bribery scheme [were] discovered, disclosed or terminated.”186

Without more, statements predicting future success are also not deemed misleading even if the company engages in illegal practices that threaten the bottom line or a predicted positive trend.187 In Menkes, for example, the court found the shipping company’s forward-looking statements predicting specific anticipated growth rates and shipping prices did not create a duty to disclose the anticompetitive price agreements that drove the predictions. These statements were “vague forecasts of future success” that were “too remote from [the] alleged illegal conduct to compel disclosure.”188 The Par Pharmaceuticals court also rejected the argument that forecasting “renewed momentum for growth in the coming year” was misleading for failure to disclose the company’s ongoing practice of bribing FDA officials.189 The subject matter of the statement was so “attenuated” from the bribery scheme that no reasonable investor would draw a false impression.190

Courts have occasionally required disclosure, however. First, rosy projections that are worded as guarantees of predicted success and knowingly false can give

184. Id.
185. The bespeaks caution doctrine and Section 21E of the Securities Exchange Act, 15 U.S.C. § 78u-5 (2012), which insulate issuers from liability arising from materially misleading statements if they are accompanied or preceded by cautionary information, reflect the law’s general unease with creating liability for forward-looking statements.
187. In re FBR Inc. Sec. Litig., 544 F. Supp. 2d 346, 359 (S.D.N.Y. 2008); Menkes v. Stolt-Nielsen S.A., No. 3:03CV409(DJS), 2005 WL 3050970, at *7 (D. Conn. Nov. 10, 2005). (“Courts that have determined that corporations had a duty to disclose uncharged illegal conduct in order to prevent other statements from misleading the public have required a connection between the illegal conduct and the statements beyond the simple fact that a criminal conviction would have an adverse impact upon the corporation’s operations in general or bottom line.”).
189. In re Par Pharm., 733 F. Supp. at 678.
190. Id.
rise to a duty to disclose contrary illegal conduct.\textsuperscript{191} Such was the case in \textit{Ballan}, where the court found that the private school’s reports characterizing its financial outlook “in a highly positive manner” and suggesting the prosperity would continue obliged the school to reveal any “‘facts’ suggesting otherwise.”\textsuperscript{192} Second, some courts have gone a step further, analyzing the half-truth question no differently for speculative forward-looking information than for historical, factual information.\textsuperscript{193} In \textit{Helwig v. Vencor, Inc.}, the Sixth Circuit put it simply: “[T]he protections for soft information end where speech begins.”\textsuperscript{194} Although the company in question was under no obligation to make speculative predictions about its future earnings, the court found its decision to speak on an uncertain subject opened the door for the statements to mislead, notwithstanding the “soft” nature of the information necessary to complete the half-truth.\textsuperscript{195}

In sum, the presumption that corporate illegality need not be disclosed to shareholders is not as strong as the language in \textit{Matthews} and like-minded cases suggests. First, such information sometimes is material. It remains true that uncharged criminal conduct is immaterial if its sole function is to enable investors to draw moral judgments regarding the company. But, uncharged criminal conduct can be material if the conduct involves (1) self-dealing; or (2) concurrent financial materiality, as when conduct carries a substantial risk of high criminal penalties or otherwise affects the bottom line.\textsuperscript{196} Second, courts have found that disclosure does not offend the Fifth Amendment or create practical self-incrimination concerns. Third, courts often find a duty to disclose misconduct. Although no court has found that Regulation S-K’s line items create an affirmative duty to disclose uncharged criminal conduct, courts have routinely required disclosure to complete half-truths spoken by companies.

\textbf{IV. THE WAY FORWARD: CLARIFYING OBLIGATIONS TO DISCLOSE UNCHARGED CRIMINAL CONDUCT}

When the exaggerated rhetoric that dominates the nondisclosure norm is peeled away, it becomes evident that courts actually do require companies to disclose corporate illegalities with some frequency in order to make statements not misleading. Requiring disclosure is a desirable outcome because, as we have

\textsuperscript{191} In re FBR, 544 F. Supp. 2d at 358.
\textsuperscript{192} Ballan v. Wilfred Am. Educ. Corp., 720 F. Supp. 241, 245, 250 (E.D.N.Y. 1989); cf. In re FBR, 544 F. Supp. 2d at 359 (a company’s general opinion that it would likely remain profitable did not rise to the level of a guarantee and thus was not actionable).
\textsuperscript{194} 251 F.3d at 560.
\textsuperscript{195} Id. at 562. The court also noted, though, that the bespeaks caution doctrine or Section 21E safe harbor might ultimately protect the forward-looking statements by defeating their materiality. Id.
seen, the wrongdoing is often quantitatively material to investors. Moreover, finding otherwise would mean the securities laws bar companies from making statements that mislead by omitting information, except where that information was criminal in nature. This would be an inequitable result because the very criminal nature of the activity makes it even more important to investors.

