When Corporate Managers Fear
A Good Thing Is Coming to an End:
The Case of Interim Nondisclosure

Mitu Gulati

Every public offering of securities is necessarily made some time during a fiscal quarter. Companies are obliged to disclose fall quarter operating results, but their obligations regarding the as-yet-incomplete quarter remain unclear. In this Article, Professor Mitu Gulati tackles both the normative question of whether companies doing offerings should be required to disclose their unripe information concerning the current quarter and the doctrinal question of whether such an obligation already exists within the framework of disclosure duties.

The Article concludes that, while market forces and regulatory requirements operate to solve the interim nondisclosure problem in the majority of cases, there exists a small subset of cases—paradoxically, the subset of cases involving the largest, most well-established companies—that calls for regulation. The doctrinal approach taken by the courts thus far, which has been to impose no more than a narrow disclosure obligation under Item 303 and reject any general obligations under Rule 10b-5, dovetails with the type of circumscribed disclosure obligation that the Article’s normative analysis suggests.

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* Acting Professor of Law, University of California at Los Angeles. I am grateful to Alison Anderson, Steve Bainbridge, David Charny, Jill Fisch, William Klein, Eleanor Myers, Robert Ragazzo, David Skeel, Jeff Stake, Steve Thel, and Peter Swire for their criticisms, support, and encouragement. I am especially grateful to Howell Jackson and Patrick Shin. Their generosity with comments and advice has been extraordinary. Responsibility for errors, however, lies with me.
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INTRODUCTION

A company is conducting a public offering of common stock. The company has disclosed its final operating results for the twelve quarters preceding the current quarter in which the offering is to take place. All of those preceding quarters have been profitable and, on the whole, have reflected a pattern of sustained growth. The effective date of the offering prospectus is eleven weeks into the current thirteen-week quarter. The prospectus discloses no information regarding the quarter in progress. The offering proceeds successfully, with all shares being sold at a price of $20. The company raises over a billion dollars.

One week after the end of the quarter and three weeks after the date of the offering, the company issues a press release announcing that the final operating results for the quarter just concluded—the quarter in which the offering took place—will be significantly worse than the market had anticipated. Within min-
utes of the announcement, the company's stock price plummets 50%, to $10 a share.

Forty-eight hours later, shareholders file a class action lawsuit in federal district court. Plaintiffs allege, among other things, that the defendant company failed to disclose material information concerning the quarter in progress prior to its recent offering in violation of the federal securities laws. The company files a motion to dismiss, claiming that, at the time of the offering, it was under no duty to disclose any inchoate operating results for the quarter that was then still in progress. The company asserts that the federal securities laws impose no duty upon it to make forward-looking predictions about the outcome of an ongoing quarter. In the alternative, the company also argues that the plaintiffs' complaint is factually inadequate under the particularity requirements of Federal Rule of Civil Procedure 9(b) because it lacks allegations of specific facts that, if believed, would establish that the company knowingly failed to disclose information in its possession.

The district court is faced with two issues. First, did the company have any duty to speak to the public at the time of the public offering about its performance in the still-ongoing fiscal quarter? Second, what must the plaintiffs allege, and at what level of specificity, to withstand the company's motion to dismiss?

Every public offering of securities is necessarily made during a quarter that is not yet complete. One can expect that, in ordinary circumstances, a firm issuing securities to the public will not know with certainty, as of the offering date, its final results for the quarter in progress. However, one can also expect that, depending on certain variables—for instance, how far into the quarter the offering occurs—there will be circumstances in which a firm will have a relatively clear and accurate picture of the quarter in progress at the time of the offering.

Suppose a firm is conducting a registered public offering and the offering date happens to fall in the eleventh week of the thirteen-week fiscal quarter. Further, suppose that the firm is in possession of information about the ongoing quarter indicating unexpectedly poor final results that will represent an extreme departure from market expectations (as reflected, for example, in third-party earnings projections). The firm faces a difficult question.

The federal securities laws explicitly require firms conducting public offerings of securities to disclose their financial results for all quarterly reporting periods concluded prior to 135 days before the effective date of the offering.

But must the firm also make disclosures concerning the status of the quarter in progress at the time of the offering? In other words, must the firm make intraquarterly or interim disclosure of any inchoate or unripe information about the quarter? If so, what specific circumstances give rise to a duty to disclose such information? And, if there is a duty to disclose, how much must the firm reveal to satisfy that duty? Neither the Securities and Exchange Commission (SEC) nor the courts have answered these questions with either uniformity or clarity.\(^2\)

One might think that given the general full-disclosure philosophy of the federal securities laws\(^3\) and the availability of loophole-closing doctrines, such as the judicially created obligations not to speak in half-truths and to update and correct previous disclosures, the answer to the interim disclosure question should be obvious. It is not. First, the term “full disclosure” is, at the margins, somewhat hyperbolic when used to describe the corporate duty to speak to the market under the federal securities laws. While the securities laws require the disclosure of a large quantity of infor-

\(^2\) For cases either holding that there exists no duty to disclose intraquarterly operating data or indicating a reluctance to find such a duty, see Schoenhaut v. American Sensors, Inc., 986 F. Supp. 785, 791 (S.D.N.Y. 1997) (citing Zucker and noting that courts have been reluctant to impose an obligation on public companies to disclose intraquarterly data); Zucker v. Quasha, 891 F. Supp. 1010, 1015, 1018 (D.N.J. 1995) (holding no duty to disclose data from an ongoing fiscal quarter, even in the context of an offering done three days prior to the end of the quarter), aff'd, 82 F.3d 408, 408 [Table] (3d Cir. 1996). See also In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1418-20 (9th Cir. 1994) (expressing reluctance to impose liability for nondisclosure of information regarding the quarter in progress).

In contrast, the First Circuit has held that, under certain circumstances, there can be a duty to disclose material intraquarterly data in the public offering context. See Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1210-11 (1st Cir. 1996); Glassman v. Computervision Corp., 90 F.3d 617, 623-24, 630-32 (1st Cir. 1996). In addition, in its recent decision in Steckman v. Hart Brewing, Inc., 143 F.3d 1293 (9th Cir. 1998), the Ninth Circuit backtracked from its suggestion in In re Worlds of Wonder and recognized that there might be a duty to disclose some intraquarterly data in the offering context. See Steckman, 143 F.3d at 1296-97.


\(^3\) See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (Powell, J.) ("The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce . . . ").
mation in the public offering context and otherwise, they do not create any standing rule or impose upon companies any general duty to disclose to the public all material information whenever such information becomes available to the company. This notion is embodied in the truism, well familiar to corporate defendants seeking to limit their duties to speak to the marketplace, that a company's silence with respect to a particular bit of material information, in the absence of some positive duty to disclose it, is not actionable. There is no SEC regulation that explicitly speaks to the question of when, if ever, a company must provide the public with operating results pertaining to a fiscal quarter that has yet to be concluded.\(^4\) Second, even those courts that have recognized gap-filling doctrines in the nature of the duty not to speak in half-truths or the duty to update and correct past disclosures have made clear that those doctrines are to be narrowly applied, and with few exceptions, the courts have avoided addressing questions relating to a potential corporate duty to disclose information concerning an ongoing fiscal quarter.

My aim in this Article is to bring clarity to this area of the law. The Article proceeds in four parts. The first order of business is conceptual housekeeping. Part I introduces and describes, for lack of a more suitable word, the notion of informational ripeness in order to aid in disentangling two notions that are often conflated in discussions concerning the possibility of imposing duties upon companies to disclose information about presently existing facts when the primary significance of those facts consists in what they say about the future. That is to say, I introduce a distinction between the concept of ripeness and that of materiality, in service of the observation that information need not necessarily be ripe in order to be material.

Part II of the Article analyzes the normative question of whether there should be a duty to disclose unripe material information regarding operational results about an ongoing quarterly reporting period and, if so, what the scope of the duty should be. The first step is to provide an account of the market forces and institutional pressures that induce companies to make

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4. Companies are required to disclose a small set of intraquarterly information such as a change in control or a change in accounting practices in a Form 8-K. But the disclosure of operating results on a Form 8-K is optional, not mandatory. See General Instructions to Form 8-K in Richard W. Jennings et al., Federal Securities Laws: Selected Statutes, Rules and Forms 1196–202 (1998); see also James D. Cox et al., Corporations 709–10 (1997) (noting that the 8-K reporting requirements are quite limited and that as a general matter companies are not under an affirmative duty to disclose information until the next quarterly report); Roger J. Dennis, Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective, 46 Md. L. Rev. 1197, 1221 n.137 (1987).
voluntary disclosure of important unripe information and to examine the circumstances in which the interests of corporate managers in disclosing or withholding such information may not be aligned with those of the investing public. The Article next constructs a simple agency cost model of a world of low monitoring by shareholders (i.e., in which managerial decision making is relatively immune from outside scrutiny) and high wages for the professional managers who run companies for the shareholders. The Article then describes how the twin facets of low monitoring and high wages, in certain narrow types of circumstances, give rise to final-period problems in the face of which managers have strategic incentives to withhold important information from the investing public.

The analysis in Part II predicts that the strategic nondisclosure of interim data about an ongoing fiscal quarter is most likely to occur in the context of secondary public offerings by larger companies that are widely followed by market analysts and less likely to occur with emergent companies conducting initial public offerings. This result runs counter to the conventional wisdom that the large, well-established public companies are the firms least in need of regulatory (and litigatory) policing because of the high level of market monitoring to which those companies are continuously subjected. In line with the normative analysis suggesting that the problem calls for no more than a narrow disclosure obligation, the Article argues that the securities laws should impose upon firms conducting offerings a duty to disclose known intraquarterly data that indicates extreme variances in a current quarter’s results from market expectations.

Part III examines the federal regulatory and statutory apparatus governing the intraquarterly disclosure of unripe information and examines whether that apparatus comports with the normative conclusion reached in Part II. What one finds is that under the existing regulatory and statutory scheme, there exists a legal duty, in the offering context, to disclose known intraquarterly data, when that data indicates that final results for the quarter in progress are likely to depart significantly from the market’s expectations.


7. The disclosure duty, therefore, is in the form of a fuzzy standard as opposed to a precise rule. See, e.g., Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 DUKE L.J. 557, 559–60 (1992).
Finally, Part IV examines how the courts that have recognized a duty to disclose intraquarterly operating results have applied it, and whether that application meshes with the theoretical model set forth in Part II. The Article concludes that, if properly applied, the recognition of a duty to disclose known intraquarterly data will serve to deter wasteful strategic behavior on the part of managers of public companies, yet will not open the proverbial floodgates to frivolous strike suits.

I. DEFINING TERMS

A. Distinguishing Ripeness, Materiality, and Temporal Orientation

In thinking about intraquarterly disclosure, it is useful, as a preliminary matter, to separate the concept of materiality from ripeness. It is similarly important to draw a distinction between unripe information and forecasts of future results. The conflation of these concepts—not an altogether uncommon occurrence—inevitably yields unsound legal conclusions. The best way to illustrate the distinctions is to explore a real-world example.

In 1994, Hanover Direct, a publicly traded company, conducted a secondary offering of its securities in order to raise additional capital. The offering was done on March 31, only three days before the fiscal quarter in progress was scheduled to end. Hanover Direct disclosed no information regarding the quarter that was ending in three days. The offering proceeded successfully, with millions of dollars worth of shares sold. Within a few weeks after the offering, the company announced that final earnings results for the fiscal quarter in which the offering had occurred would fall below the range of results that analysts had predicted. Presumably as a result of this unwelcome news, the company’s stock price dipped. As one might expect, a group of investors who had participated in the recent public offering filed a suit (captioned Zucker v. Quasha), alleging that the company, its directors, and some of its managers, in failing to fulfill their

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10. See id. at 1013, 1015.
11. See id.
12. See id.
13. Id. at 1010.
disclosure obligations, had violated section 11 of the Securities Act of 1933. The plaintiffs asserted that the defendants impermissibly withheld from the purchasers in the public offering certain adverse information concerning the company’s financial performance for the fiscal quarter that was in progress at the time the public offering was made. The plaintiffs contended that the securities laws required defendants to disclose this adverse information at the time of the offering, not after the quarter had ended.

The district court, however, dismissed the plaintiffs’ claim on the grounds that the company had no duty under the securities laws to report interim results for a quarterly reporting period that was not yet “complete.” At most, the district court reasoned, the plaintiffs’ claim of nondisclosure was no more than an assertion that the company should have provided potential investors with a prediction of its financial results for the quarter in progress at the time of the offering; and it is well settled that the federal securities laws do not require companies to provide investors with purely forward-looking information, such as internal forecasts of future financial results.

For purposes of my analysis, the most interesting aspect of the district court’s analysis in Zucker is the assumption that, as of the time of the public offering at issue, the only information concerning the ongoing quarter that may have been of interest to potential investors was the company’s then-current forecasts of its final results for that quarter. Implicit in this assumption is the proposition that because the quarterly reporting period in progress at the time of the company’s public offering was not yet concluded, any information about the company’s operating results for that period was necessarily incomplete, and any such incomplete information would be immaterial to the investing public.

But why should it follow that if a quarterly reporting period is incomplete then information about the company’s quarter-to-date performance as of that time is immaterial? Surely, no such deduction can be made.

15. See id. at 1015.
17. See Zucker, 891 F. Supp. at 1015–16; see also Steckman v. Hart Brewing, Inc., No. 96-1077-K, 1996 WL 881659, at *3–*4 (S.D. Cal. Dec. 24, 1996) (concluding that “companies are under no duty to disclose intraquarter results” because a request for such disclosure boils down to no more than a request for forecasts), aff’d, 143 F.3d 1293 (9th Cir. 1998); Brodsky, supra note 16, at 4.
Any given category of internally generated operational information about a company's financial performance (e.g., revenues, earnings, profit margins, costs of sales, etc.) is ripe for disclosure as of a certain time if, as of that time, no additional data need be obtained for the company to tabulate, calculate, or otherwise derive final results for that category of information. According to my usage, most financial information about a company's quarterly performance will not be ripe for disclosure until after the quarter in issue is concluded, and the company has had an opportunity to gather all of the information it needs (for instance, sales numbers from the field) and process that information as necessary to put the numbers into disclose-ready form. Operational data pertaining to a quarter still in progress will almost always be unripe. In short, ripeness is a function of informational completeness relative to a specified period of time. In my analysis of disclosure requirements, the relevant period of time will be the reporting periods—generally, quarterly established by the applicable SEC rules and regulations. Thus, when I say that a company's information about its quarterly revenues is unripe at a given point in time, I mean that, as of that time, the company needs to obtain further data or perform further analysis in order to ascertain its final revenue results for the quarterly reporting period in question.

To exemplify this point, the information concerning quarterly earnings that the plaintiffs in Zucker asserted was wrongfully withheld was not ripe as of the time of the public offering in which the plaintiffs purchased securities because, as of that time, the company could not have known its final earnings results for that period. But this does not mean that any (unripe) earnings-related information in the company's possession as of the time of the offering was necessarily immaterial.

“Materiality,” in contrast to ripeness, is a function of informational importance or usefulness, as gauged by the reasonable investor. Material information is that which a reasonable investor would find useful in making

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18. Analogously, in Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), the court stated “information ... must be 'available and ripe for publication' before there commences a duty to disclose.” Id. at 519 (quoting Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971)). To be ripe under this requirement, the contents must be verified sufficiently to permit the officers and directors to have full confidence in their accuracy. See id.; see also Douglas J. Skinner, Earnings Disclosure and Stockholder Lawsuits, 23 J. ACCT. & ECON. 249, 253 (1997) (stating that there is no duty to disclose information that is not ripe).

19. In response to a defendant's argument based on ambiguous language from a series of prior cases that intra-quarterly information was necessarily immaterial, a panel on the Ninth Circuit recently stated that “[w]e have never held—nor even hinted—that forward-looking information or intra-quarter data cannot, as a matter of law, be material.” United States v. Smith, 155 F.3d 1051, 1055 (9th Cir. 1998).
an investment decision.\textsuperscript{20} As a financial economist might put it, information is material if, other things being equal, it would tend to affect the price of a security.\textsuperscript{21}

From this definition, it should be clear that unripe information can sometimes be material. For example, a company’s revenue figures for any given quarter will probably remain unripe as of week eleven in a twelve-week quarter, but if that figure happened to be zero (to take an extreme case), whereas expected revenues for the period happened to be $10 million, it would be difficult even to articulate an argument that the interim figure of zero revenues should be deemed immaterial simply because the company’s quarterly revenue results would be unripe as of that time.