Although requiring some disclosure of uncharged criminal conduct is surely desirable to expose corporate wrongdoing, courts are currently inconsistent with respect to when disclosure is required. This uncertainty may encourage companies to share less information with investors. Because the half-truth doctrine can only be triggered when companies speak, the natural reaction in the face of uncertainty is to not speak at all. If sunlight really is the “best of disinfectants,” then clearer guidance for issuers is necessary to ensure the securities laws promote investor protection and deter corporate misconduct.

Section A explores how some commentators writing before the expansion of leniency programs called for an explicit line item requiring companies to disclose uncharged criminal conduct that is likely to be prosecuted. Although such a rulemaking would maximize the amount of information available to shareholders regarding corporate wrongdoing, it is impossible to know in advance of a formal investigation if liability will result and what the scope of that liability might be. Line items that require premature disclosure risk harming shareholders by causing an unjustified drop in share price. Section B posits that the better solution from both an issuer and shareholder perspective is for courts to clarify the current half-truth doctrine with respect to corporate illegalities so that companies retain discretion over when to disclose the information. Insofar as more disclosure of corporate wrongdoing is desired, enforcement agencies should provide incentives for companies to voluntarily disclose information to shareholders instead of requiring it via a line item.

197. See supra section II.A. The information may, of course, also be ethically material. But, as discussed, the SEC and courts abandoned the ethical materiality doctrine in the 1980s. See generally Fedders, supra note 39.

198. One commentator has posited that the more serious a crime is, the more material it is to investors because higher penalties, risks of prosecution, and legal fees associated with more serious crimes pose greater economic costs to the company. See Russell B. Stevenson, Jr., The SEC and the New Disclosure, 62 CORNELL L. REV. 50, 82–83 (1976). This spectrum likely also applies when comparing noncriminal to criminal misconduct.

199. See, e.g., Langevoort, supra note 158, at 125 (noting that lawyers often urge “an abundance of caution” when advising on disclosures, and frequently advise outright silence when there is a “compelling need for secrecy”); Stuart & Wilson, supra note 17, at 992–97 (recommending that companies consider all of the consequences of disclosure before deciding whether, when, and how to disclose information related to an internal or government investigation).


201. See Branch & Rubright, supra note 196, at 1479–81; Stevenson, supra note 198, at 82; see also Redwood, supra note 107, at 404–07 (discussing Branch & Rubright’s and Stevenson’s proposals and proposing another).
A. LINE ITEM PROPOSALS

Proposals to create a line item requiring disclosure of uncharged criminal conduct aim to make financially material information available to shareholders and deter corporate wrongdoing. Although the creation of a duty to disclose incriminating information might not actually increase the amount of information available to investors because of the practical concerns discussed in Amalgamated Clothing, a duty would nonetheless “provide a basis for aggrieved shareholders to obtain justice.”

Several different iterations of a corporate illegality line item have been proposed in the literature in the years since the SEC supported qualitative disclosure. These proposals echo a general movement favoring ethically grounded line items to expose corporate practices in areas as diverse as environmental compliance, international labor practices, and health of executive officers, to name a few. Russell Stevenson argues that the SEC should require disclosure of crimes of “moral turpitude or the corruption of important systemic values,” so long as the manager intended to commit the crime. George Branch and James Rubright would require disclosure of illegal conduct where three conditions are met: (1) it is probable that the illegal conduct would be discovered and litigated; (2) corporate counsel, in light of all the surrounding circumstances, has determined that the conduct would in fact be found illegal; and (3) the conduct would subject the company to a “substantial threat of financially material consequences” as opposed to minor sanctions. Addressing disclosure of illegal conduct committed by director-nominees, James Redwood proposes modifying Item 401(f)(2) of Regulation S-K to require that proxy statements disclose not only if a director was a “named subject of a pending criminal proceeding,” but also if he or she was “a subject or target of a criminal proceeding known to be contemplated by governmental authorities.” This proposal would require disclosure before the commencement of legal proceedings, perhaps as early as the start of an investigation.