Furthermore, as an empirical matter, the market values information about changes in expectations concerning a company’s quarterly financial results.\textsuperscript{22} When a public company announces, prior to a quarterly reporting period’s conclusion, that its internal information indicates that results for the quarter in progress will be worse than anticipated by the market, the stock price of the company will likely fall.\textsuperscript{23} The materiality of the unripe internal information underlying the company’s predictive warning thus cannot be gainsaid. (Note that it matters not whether the company discloses its forecast of an earnings shortfall or the actual unripe information upon which the forecast is based. Provided that the market is sophisticated as a whole, one can assume that if the company discloses only the underlying unripe information rather than the forecast itself, the market would be able to figure out for itself that there would be an earnings shortfall and would accordingly penalize the company’s securities. This assumes, of

\begin{itemize}
  \item \textsuperscript{20} TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438 (1976), defines materiality as depending on whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the “reasonable investor as having significantly altered the ‘total mix’ of information.” Id. at 449; see also Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 517 (7th Cir. 1989).
  \item \textsuperscript{21} See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997) (citing cases and articles); ROBERT C. CLARK, CORPORATE LAW 328 (1986) (defining materiality as whether “[t]he reasonable investor would consider it important to know facts that in reasonable and objective contemplation might affect the value of the corporation’s securities”); Dennis S. Corgill, Insider Trading, Price Signals, and Noisy Information, 71 IND. L.J. 355, 363–64 (1996). But see Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. CAL. L. REV. 303, 336 (1998) (suggesting that the standard of materiality applied by the courts is, in practice, higher than that of information that might move price).
  \item \textsuperscript{22} In a securities fraud case, the market is often taken as a surrogate for the reasonable investor. Cf. Schneider v. Vernard, 886 F.2d 1109, 1113–14 (9th Cir. 1989) (explaining that “partially informed investors will cancel each other out,” and thus stock prices will accurately reflect all relevant information); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 297 (1991) (explaining how unsophisticated investors free ride on information incorporated into the market price).
  \item \textsuperscript{23} See, e.g., Dennis, supra note 4, at 1213–14.
\end{itemize}
course, that the unripe information in question would provide a sufficient basis for reliably extrapolating full-quarter results.)

In more theoretical terms, assuming that a company's stock price represents some present discount of its future earnings streams, the company's financial results will be material to the extent those results allow investors to predict the company's future earnings potential. But there is no logical reason to believe that a company's financial results can provide a useful basis for predicting the company's future earnings only when measured over the entirety of a thirteen-week quarterly reporting period. After all, from a theoretical perspective, the thirteen-week quarter is a more-or-less arbitrary invention. In principle, a company's financial performance for any given duration of time, whether less than or equal to a full thirteen-week quarter, could provide some useful basis for predicting its future earnings stream.

The basic point is that the materiality of information is not definitionally linked to any measure of how fully developed, or ripe, that information might be. Ripeness is neither a necessary nor sufficient condition of materiality. To be sure, materiality may be empirically correlated with ripeness (insofar as final results may tend to be more important to investors than interim results), but there is no necessary logical relationship between the two concepts. Unripe information may sometimes be highly material, and ripe information may sometimes be clearly immaterial.

In addition to ripeness and materiality, there is a third concept that plays a role in discussions about the disclosure requirements imposed by the federal securities laws: temporal orientation. When a company speaks to the marketplace, the statements, assertions, or other disclosures that it provides can have three temporal orientations: historical, contemporaneous, or forward looking. Examples of each type of orientation are as follows:

Historical—"The company's earnings last quarter represented a 50% increase over the comparable period in the prior year."

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24. But more on this point later. See Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988) (stating that the materiality of information as to a "contingent and speculative" event depends "upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity" (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968))).


26. For example, if tomorrow the SEC were to decide that because of advances in information technology and the sophistication of the market, information should be disclosed 20 days after every eighth of a year (as opposed to after every quarter), data as to half-quarters would become ripe nine weeks into a quarter. Ripe information, therefore, is complete information, and complete information is whatever I define complete to be.
Contemporaneous—"In the current ongoing quarter, the company is experiencing a dramatic increase in new orders."

Forward-looking—"The company anticipates that it will achieve substantial earnings growth in the upcoming fiscal year."

Some statements are a combination of two or more different orientations. For example, a statement such as "The company is well positioned to deliver consistent earnings growth in the years to come" is both a statement about the company's current position and an assertion about its future prospects. But the point here should be an uncontroversial one. When a company speaks to the market, it can talk either about the past, the present, the future, or some combination thereof.

A common defense asserted by companies faced with claims that they wrongfully failed to disclose interim, or unripe, operating information is that the asserted claim is really a disguised argument to require the defendant to disclose forward-looking information, even though the securities laws are clear that a company is not required to provide such information. Indeed, this is essentially what the district court held in Zucker. The court characterized the plaintiffs' claim of nondisclosure of unripe information as an oblique complaint against the company's refusal to divulge its internal forecasts. It was then an easy matter for the court, given the rule against

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27. See, e.g., Rosen, supra note 2, at 668 ("Requiring disclosure of [intraquarterly] information is...tantamount to requiring disclosure of internal projections that will constantly change as the quarter progresses."); Steve Bailey & Steven Syre, Insecure Feeling Hits Defendants in Securities Suit, BOSTON GLOBE, June 11, 1996, at 45 (noting the corporate defendants' characterization of the plaintiffs' interim disclosure claim as one that the company should have disclosed internal forecasts); Hale & Dorr, Securities Litigation Bulletin (visited Oct. 1, 1998) <http://www.haledorr.com/publications/seclit/1996_09_SecL> (describing the interim disclosure claims in two First Circuit securities cases as boiling down to requests that internal forecasts be disclosed—something the securities laws have clearly said are not required to be included in a prospectus).

Recent case law and the SEC's position is clear that, while companies are encouraged to disclose forecasts, they are not obligated to do so. See Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996) (noting that companies are under no duty to predict the future); In re Donna Karan Int'l Inc. Sec. Litig., No. 97-CV-2011 CBA, 1998 WL 637547, at *11 (E.D.N.Y. Aug. 14, 1998) (same); In re Websecure, Inc. Sec. Litig., No. CIV.A.97-10662-GAO, 1998 WL 685156, at *5 (D. Mass. Sept. 24, 1998) (same); RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 234 (8th ed. 1998) (noting that, while many have misunderstood the SEC's Management's Discussion and Analysis (MD&A) requirements as saying that forward-looking statements are required to be disclosed, these statements are "encouraged" but not "required"). Nevertheless, there is some language in both the case law and the regulations that might be read to say that in some narrow sets of circumstances forecasts have to be disclosed. See, e.g., In re Convergent Tech. Sec. Litig., 948 F.2d 507, 516 (9th Cir. 1991) (stating that there may be a duty to disclose internal forecasts that are made with reasonable certainty); Dennis, supra note 4, at 1201 (describing the issue of whether projections have to be disclosed when a control transaction is pending as per Flynn v. Bass Brothers Enterprises, 744 F.2d 978 (3d Cir. 1984)).
mandating disclosure of forward-looking information, to dismiss the plaintiffs' claim.

B. Not Confusing the Concepts

The problem with the above line of reasoning is that it confuses ripeness with temporal orientation. The fact that a company's results in a particular category of financial information (e.g., revenues) are not ripe at a certain point in time does not necessarily imply that any disclosure of such results would constitute a forward-looking statement. For example, a company's quarterly revenue figures as of week ten in a thirteen-week quarter are necessarily unripe. If, at week ten, the company stated, "Our quarter-to-date revenues have reached $5 million," the announcement would constitute a statement of present fact about an unripe category of data, not a forward-looking statement about future results. The disclosure of unripe data is not, standing alone, tantamount to the disclosure of forward-looking information, nor does it necessarily imply a commitment to any particular forward-looking inference.

Having made this observation, I should point out that it may well be true—and this is the potentially confusing point—that the materiality of unripe data may, in many or even perhaps in most cases, derive from forward-looking inferences drawn from the incomplete data. In other words, unripe data may be considered material by investors not because of any intrinsic significance that attaches to it, but because of what it may suggest about what the data will look like once it ripens. For example, the fact that a company's quarter-to-date revenues have reached $500,000 as of the eleventh week of a thirteen-week quarter may or may not hold any intrinsic significance for the market. The materiality of this unripe information depends upon what the $500,000 figure indicates for the company's full-quarter results. Thus, if the company has historically booked 95% of its revenues in the final two weeks of the thirteen-week quarter, and if the market expects the company to produce a $10 million quarter, then perhaps the market will not attach much significance to the $500,000 interim figure at all, inasmuch as it permits only weak inferences about the company's full-quarter results. If the company's revenues have, in the past, been uniformly distributed across each quarter, however, and if the market expects to see revenues of $10 million in the current quarter, then an interim revenue figure of $500,000 at week eleven might be deemed very significant indeed, inasmuch as it permits a strong inference that there will be a substantial revenue shortfall for the quarter. Furthermore, while the intraquarterly disclosure of unripe information is not equivalent to the making of a forward-
looking statement, such disclosures may often be highly suggestive about future results. If a company says, at week eleven of a thirteen-week quarter, "Our revenues in the quarter-to-date are 50% lower than our revenues at the same point in this quarter last year," the natural inference is that the company's revenues at the end of the quarter will probably turn out to be some 50% lower than the revenues achieved in the same quarter of last year. Thus, while ripeness is conceptually distinct from temporal orientation, questions pertaining to the materiality of a given piece of unripe information will often, if not always, require examining the forward-looking inferences suggested or supported by the information at issue.

C. The Issue Refined

The purpose in laying down the conceptual groundwork has been to sharpen the issue discussed in the remainder of this Article: To what extent should the federal securities laws require companies doing offerings to disclose unripe information pertaining to their operating experience in an ongoing quarter, before the quarter has come to an end? 28 By separating the concept of ripeness from materiality, I first try to demonstrate the implausibility of any per se rule that unripe data should be deemed immaterial simply by virtue of its unripeness. Second, the point of showing that the disclosure of unripe information is not inherently tantamount to the making of a forward-looking statement is to illustrate the fallaciousness of the argument that demands for unripe data are nothing more than demands for the mandatory disclosure of forward-looking information. The analysis to this point has rebutted two of the easy objections to a potential duty to disclose unripe information. Now I am ready to address in earnest the central topic of this Article. Before tackling the question of whether the securities laws do in fact impose upon companies a duty to disclose unripe financial information, comes the question of whether, as a matter of policy, there is a need for any such duty of mandatory disclosure.

28. This Article's focus is on the disclosure of quarterly operating results—information that is necessarily incomplete and unripe prior to the conclusion of the quarter. That is not to say, however, that there cannot be intraquarterly information (e.g., that the firm has landed a major contract or that the chief executive officer (CEO) has passed away) that is ripe, complete, and material prior to the end of the quarter. Indeed, when there are extraordinary intraquarterly events that are ripe, such as changes in control, major acquisitions, or filing for bankruptcy, disclosure is often required in a Form 8-K Exchange Act filing. See Dennis, supra note 4, at 1221 n.137.
II. MANDATORY DISCLOSURE?

A. Optimal Voluntary Disclosure Theory

Critics of mandatory disclosure, such as Judge Frank Easterbrook and Professor Daniel Fischel, while recognizing the importance of full and accurate corporate disclosure, argue that it is more efficient to allow firms to voluntarily choose for themselves the optimal level of disclosure. They point out that firms are dependent on the market for sustenance (via the infusion of new capital), and this sustenance will accrue only to those companies that the market trusts to provide it with good information about their financial performance and outlook. Hence, the argument goes, firms have a strong incentive to keep the market happy by providing it with complete, accurate, and up-to-date information about their financial position. Furthermore, even in situations in which a firm decides that the cost of producing information and providing it to the market is too high to justify the advantages of doing so, the market will look favorably upon the firm's decision not to disclose because the market ultimately wants companies to achieve the highest possible profit at the lowest possible cost. Thus, allowing companies to choose for themselves what they will and will not disclose to the public will result in an optimal level of corporate disclosure.

By contrast, mandatory rules of disclosure force the corporate hand to disclose a fixed set of data (or at least a fixed range of data), whether or not such disclosure would be optimal. For example, a mandatory disclosure rule of general applicability would force companies to invest resources in gathering, producing, and providing information to the public even in circumstances in which neither the company itself nor its investors perceives a need or use for the information. Moreover, in a competitive environment, a rule of mandatory disclosure requiring all companies to produce a current snapshot of their financial performance on an up-to-the-minute

29. See EASTERO Brock & FISCHEL, supra note 22, at 288–89.
30. See id.; Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359, 2373–75 (1998); see also Douglas W. Diamond & Robert E. Verrecchia, Disclosure, Liquidity and the Cost of Capital, 46 J. Fin. 1325, 1327 (1991). This suggests that the cost of equity capital is greater for securities with wider bid-ask spreads because of the higher transactions cost. In this context, greater disclosure reduces the adverse selection component of the bid-ask spread. Because the greater disclosure reduces the amount of information revealed by large trades, investors are willing to take larger positions in the firm's stock, thereby reducing the cost of equity capital. See Diamond & Verrecchia, supra; see also Jeffrey L. Coles et al., On Equilibrium Pricing Under Parameter Uncertainty, 30 J. Fin. & QUANTITATIVE ANALYSIS 347, 349 (1995) (suggesting that greater disclosure can reduce the cost of equity capital by reducing nondiversifiable estimation risk).
basis might disadvantage smaller companies for whom the production of such information might be extremely expensive (relatively speaking). This creates a competitive advantage for larger companies whose basic infrastructure permits the constant production of up-to-date information on a relatively inexpensive basis.

Theories in favor of voluntary disclosure rest centrally on the ability of the market to force companies to internalize the costs of nondisclosure. If a company cheats the market, for example, by conducting a public offering of securities without disclosing internally known bad news, the market will penalize the company later by devaluing its securities (to account for the risk that the company might be holding out on additional bad news not yet known to the public). Because the market itself disciplines firms, through the imposition of nonlegal sanctions such as reputational costs, the creation of legal sanctions is largely unnecessary to force appropriate disclosures and, in fact, is positively detrimental to a well-functioning market—witness the phenomenon of frivolous "strike suits." Furthermore, as Professor David Charny explains, if reputational or nonlegal sanctions are going to work in any market, they are likely to work in the American securities markets

32. Cf. EASTERBROOK & FISCHER, supra note 22, at 290–92 ( hypothesizing that one possible justification for mandating the disclosure of certain information by public companies is that this information produces a valuable externality for the market as a whole, but that firms, because they disclose information only when it benefits their own shareholders, do not disclose at the socially optimal level because they cannot reap the benefits of the externality); Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 VA. L. REV. 945, 959–60 (1991) (describing the argument that companies do not always internalize the costs of failing to provide the market with negative material information).

33. It was, in part, the perception that a high fraction of securities class action lawsuits are nothing more than frivolous strike suits that led to the enactment of the 1995 Private Securities Litigation Reform Act. See Michael A. Perino, Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action, 50 STAN. L. REV. 273, 290–92 (1998) (describing the debate in Congress); see also Securities Litigation Uniform Standards Bill Passes House, CORPORATE SECRETARY'S GUIDE, Aug. 11, 1998, at 113 (noting the continued perception in Congress that a number of securities suits filed are frivolous). The academic literature is divided over the question of the percentage of securities disclosure suits that are in fact frivolous. See, e.g., Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 STAN. L. REV. 497, 523 (1991) (concluding that, most likely, the "merits did not affect the settlement amounts" in nine securities class actions); Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. CHI. L. REV. 1, 78 (1991) (noting that the frequency of strike suits in the securities area is an open question); Elliott J. Weiss & John S. Beckerman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 YALE L.J. 2053, 2080–88 (1995) (rejecting Janet Alexander's claim, but acknowledging that some portion of securities suits are surely frivolous).

because these are the markets that come closest to (1) having infinitely lived actors (institutional investors and corporations that can regenerate themselves through the American bankruptcy system even if they fail), and (2) providing the public with full information about all companies in which investors might be interested.\textsuperscript{35}

But, as we shall see, voluntary disclosure theory depends upon two central assumptions, both of which can break down under certain conditions—conditions that sometimes may prevail even in the American securities markets. First, voluntary disclosure theory assumes that companies and the market are playing an infinitely repeated game in which the benefits of cheating once are far outweighed by the reputational costs or other non-legal sanctions the company will have to bear in later transactions. Second, the theory assumes that the market can verify when the company has cheated it by not disclosing important information and thus penalize the company for its misbehavior. I turn to an examination of these assumptions.

B. Agency Problems and Nonclearing Labor Markets

Public companies, although owned by shareholders, tend to be run by professional managers.\textsuperscript{36} The managers of a company are duty-bound to act in the interests of the company's shareholders. Theories of voluntary disclosure that predict how a company will behave in certain circumstances generally must presuppose that the managers who effect corporate behavior act with corporate interests in mind; or, to put it another way, that only the company's rational interests are instantiated in the managerial decision-making process.

A common objection to theories positing that public corporations will internalize the costs of their own misbehavior in the marketplace is that there will be circumstances in which the interests of managers will not

\textsuperscript{35} See id. at 408–25; see also Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 HARV. L. REV. 1911, 1939–40 (1996) (describing David Charny's work on the conditions under which nonlegal sanctioning systems will work and examining, in part, whether the market's reputational sanctions will work quite as well in a system, such as that of Russia, in which assumptions about informational efficiency of markets are less plausible than on the New York Stock Exchange (NYSE)).

wholly coincide with the interests of the company itself, i.e., its shareholders. When the interests of a company's managers diverge from those of its shareholders, managers will naturally tend to act in accordance with their own selfish interests, even if doing so is inconsistent with serving the shareholders. And because the managers determine how a company behaves (at least in the short term), any managerial failure to respond to market incentives designed to discipline companies for their misbehavior will effectively render the company itself unresponsive to those same incentives.

In theory, the shareholders (acting through the company's directors) have the power to override managerial decisions that are not in their interests, and to replace managers who fail to serve shareholder interests. But to exercise this power in anything approaching an efficacious way, shareholders effectively would have to become managers themselves, hence undermining the raison d'être of the public corporate structure. In its purest form, the public corporate structure enables shareholders to own companies without having to worry, or even know anything, about how to run the companies themselves.