202. See Branch & Rubright, supra note 196, at 1479–80; see also Stevenson, supra note 198, at 82–83 (discussing the corporate economic impact of criminal activity as justification for requiring disclosure).


204. Williams, supra note 32, at 1308.

205. Id.


207. Stevenson, supra note 198, at 82.

208. Branch & Rubright, supra note 196, at 1481.

209. Redwood, supra note 107, at 407.

Despite purporting to benefit shareholders and provide clarity to issuers, these line items run the risk of doing neither. The chief problem—even in a line item like Branch and Rubright’s that only requires disclosure of criminal conduct likely to result in liability—is that it is simply impossible to predict with any certainty before the commencement of a formal investigation whether there will be prosecution or liability, the line currently drawn by case law interpreting Item 103’s “pending legal proceedings” and “known to be contemplated” language.211 As discussed supra in section II.B, the inherent uncertainty surrounding whether an investigation will result in liability is routinely invoked as reason to not require disclosure of target letters and Wells Notices.212

Browning-Ferris Industries, Richman, and Houston American Energy Corp. jointly illustrate why requiring disclosure of corporate illegals when prosecution is “likely” or “probable” is ill-advised. First, the mandate is not sufficiently clear for issuers, who would puzzle over how it is ever possible to know that a formal investigation is coming down the pike given that the receipt of a target letter or Wells Notice does not signal likely liability. A line item might therefore be ineffective in actually requiring disclosure of criminal conduct much before the current standard under Items 103 and 401(f). But, even if courts were to interpret a line item to require earlier disclosure, disclosure might end up harming its intended beneficiaries: present shareholders.

Disclosure of corporate misconduct can unduly punish shareholders, primarily where investigations do not lead to liability. It is well documented that disclosure of corporate wrongdoing causes share prices to drop precipitously.213 This drop in value is justified where the company actually will face criminal liability, but reflects mere speculation when none materializes. In this latter subset of cases—where a company discloses criminal conduct that does not result in criminal liability—the ensuing sharp decline in share price benefits the market generally by enabling more accurate assessment of company risk, but does so at the expense of present shareholders forced to bear the loss.214 An

211. See id.; see also Richman v. Goldman Sachs Grp., Inc., 868 F. Supp. 2d 261, 274 (S.D.N.Y. 2012) (holding disclosure of a Wells Notice sent by the SEC Enforcement Division is not required under Item 103).


213. See discussion, supra pp. 1648–49, regarding the drop in Wal-mart’s stock price upon discovery of its FCPA violations in Mexico. The Wal-mart example might underestimate the likely drop. See Peter Spivack & Sujit Raman, Essay, Regulating the ‘New Regulators’: Current Trends in Deferred Prosecution Agreements, 45 AM. CRIM. L. REV. 159, 160 n.7 (2008) (noting that the share price of publicly traded companies regularly drops by half upon announcement of a criminal investigation, and that this drop happens “immediately.”). But see Christine Nelson et al., Disclosures of SEC Investigations Resulting in Wells Notices, 19 SEC. LITIG. J. 19, 20 (2009), available at http://www.cornerstone.com/get_attachment/0646b4bf-f229-4d83-83f1-940a038a229f/Disclosures-of-SEC-Investigations-Resulting-in-Wel.aspx (examining fifty-eight disclosures in an event study, authors concluded that the disclosure of Wells Notices was associated with a statistically significant drop in share prices the day of the disclosure, but found the average drop to be in the 1–3% range).

214. Rapp, supra note 203, at 127.
efficient market might be able to internalize the premature nature of the disclosure such that the stock price would not decline as dramatically for earlier disclosures, or alternatively, would rebound quickly once no liability attached. But there is considerable debate about just how efficient the market really is. Just as enforcement agencies must bear in mind the collateral consequences of indicting companies,215 so too should the SEC consider the negative effect on shareholders that requiring disclosure of uncharged criminal conduct before formal investigation would entail.