Still, according to the conventional model, a company's stockholders can get an accurate picture of managerial performance—albeit from an ex post perspective—by monitoring the market price of the company's securities. Under the strong or semistrong forms of efficient markets theory, a company's stock price reflects either all existing information or all public information about the company. Given the information content of stock prices, investors can monitor price movements as a proxy for managerial performance. Good management practices will result in higher stock

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37. This is conventionally referred to as a principal-agent problem. In this case, the agents are the managers and the shareholders are the principals. See Ross et al., supra note 36, at 15.


prices; managerial failure to serve corporate interests will result in the market's devaluation of the company's securities. Thus, if a manager does something against corporate interests, the market will discount the price of the company's securities accordingly, and the manager will then have to answer to the company's shareholders and directors for his malfeasance. In cases of extremely poor performance or breach of fiduciary duty, the manager will run a substantial risk of being fired. Further, because stock prices are highly visible, a manager's actions will always have repercussions in the managerial labor market.41 Once a manager develops a reputation for diserving corporate interests, the manager will be unable to find alternative sources of employment.42 All of which is to say that, under the traditional conception, managers have strong incentives, even in the absence of legal sanctions, to undertake only those actions that serve the interests of the company's shareholders (or, if there is any difference, to enhance the value of the company's securities).

Modern labor economics suggests, however, that the information content of stock prices—including the largest, most well-followed companies that finance theorists suggest are most likely to be trading in a near-efficient market43—is inadequate to serve an accurate monitoring


41. See, e.g., ROSS ET AL., supra note 36, at 17; Fama, supra note 36, at 200.
42. Law and economics scholars also posit a variety of other pressures that keep managers in line. These include product market competition and the threat that a self-interested management will be taken over by an alternative set of managers who can promise the market higher returns for the same amount of risk. See, e.g., Black & Kraakman, supra note 35, at 1923. Other supplemental mechanisms that arguably keep the interests of managers in line with those of investors include paying managers in securities of the company that have long-term lockups, having large institutional investors play larger roles in the administration of companies, and having independent boards of directors. See, e.g., Jill E. Fisch, Relationship Investing: Will It Happen? Will It Work? 55 OHIO ST. L.J. 1009, 1017 (1994); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 872–76 (1991) (describing the role of outside directors); Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 COLUM. L. REV. 124, 170–74 (1994). Note that the degree to which a number of these supplemental pressures work on management, however, is unclear as a general matter and will likely differ from firm to firm depending on how a particular firm is structured.

43. See, e.g., Brad M. Barber et al., The Fraud-on-the-Market Theory and the Indicators of the Common Stocks' Efficiency, 19 J. CORP. L. 285, 291 (1994); Victor L. Bernier et al., Challenges to
function." As detailed later, the research suggests that a company's stock price is, at best, only a rough and noisy signal of corporate managerial performance. Relatedly, therefore, the level of monitoring provided by the proxy of market prices is low, not high. 44

Further, there are some conceivable circumstances in which corporate managers will be indifferent to the usual forms of market discipline, such as prospective excommunication from the managerial labor market. One familiar and studied example of such a situation involves the "final-period" problem. 46 The final-period problem arises when a corporate manager fears that he is about to lose his job and either does not want to, or does not think he will be able to, obtain another job as good as his present one. Such a situation might occur when a company is under threat of a hostile takeover, under threat of bankruptcy, or even when a manager is about to retire. 47 When a manager perceives himself to be in a final-period situation, he will no longer be disciplined by the fear of reputational sanctions on the


44. Cf., e.g., Noel Gaston, Efficiency Wages, Managerial Discretion, and the Fear of Bankruptcy, 33 J. Econ. Behav. & Org. 41, 42 (1997) ("A recognition that share prices do not necessarily provide perfect guidance in evaluating corporate decisions underpins recent theoretical models stressing the value of delegation.").

45. As of late, an alternative economic theory to the efficient markets theory of full information in prices has begun to gain acceptance in legal academia. This alternative theory is called "noise theory" and, as its name suggests, it hypothesizes that, while prices do contain information as to the company in question, they also contain noise (in large part because many investors trade for reasons other than changes in the amount of information they have about a company's future prospects). See Corigill, supra note 21, at 359; see also Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 Geo. Wash. L. Rev. 546, 559–66 (1994); Donald C. Langevoort, Theories, Assumptions and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851, 857–72 (1992); Andrei Shleifer & Lawrence H. Summers, The Noise Trader Approach to Finance, 4 J. Econ. Persp. 19, 19–33 (1990).


47. See, e.g., Arlen & Carney, supra note 5, at 702–03; Kraakman, supra note 46, at 866 n.25; Langevoort, supra note 46, at 643; Rose-Ackerman, supra note 46, at 277–310; see also H. Nejat Seyhun & Michael Bradley, Corporate Bankruptcy and Insider Trading, 70 J. Bus. 189 (1997) (documenting significant sales by insiders—especially top executives and officers—prior to the filing of a bankruptcy petition); cf. Lowenstein, supra note 40, at 1344–45 (arguing that a mandatory disclosure system that focuses on hard accounting data on firms enables analysts (and hence the market) to better monitor management rather than having to impose discipline through threats of takeovers that can produce in managers a "desperate temptation . . . to destroy the village in order to save it").
managerial labor market—by hypothesis, the manager assumes that he will be exiting that market. At that point, if the manager wants to keep his present job, he will act out of desperation to avoid being fired at all costs, or will otherwise act entirely in his self-interest in order to obtain the maximum private payoff before permanently departing from the managerial scene. For example, under threat of a hostile takeover, incumbent managers of the target company might overinvest in fighting off the predator company, even if the target company's shareholders want the takeover to be completed.\footnote{See, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 83 (1993) (discussing the problem of incumbent corporate managers exerting resources to persuade legislatures to enact antitakeover legislation); cf. David A. Skeel, Jr., A Reliance Damages Approach to Corporate Lockups, 90 NW. U. L. REV. 564, 565 (1996) (noting the problem of managerial self-dealing through lockups in the takeover context).}

An important twist to the final-period problem is the assumption of a \textit{nonclearing labor market}. According to the neoclassical conception, the market should have sufficient information about companies and their managers to be able to distinguish corporate woes that are the consequence of managerial incompetence or malfeasance from events that cannot be directly attributed to the actions of managers. That being the case, managers of corporate takeover targets should not be pushed to high-risk behavior against corporate interest, even though they face the threat of job loss as a result of the takeover, because they should be able to find new jobs after being forced to leave their current ones.\footnote{See Rose-Ackerman, supra note 46, at 284.}

In general, assuming that the market knows the degree to which a particular corporate manager is responsible for a company's ill fortunes, managers should not be moved by the prospect of a final-period event to take high risks with the company's resources simply to preserve their jobs. In the neoclassical high information, labor market-clearing world, workers should not fear losing one job because they can easily find another.\footnote{For the final-period problem when a manager is about to retire to come into play, one would have to posit either that all the managers are about to retire (which appears to be highly implausible in a big public company) or that the top manager or managers who are about to retire can completely dominate younger nonretiring managers who value their reputations and part of whose job is to make sure their fellow managers act in the interests of investors as opposed to in their own interests. In other words, one has to posit a world in which cross monitoring does not work effectively.}
Thus, in order for the final-period problem to have any teeth, one must be able to articulate a plausible story of why corporate managers should ever be desperate to hold on to their existing jobs, except in the relatively rare situations in which they really are personally responsible for their company’s predicament. One such story becomes viable if one assumes a nonclearing managerial labor market in which there is a scarcity of jobs.

C. Giving Teeth to the Final-Period Problem: The High-Wage, Low-Monitoring World

The conditions that give rise to real final-period problems in the context of managerial decision making with regard to corporate disclosures are low levels of direct information in the marketplace about the performance of corporate managers: This results in a situation in which corporate managers are subject to relatively low levels of monitoring by the marketplace, except by means of a few highly visible signals, such as deviations in periodic earnings, takeovers, firings, and bankruptcies.\(^{51}\) It is a version of this low-monitoring or low-information world that a number of modern


In addition, the expanding use of the puffery defense as a means of dismissing claims based on vague managerial expressions of optimism on the grounds that such statements can be held immaterial as a matter of law is also more consistent with a low- rather than a high-monitoring conception of financial markets. As a theoretical matter, managerial predictions, vague or not, should be material to investors in a high-monitoring world. After all, managers understand their firms better than outsiders. Cf. Dennis, supra note 4, at 1212. In a low-monitoring world, however, one might expect the markets to ignore such vague statements. For a discussion of the expansion of the puffery defense, see Langevoort, supra note 46, at 162. See also R. Gregory Roussel, Note, Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense, 51 VAND. L. REV. 1049 (1998).
labor theory scholars suggest characterizes the world of public companies and their managers.

Why is monitoring managers difficult? It is difficult because much of what the top managers of public companies do is not readily susceptible to objective evaluative measurement. One of the most important job responsibilities of top management is to exercise judgment in a variety of areas such as marketing strategy, research choices, and the hiring and motivating of other employees. This kind of managerial decision making does not lend itself to easy evaluation by externally visible objective criteria, like earnings reports. In other words, measuring managerial performance requires making subjective measurements. This kind of measurement of managerial performance is not only expensive and difficult, but also leaves room for a significant amount of disagreement and bias.

Given a world in which monitoring managers is difficult and expensive, professional managers must be given incentives to work in the pursuit of maximizing shareholder value, even knowing that they are being subject only to low levels of market monitoring. I hypothesize that these incentives come in the form of high wages that exceed the hypothetical market-clearing rate, or the point at which demand equals supply and there is no

52. See MILGROM & ROBERTS, supra note 39, at 391–92 (describing more fully the tasks of modern managers).
53. Along a related vein, Professor Marleen O’Connor argues that the securities regulatory authorities have been oblivious to the importance of a firm’s human capital assets, and that the disclosure of such information should be mandated. See Marleen A. O’Connor, Organized Labor as Shareholder Activists: Building Coalitions to Promote Worker Capitalism, 31 U. RICH. L. REV. 1345, 1391 (1997).
54. Cf. Lawrence A. Cunningham, Introduction to the Warren Buffett Symposium Papers, 19 CARDOZO L. REV. 5, 8–9, 13 (1997) (describing Buffett’s theory of understanding and evaluating companies through their managers and noting the difficulty inherent in such a task).
55. See MILGROM & ROBERTS, supra note 39, at 404–07; George P. Baker et al., Compensation and Incentives: Practice vs. Theory, 43 J. FIN. 593, 616 (1988). The fact that there can exist, in equilibrium, a substantial amount of legitimate disagreement as to evaluations of managers and predictions of their future behavior is consistent with Professor Lynn Stout’s argument that financial markets are characterized by “heterogeneous” not “homogeneous” expectations. See, e.g., Lynn A. Stout, How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement, 19 CARDOZO L. REV. 475, 480–84 (1997).
56. What the shareholders can and do monitor are stock prices, and managers, recognizing this, worry obsessively about stock prices. The point is that the monitoring is highly imperfect. The story is analogous to the case of law firm associates and billable hours. There is a large amount of literature on the fact that monitoring is difficult in large law firms and that hours billed provide a highly imperfect measure of the quality of associate work. See, e.g., Renee M. Landers et al., Rat Race Redux: Adverse Selection in the Determination of Work Hours in Law Firms, 86 AM. ECON. REV. 329, 341 (1996); David B. Wilkins & G. Mitu Gulati, Reconcepting the Tournament of Lawyers, 84 VA. L. REV. (forthcoming 1998). Nevertheless, because hours billed are easily visible and provide a rough estimate of quantity worked, associates worry obsessively about billing high hours.
unemployment. When professional managers (especially those at the highest levels such as chief executive officers (CEOs)) are paid more than the market-clearing wage, the result is a scarcity of equivalent employment opportunities in relation to the number of managers who could ex ante do the job equally well. The few executives who occupy these top-paying managerial positions can look out to the sea of similarly qualified but more modestly compensated individuals and realize that they are easily replaceable. This realization produces a fear of losing their scarce, high-wage jobs. It is precisely this fear of a large loss that keeps them working to serve shareholder interests even though shareholders cannot effectively monitor them. The low probability that the shareholders might detect that managers are not working to further shareholder interests is enough, in


58. In their article on final-period problems and securities fraud, Jennifer Arlen and William Carney suggest that the reason managers engage in strategic behavior to preserve their jobs is to preserve firm-specific human capital that they would forfeit if they had to go to work for another firm. See Arlen & Carney, supra note 5, at 702. While their suggestion may apply in some situations, it is problematic in light of the fact that top management in U.S. companies appears to be mobile across firms. See MILGROM & ROBERTS, supra note 39, at 430-31; see also Executive Compensation at the Top 800 Companies, FORBES, May 18, 1998, at 324 (reporting data on the number of years that CEOs have been with their companies). An example of the mobility of top managers is the movement of senior management consultants from firms such as McKinsey & Co. into top corporate jobs. See, e.g., JAMES O'SHEA & CHARLES MADIGAN, DANGEROUS COMPANY: THE CONSULTING POWERHOUSES AND THE BUSINESSES THEY SAVE AND RUIN 252-87 (1997); cf., e.g., Richard Gibson, New U.S. Chief Orders Change at McDonald’s, WALL ST. J., May 20, 1998, at B1.

59. See MILGROM & ROBERTS, supra note 39, at 250-53 (discussing the usefulness of efficiency wage contracts in contexts in which performance evaluations are subjective).
most cases, to ensure that managers will exert high levels of effort and care.\footnote{It is in the nature of the high-wage, scarce job, low-monitoring managerial market that a high-visibility negative signal (such as a takeover or bankruptcy), indicating that some portion of the managerial team was not performing adequately, can eliminate that entire group of managers from the high-wage managerial labor market as a whole, even though some managers on that team may have been performing quite well. Remember, this is a market in which there are scarce jobs and many available employees. Because it is a low-monitoring world, the market notices only strong (albeit sometimes noisy) signals of managerial underperformance (such as a takeover, bankruptcy, or the fact that the manager was fired by someone else). With a large pool of equally qualified managers, why should a firm hire a manager who has the stigma of having been on a team that took its company into bankruptcy or a takeover. This individual manager applying for a job elsewhere might not have been the cause of that prior bankruptcy or takeover, but in a low-monitoring, high-wage world, with many comparable alternate employees available, a company is not going to spend the resources investigating whether or not the takeover or bankruptcy was a false signal of this individual manager's abilities. Along these lines, Stuart Gilson and Michael Vetsuypens provide evidence of the high cost of bankruptcy for managers. See Stuart C. Gilson & Michael R. Vetsuypens, CEO Compensation in Financially Distressed Firms: An Empirical Analysis, 48 J. Fin. 425–58 (1993). For firms that are financially distressed or file for bankruptcy about one-third of the CEOs are replaced, and those keeping their jobs experience large salary and bonus reductions. In addition, newly appointed CEOs with ties to previous management are typically paid about 35% less than the CEOs they replace; while those without such ties are paid 36% more. See id. at 426; see also Lynn M. LoPucki & William C. Whitford, Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. REV. 125, 150 (1990) (discussing how managers usually lose their jobs in bankruptcy reorganizations); cf. J. Hout Verkerke, Legal Regulation of Employment Reference Practices, 65 U. Chi. L. REV. 115, 147–49 (1998) (describing how previous dismissals may scar an employee by sending a negative signal to other employers, even though the reasons for the dismissal may be benign).} Now, to return to the final-period problem. Managers work to further shareholder interests because they fear losing their scarce, ultra high-paying jobs and especially fear the stigmatization that they were terminated for a failure to serve their shareholders (because the latter eliminates them from the high-wage segment of the labor market). This fear of reputational stigma, however, diminishes as a manager approaches the end of her career. After all, if the manager is about to retire and leave the managerial market anyway, she has little reason to care about reputational stigma. This is the classic final-period problem.

Firms, however, tend to have a variety of mechanisms in place that serve to counter any managerial tendencies to act contrary to shareholder interest. These mechanisms can be in the form of future compensation that is linked to the fortunes of the firm even beyond the final period, such as locked-up stock options, pensions, consultancies, and other forms of deferred compensation that are explicitly linked to the firm's future performance. One mechanism that may work particularly effectively is cross-monitoring between managers. While at any given point some managers
will be in their individual final periods, there will be others who are not. The ones who are not in their final period (usually the younger managers) have an incentive to monitor the older managers to make sure that the older managers do not hurt the firm as a whole and thereby injure the reputation of the younger managers in the managerial job market. Once again, keep in mind that the market for managers is a low-monitoring, low-information world, in which the market's primary source of information about managerial performance is stock price. If the stock price of a company falls drastically or the company goes into bankruptcy, the resultant stigma or negative signal attaches to all the managers because the market does not have the information to discern which managers actually caused the company's downfall.