B. WORKING WITHIN THE EXISTING FRAMEWORK

Rather than creating a new duty for companies to disclose criminal wrongdoing before liability is certain, the focus should be on clarifying issuer obligations to disclose under the half-truth doctrine. Whereas line items run the risk of requiring premature disclosure, the half-truth doctrine lets companies adjust the spigot of information they release to the public. This mitigates the risk that companies will disclose misconduct before criminal liability is certain, a result which exposes the information but harms shareholders in the process.

Some companies choose to disclose criminal wrongdoing before Item 103 creates an express obligation to do so, perhaps in an attempt to control market reactions by demonstrating accountability.216 Such voluntary premature announcements may very well result in the same kind of “unjustified” share price drop as would a required line item disclosure. But the decision to speak and disclose under the half-truth doctrine is a business judgment, and any ensuing losses from disclosing criminal conduct that ends up not being prosecuted would reflect the company’s miscalculation. Given the difficulty of predicting whether liability will attach to criminal conduct identified in *Browning-Ferris Industries*, *Richman*, and *Houston American Energy Corp.*, the company should retain discretion to decide when disclosure is proper. Control over timing will enable issuers to (1) properly investigate and address the alleged criminal conduct; and (2) make meaningful disclosures instead of boilerplate recitals devoid of factual specificity.217

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215. See Assaf Hamdani & Alon Klement, *Corporate Crime and Deterrence*, 61 STAN. L. REV. 271, 308 (2008) (“[P]olicymakers should generally ensure that entities are not subject to penalties carrying severe collateral consequences.”); see also Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 73 (2007) (“[C]orporate defendants, subject as they are to market pressures, may not be able to survive indictment, much less conviction and sentencing.”).

216. See Mike Koehler, *Voluntary Disclosures and the Role of FCPA Counsel*, FCPA PROFESSOR (Dec. 1, 2009, 2:54 PM), http://www.fcpaprofessor.com/voluntary-disclosures-and-the-role-of-fcpa-counsel (explaining that many companies voluntarily disclose FCPA violations in public filings with the hopes of gaining leniency from the DOJ and SEC, and even misconduct that is only potentially a violation).

217. Cf. Elizabeth Glass Geltman, *The Pendulum Swings Back: Why the SEC Should Rethink Its Policies on Disclosure of Environmental Liabilities*, 5 VILL. ENVTL. L.J. 323, 378 (1994) (arguing that the SEC should utilize the *Basic Inc. v. Levinson* probability/magnitude approach to determining the materiality of environmental information that allows the company to decide when to disclose informa-
Relying on the half-truth doctrine does not leave regulators without means to encourage more disclosure to shareholders. The SEC leniency program and the Sentencing Commission’s advisory guidelines for sentencing business organizations reduce criminal penalties for companies that self-report to enforcement agencies, whether confidentially or in their public filings. To encourage disclosure of quantitatively material corporate wrongdoing to shareholders, the SEC could institute greater reductions in penalties if companies disclose misconduct in their public filings in particular. This would boost the volume of illegal conduct that companies disclose to investors—the goal of creating a line item—while allowing companies to retain the discretion of when and whether to disclose based on the types of statements they make.

The task for courts and the SEC, then, becomes how to refine the half-truth doctrine to provide greater clarity to issuers drafting public statements and filings. As previously explored, courts currently take varying approaches to determine when certain statements—earning statements, legal compliance statements, statements attributing prior successes, and projections about growth—touch on corporate illegalities to the extent that the statement is misleading without disclosure. A more principled approach is needed to avoid the sorts of unpredictable splits we saw across circuits and even courts within the same jurisdiction. Section 1 proposes two basic questions courts can ask to analyze corporate illegality disclosure questions under the half-truth doctrine. Section 2 then applies that template to the four categories of statements that courts have found might require disclosure of uncharged criminal conduct.

1. A Proposed Decisional Template

Courts addressing half-truth questions in the context of corporate wrongdoing disclosures would achieve greater consistency if they bore two points in mind. First, when addressing statements made in public filings, courts should begin the analysis by considering what is expressly required by the line item to which the company is responding. The line item in itself should not trigger a duty to disclosure in lieu of the then-current approach of requiring companies to disclose information upon receipt of a letter of noncompliance).