The question then is when do these checks on final-period problems, such as cross-monitoring and deferred compensation, break down, because it is only then that one would want the legal regime to play a role. Cross-monitoring unravels in situations in which the interests of older and younger managers become aligned.\textsuperscript{61} Take, for example, situations such as a bankruptcy, takeover by a new management, or a systematic internal purge of existing management. In all of these situations, the entire management staff is eliminated and stuck with a negative signal that could eliminate them from the high-end managerial market. This negative signal is the fact that they were part of a management team that failed. Deferred compensation incentive schemes are also unlikely to work as well in this situation because the company is doing badly—whatever locked-up stock or pensions the managers are expecting are likely to be in jeopardy.\textsuperscript{62} But more important, the deferred compensation is unlikely to be as valuable to the younger managers who will not have accrued quite as much of it; instead, they will be more concerned about the prospects of getting eliminated from the high-wage managerial job market. In sum, one is looking for situations in which the entire management's interests are aligned because they perceive that they are in the final period of their managerial lives.

The situation I envision is one in which management as a whole understands that if things continue to proceed along their current path, they are going to be fired or their company is going to fail. Their only hope is to put what few resources they can grasp in a high-risk gamble and hope that the gamble pays off big. In the context of a public offering and non-

\textsuperscript{61} See Langevoort, supra note 46, at 111–12.
\textsuperscript{62} Although, in a takeover, a top corporate manager might be willing to let the takeover go through if the stock is expected to go up and she has a large holding of stock or call options.
disclosure of material unripe information, the scenario might play itself out in the following way:

The company's management realizes that it is in danger of being terminated. Its only hope of survival is a new project that is highly risky. But if the risky project succeeds, it might keep the company afloat and the managers' jobs intact. Despite the company's recent lackluster performance, it has built up enough good will and trust among analysts that its statements about performance and results are trusted. The past few quarters have been somewhat successful and have, in fact, indicated that the company was improving its condition. But the quarter in progress is proving to be a complete disaster. Management knows that, based on the market expectations built up as a result of the past few quarters, it can raise approximately $1 billion on the market, but that if this current quarter ends badly, the market will quickly lose faith in the company's future prospects. Management decides to conduct a public offering immediately, before the current quarter, likely to be disastrous, comes to an end and earnings results are released. The company can invest the billion dollars in its high-risk venture and thus, its managers hope, the company will be able to survive. There is the danger that analysts will be upset at them for having withheld information, but that will happen only if analysts discover that information was withheld. Once the company has raised the money, perhaps it can produce a turnaround in the company's fortunes. In the context of a takeover threat, the new funds could be used to invest in projects that would make the company an unattractive target.

When the quarter in progress ends, the company will be required to disclose that quarter's results sooner or later. If the results are negative, plaintiff-shareholders will attempt to sue based on the resulting drop in the stock price. However, this suit can exist only with a legal rule that obliges companies to disclose at least some interim data. To the extent there is such a legal rule, it will partially solve the problem of managerial strategic behavior because it will enable the market to discover (through the litigation) that negative information was intentionally withheld from the market at the time of the offering. Without the lawsuit, the market (and its analysts) will get only the full-quarter results and will not know if the company knew at the time of the offering that the quarter's results were going to be a disaster. Further, even if analysts are suspicious that there was some managerial self-dealing, if the managers' gamble pays off and the company survives, then perhaps over time the analysts can be appeased and brought back into the fold.63 Remember, this is a low-monitoring world in which only strong negative signals attract attention.

63. Cf. Anup Agrawal et al., Management Turnover and Governance Changes Following the Revelation of Fraud, 42 J.L. & ECON. (forthcoming 1999) (manuscript at 3, on file with author) (finding little systematic evidence that firms suspected or charged with fraud have unusually high
To reiterate, under ordinary circumstances managers care deeply about their reputations on the market. Managers especially care about their reputation with analysts because analysts are the conduit through which information reaches the market. It is through the information that analysts convey to the market that the market evaluates managers; if analysts do not trust managerial information, they will not transfer information at the speed at which managers would like. Fear of loss of reputation with analysts keeps managers honest for the most part. But that fear falls apart when managers see that they face a high likelihood of job loss anyway. It is in this situation that the nonlegal sanctions of the reputational market cease to be as effective.

The situation is especially problematic in the context of the nondisclosure of interim results precisely because these are interim results. Once the offering is over and the interim results have not been disclosed, the market has no way of discovering what those interim result were at the time of the offering. All the market finds out are the full-quarter results (which may have been significantly altered as a result of managerial investments using the resources raised in the public offering). The fact that, in the absence of a legal rule requiring the disclosure of known interim results, the market will never know whether at the time of the offering the company knew of the existence of strong negative information regarding the quarter in progress produces a window of opportunity for managers to act strategically to try to save their jobs. If the managers use the resources raised in the offering to engineer a quick turnaround in the company’s fortunes, the market may never get a strong signal that there was strategic nondisclosure of known negative information at the time of the offering.

D. But Won’t There Be Unraveling?

In theory, even if reputational sanctions do not always induce voluntary disclosure, market forces should produce unraveling. Specifically, companies who were doing public offerings and knew that they had not produced any negative information would attempt to distinguish themselves from the others who might have “known” negative information by making

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64. Cf. Arlen & Carney, supra note 5, at 702 (noting that circumstances under which final-period problems will arise are rare).
the following type of statement: "We do not know of any information as to the quarter in progress that would lead us to think that the results for this quarter will represent an extreme departure from either the results for past quarters or from what analysts expect." 65

A reason why one might ordinarily not think that unraveling would take place here is because intraquarterly data is not verifiable by the investing public—only the full-quarter information is visible. In other words, because the market has no way of identifying what information was known by the company's top management at the time of the offering, it cannot identify whether the company was attempting to deceive it.

The combination of nonverifiability and a significant risk that the company has undisclosed negative interim information creates a "lemons" problem. 66 A lemons problem occurs when investors cannot distinguish between truthful issuers and those that are hiding information. The result is that the market discounts the prices of all securities. Consequently, honest companies use more cumbersome registration processes that signal to the market that they are not strategically timing their offerings, and only the dishonest companies use the registration processes that allow them to time their offerings. This occurs because the market assumes that companies using the faster (pinpoint-permitting) process are seeking to take advantage of undisclosed interim information, and thus discounts them appropriately. 67

As Professors Douglas Baird, Randal Picker, and Robert Gertner explain, however, a legal regime that enables verification through the discovery process can solve the nonverifiability problem. 68 And as the Supreme Court suggested in Virginia Bankshares v. Sandberg, 69 the civil discovery system should be able to ferret out or verify what was actually known by the corporation.

In theory, therefore, the solution is not necessarily a new mandatory disclosure rule. Even without a rule mandating that certain intraquarterly data be disclosed in the offering context, companies seeking to make

65. See, e.g., BAIRD ET AL., supra note 31, at 79–109; EASTERBROOK & FISCHEL, supra note 22, at 288–89 (discussing how a firm with a "good project," seeking to distinguish itself from a firm with a "bad project," would disclose more information because "s[ilence is bad news]").


67. As I note later, the S-3 shelf offering market appeared to match the lemons problem scenario in its early years. Despite the fact that the shelf process was cheaper, only a few companies used it, and their equity sold at what appeared to be a discount. See infra note 77.

68. See BAIRD ET AL., supra note 31, at 95–96.

interim results verifiable (in order to garner an advantage on the market) can opt in to the existing disclosure system by making an affirmative statement that they do or do not have this information. The affirmative statement of fact then subjects the company to liability under the federal securities laws because affirmative statements of fact made by public companies have to be true.

Anecdotally, however, my sense from talking to market participants is that companies do not make statements to the effect that they do not know of any negative information. The reason for this appears to be the perceived costs of making a statement about what the company knows. Companies (and their lawyers) are uncertain as to how the markets (or courts) will interpret a statement saying that "there is no information regarding extreme departures from expectations." Will the market and/or a court interpret such a statement as a signal that there is information regarding a small departure from expectations? If they do, then making such a statement risks misleading the public because the company might not have data suggesting a small departure from expectations or, more plausibly, the company might be uncertain about what its data reveal about possible small departures. Companies could tell the markets about their uncertainty concerning the data, but I do not see them doing so. Once again, their rationale is that it is too difficult to communicate such information because such statements are too easily misinterpreted.


71. Cf. Russell Hardin, Trusting Persons, Trusting Institutions, in STRATEGY AND CHOICE 185, 186 (Richard J. Zeckhauser ed., 1991) (noting that "the right to be sued is the power to make a promise" (quoting Thomas Schelling)); Marcel Kahan, Games, Lies and Securities Fraud, 67 N.Y.U. L. REV. 750, 768–72 (1992) (arguing that the loss of the ability to lie affirmatively as a result of the antifraud provisions of the securities laws empowers companies to make commitments).

72. In order to check the anecdotal observation, I collected data on the disclosure behavior of every S-3 company that had conducted a public offering in the first six months of 1998. In this sample of 369 companies and 429 offerings, I found that during the two weeks immediately prior to the offering date and two weeks immediately after, approximately 30% of the companies disclosed good news (106/369), less than 1% disclosed bad news (4/369), and none disclosed that it had no news. For more information, see data on file with author.