219. U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2010); see also supra note 16 and accompanying text.

220. See Koehler, supra note 19 (noting that companies can receive credit by voluntarily disclosing in public filings); see also supra notes 14–15 and accompanying text.

221. See generally Arlen, supra note 19 (arguing that enforcement agencies must rely on companies to come forward with evidence of wrongdoing in order to police misconduct, and that voluntary disclosure is only rational for companies when the resulting mitigation in penalties far outweighs the increased likelihood of being prosecuted that necessarily flows from providing the SEC with incriminating information).
disclose criminal conduct because that would be tantamount to finding in the
line items the sort of implicit affirmative duty to disclose the information that
Matthews, Crop Growers, and other courts have uniformly rejected. In other
words, prior to finding a statement misleading, courts should consider whether
there would be any possible way to respond to the line item truthfully without
disclosing the wrongdoing. If not, imposing 10b-5 liability would effectively
recognize an implicit duty. The half-truth doctrine should operate in that narrow
space where that company’s particular response to a line item is misleading by
virtue of the omission of the illegal conduct, not where all responses would
require disclosure.

Only once a court determines that the disclosure question falls within the
realm of the half-truth doctrine should it begin to consider whether the state-
ment misleads because it would convey a “false impression” to the reasonable
investor.\footnote{SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862–63 (2d Cir. 1968).}
Then, instead of addressing what is “misleading” in a vacuum, courts should take care to consider what investors expect from that particular
type of statement and require disclosure where the investor expects that the
company is speaking truthfully based on insider knowledge.\footnote{See Langevoort, supra note 158, at 113 (advocating a three-part test for determining whether a
half-truth is actionable, which includes considering the types of inferences a “reasonably savvy
investor” would draw from the statement in context).} Since a detailed
and concrete misstatement carries a greater likelihood of misleading than an
abstract misstatement subject to varying interpretations, courts should determine
whether a statement creates a false impression by assessing the specificity of the
statement and the degree of the nexus between the statement and the illegal
conduct. Although the materiality and duty concepts notoriously overlap,\footnote{See Donald C. Langevoort & G. Mitu Gulati, The Muddled Duty to Disclose Under Rule 10b-5,
57 Vand. L. Rev. 1639, 1644 (2004) (“One reason is that in deciding whether a certain duty to disclose
is broad enough to include a particular type of information, the court often has to consider how and why
the information at issue would have been important to investors. This is because the underlying
rationale for the construction of the disclosure duties (by Congress, the SEC, or the courts) is that this
type of information is likely to be important to investors.”); see also David Monsma & Timothy Olson,
Muddling Through Counterfactual Materiality and Divergent Disclosure: The Necessary Search for a
(exploring the overlap between the duty to disclose and materiality doctrines).} to
the extent practicable, courts should avoid considering how important the
omitted information is to investors when deciding whether the statement mis-
leads; this avoids duplicating the materiality inquiry.

2. Applying the Template

Some clear lessons emerge upon following this analysis. First, earning state-
ments themselves should not trigger a duty to disclose that the revenue derived
from illegal activity because this information is required by Regulation S-K,
and such a holding would essentially create an implicit duty to disclose illegal
conduct. The court in Greenfield should not have found earning statements

\footnote{222. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862–63 (2d Cir. 1968).
223. See Langevoort, supra note 158, at 113 (advocating a three-part test for determining whether a
half-truth is actionable, which includes considering the types of inferences a “reasonably savvy
investor” would draw from the statement in context).
224. See Donald C. Langevoort & G. Mitu Gulati, The Muddled Duty to Disclose Under Rule 10b-5,
57 Vand. L. Rev. 1639, 1644 (2004) (“One reason is that in deciding whether a certain duty to disclose
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rationale for the construction of the disclosure duties (by Congress, the SEC, or the courts) is that this
type of information is likely to be important to investors.”); see also David Monsma & Timothy Olson,
Muddling Through Counterfactual Materiality and Divergent Disclosure: The Necessary Search for a
(exploring the overlap between the duty to disclose and materiality doctrines).}
misleading simply because they speak directly to the financial condition of the company. This would create the inequitable result of holding a company liable for doing something required of it in its public filings. In the same vein, a statement that misleads with respect to the sources of revenue does not trigger a duty to correct the revenue figures, a distinction the courts in Marsh and FBR were correct to make. Finding earnings figures misleading based on a separate misleading statement holds the company liable twice for the same underlying criminal conduct.

Certifications of legal compliance are nowhere explicitly required to be made in public filings, and thus the half-truth doctrine applies here. When a company states that it is fully complying with the law despite having engaged in illegal conduct, the company assumes the risk of 10b-5 liability for making a misleading statement. Accordingly, in addressing legal compliance statements courts must focus on the second-prong of the suggested inquiry, namely whether a reasonable investor would place stock in that kind of statement. Here, the more specific the statement is regarding law abidance, the more likely a reasonable investor would be to rely on it. As in Omnicare, a general statement that the company follows the law should not give rise to liability. However, a more specific statement detailing the steps a company follows to assure law abidance might trigger a duty to disclose the misconduct. Likewise, a statement that addresses compliance in a specific part of the business might trigger a duty to disclose illegalities in those specific company operations. This specificity test is inconsistent with the outcomes in Craftmatic and Ballan insofar as those cases found a duty to disclose the underlying criminal conduct based on more general legal compliance statements.

Statements identifying the causes of prior success might be required to be disclosed by Item 303’s MD&A if the company is describing past results of operations that might change in the future. Thus, under the first prong of the analysis, courts should not impute liability simply for describing the sources of past success without mentioning the illegal practices that contributed to the success. But the way in which a particular company fills out the MD&A could create a duty to disclose the underlying criminal conduct. If a company attributes prior successes to specific activities without disclosing that those activities were illegal, courts should follow Craftmatic, Par Pharmaceuticals, and Sotheby’s Holdings and characterize the statement as a half-truth. Liability is appropriate here because the company willfully identified particular areas of the business to highlight and omitted how their illegal nature drove its success. In addition, statements that specifically attribute past success to sources unrelated to the specific activities that are illegal should also trigger disclosure of the corporate

226. See supra section II.C (discussing S.D.N.Y.’s subsequent rejection of In re Van der Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388 (S.D.N.Y. 2005)).
wrongdoing because the company, to borrow the Third Circuit’s formulation, has put the source of its revenues “in play.”

Lastly, and perhaps most problematically, are future rosy projections that mislead by failing to account for the potential liability created by corporate misconduct. Forward-looking projections might again be required by the MD&A depending on a company’s specific circumstances. Because forward-looking statements are necessarily contingent, a reasonable investor would generally rely less heavily on their veracity, and thus they should not trigger a duty to disclose. Moreover, since the liability attaching to criminal conduct is itself speculative, requiring disclosure would not necessarily do much to reduce the misleading nature of the projection. Just as an opinion can only be misleading to the extent that it has a clear factual basis, a forward-looking statement might never be a half-truth because, by definition, it is based on forward-looking estimates rather than verifiable facts. This analysis cuts against the grain of cases like Helwig that treat the duty to complete speculative statements no differently than statements based on historical factual information. It is also contrary to cases that have found that future rosy projections guaranteeing certain results triggered a duty to disclose uncharged criminal conduct. The proposed framework contemplates that the reasonable investor recognizes that it is impossible to guarantee future results.

CONCLUSION

Reading the Second Circuit’s opinion in Matthews for all it’s worth, one might think that a company is never obliged to disclose uncharged criminal conduct. However, courts have often required disclosure. Corporate illegality may be important to investors where it has a quantitative impact on the company. Further, there may be duty to disclose it under the half-truth doctrine if a company makes a statement that, without the disclosure, would be materially misleading. In order to balance the interests of shareholders in learning of corporate wrongdoing with the interests of issuers in retaining control over the timing of disclosures, the best approach moving forward is for courts to streamline how they approach half-truth questions. Courts should first consider what a particular line item expressly requires and only apply the half-truth doctrine if the company has chosen to respond to the line item in a way that is misleading. Next, if the half-truth doctrine applies, courts should address whether a statement is misleading against the background of investor expectations, assessing the statement’s specificity and the degree of nexus between the

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229. See supra note 193 and accompanying text (discussing Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001)).
statement and the illegal conduct. The desired volume of disclosure can then be calibrated at the margins by creating stronger incentives to disclose the information to shareholders. There is still hope to create greater clarity under the existing framework without resorting to a line item that wrests control from issuers and risks premature disclosure at the expense of shareholders forced to bear the loss.