73. Professor Donald Langevoort suggests that the reason why companies find it difficult to be entirely candid about their financial condition is that there is a norm of optimism or puffery. See Langevoort, supra note 46, at 116. When such a norm exists, an accurate statement results in investors imposing an excessive discount because the literally truthful statement is taken as an attempt to cover up something negative. See id. ("Where puffing is the order of the day, literal truth can be profoundly misleading." (quoting Judge Posner's statement from Eisenstadt v. Centel Corp., 113 F. 3d 738, 746 (7th Cir. 1997)).
In this circumstance, there is a role for a central planner (a regulatory agency in this case) to speak for the companies by specifying that their silence means that they do not have knowledge about negative interim results.\(^74\)

E. The Standard to Deter Strategic Nondisclosure

The disclosure of accurate and full information in the public offering context helps market efficiency by ensuring that capital flows to the companies that can best utilize it.\(^75\) The less the disclosure of accurate information the greater the uncertainty for investors in terms of which company will best utilize their money. Hence, there is a strong rationale to encourage companies doing offerings of securities to disclose full and accurate information. However, as explained earlier, whether we need a legal regime mandating this disclosure is less clear.

Some argue that companies are long-lived entities in a competitive market and therefore have an incentive to disclose full and accurate information themselves. The market will penalize companies that do not disclose full and accurate information by reducing the amount of capital it is willing to give them vis-à-vis companies that can show themselves to be

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\(^74\) In effect, the government solves the problem that firms have in communicating candidly or in a neutral way by providing a regulation that speaks for them. I am grateful to Professor Jeffrey Stake for helping me think through this "mixed messages" problem. Cf. Jeffrey Evans Stake, Mandatory Planning for Divorce, 45 Vand. L. Rev. 397, 427 (1992) (describing such a problem in the "about to be married" (or "planning for divorce") context—an environment that could easily be characterized as one of puffery).

The above discussion relates to the modern literature on default rules. Cf. Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989) (finding that parties sometimes fail to negotiate efficient terms because certain terms signal that the other party is a less valuable trading partner); David Charny, Hypothetical Bargains: The Normative Structure of Contract Interpretation, 89 Mich. L. Rev. 1815, 1847-48 (1991) (noting that it may make sense for a central planner to draft mandatory contract rules for parties when the costs of determining the optimal rule are too high for individual parties to be willing to incur (through the litigation/lawyer process) and that where does not appear to be an efficiency gain to parties from allowing them to opt out of these rules); Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 WASH. U. L.Q. 347, 350 (1996) (explaining that reduced uncertainty about the meaning of certain standardized terms makes them easier to price and less risky to use in terms of the risk of lawsuits arising out of misinterpretations of these terms); Jerry Kang, Cyberspace Privacy, 50 Stan. L. Rev. 1193, 1246-59 (1998) (applying the Ian Ayres and Robert Gertner analysis to cyberspace transactions).

\(^75\) See HLHC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir. 1988); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1207 (1st Cir. 1996); Brudney, supra note 38, at 735 (describing the theory of allocational efficiency); see also Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 Duke L.J. 977, 988-89, 1014-15 (1992) (noting the heightened need to target disclosure laws at companies engaged in public offerings).
honest. To the extent market forces promote disclosure, we do not need a legal regime, especially a legal regime that allows for a large number of frivolous suits brought solely to extract settlements.

There are, however, a set of final-period situations during which managers have strategic incentives not to disclose certain known negative information about the company's future prospects. These are the situations in which the company's top management (1) faces a significant likelihood of termination or job loss, (2) knows negative information about the quarter in progress, and (3) is about to do a public offering. It is under these conditions that there is a high risk of strategic nondisclosure. This situation produces inefficiencies in the public offering markets for a number of reasons.

First, the ability to behave strategically in this way and cheat the market produces an incentive for companies to waste resources in (1) collecting information and (2) making unneeded public offerings that exploit their informational advantage. Second, the market, realizing that companies may be timing their public offerings to take advantage of temporary informational advantages that they have, will discount the value of all companies that have the ability to pinpoint their offerings strategically by the risk of strategic nondisclosure of negative intraquarterly results. This discount will be especially large for those companies that do their offerings late in a quarter because in these latter situations there is more room for strategic behavior; after all, the company is likely to have more intraquarterly infor-

76. Note that I structure the suggested legal standard against the backdrop of the SEC's disclosure system that is already in place (requirements of quarterly and annual disclosure by public companies), as opposed to structuring the standard against a backdrop of a zero disclosure system. The backdrop here is zero disclosure only as far as intraquarterly operating results go.

77. This is the lemons problem described in the prior section. See infra notes 66–67 and accompanying text. Later, I explain that it is only a small group of companies (primarily those using the SEC's Form S-3 that allows a company to register securities ahead of time, put them on the shelf, and then do take-downs from the shelf whenever the market conditions are right) that are likely to be able to pinpoint their offerings strategically. See Clark, supra note 21, at 751 (describing the S-3 shelf offering and how it gives companies the ability to pinpoint their offerings so as to take advantage of things such as favorable interest rates); Langevoort, supra note 46, at 160. Hence, the increased risk of strategic behavior in S-3 offerings and the concurrent discount that the market will apply to such offerings will bias companies away from using this method of doing a public offering.

In fact, there is evidence that the market, in the past, has devalued shelf offerings relative to other offerings because of a perception that these particular offerings were overpriced. See John C. Coffee, Jr., Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration, 52 WASH. & LEE L. REV. 1143, 1184 (1995) (noting underpricing in the market for equity shelves); David J. Denis, Shelf Registration and the Market for Seasoned Equity Offerings, 64 J. BUS. 189, 197–98 (1991); cf. ROSS ET AL., supra note 36, at 540 (expressing surprise at the underuse of shelf registrations).
mation the later in the quarter the offering is done. This produces a bias in favor of offerings done earlier in a quarter and results in an economic inefficiency if there are welfare-increasing legitimate reasons why some companies might need to do their offerings later.

This discussion points to a need for a disclosure duty that would require companies to disclose known information representing a significant departure from existing expectations. This proposed obligation has three key aspects:

(1) It focuses on known information. It does not impose on companies a duty to produce information sooner than the 135 days prior to an offering already mandated by the SEC. The reason for focusing on known information is because the problem concerns strategic nondisclosure, not the general problem of insufficient production of information. I am worried about the cases in which the company, for its own reasons, produces information but chooses not to disclose it.

78. A question that finance theorists ask is whether the risk I have identified is diversifiable risk. The theory is that if investors hold infinitely large portfolios, and the risk at issue is one that only affects a small number of securities, it should be diversifiable (unlike CPI or inflation risks that would presumptively be nondiversifiable). See ROSS ET AL., supra note 36, at 294–302.

To the extent one looks at the world of offerings alone, the risk should not be diversifiable because there is a risk in every offering that known interim negative data exist that are not being disclosed. There is little offsetting risk that known interim positive data are being hidden because this would raise the value of the offering. In other words, one cannot put together a bundle of offerings and expect that, on average, the good and the bad will cancel each other out. The more complex question, however, is when one asks whether the set of companies to whom this risk applies is small enough that the risk can be deemed "unsystematic" and diversified away in a large enough portfolio. See id. Indeed, as Professor Stout has pointed out, the volume of trades in the secondary markets swamps the number of purchases in offerings. See supra note 63, at 645.

Nevertheless, two pieces of evidence push us toward thinking that the risk at issue is not diversified out by investors. First, investors, in practice, are less diversified than finance theory predicts. Instead, there is a fair degree of concentration in areas with which they are familiar. See, e.g., Merritt B. Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom, 95 MICH. L. REV. 2498, 2512, 2526 (1997) (noting that investors are not diversified across international markets); Stout, supra note 55, at 484–85 (discussing the investment strategies of investors such as Warren Buffett). Second, the market appears to price specifically a risk associated with shelf offerings. See supra note 77.

79. By "known" I mean actual knowledge. The state of mind requirement in my proposed rule, therefore, excludes recklessness. Cf. William H. Kuehnle, On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws, 34 HOUS. L. REV. 121, 125–27 (1997). As discussed in the text, the reason I use this narrow state of mind definition is that my focus is on instances in which management consciously chooses to do a public offering to take advantage of an information asymmetry.

80. Professor Margaret Radin raised the point that the legal rule I suggest might have the unintended consequence of deterring companies from producing information that they need for internal reasons because now they face the danger of being sued for having known the information and not disclosed it. I think, however, that the risk of deterring companies from producing information they need for otherwise legitimate purposes is minimal. There are a couple of reasons for this. First, ex ante, the company will not know whether or not the information it is producing will be
(2) In addition to focusing on known information, I am concerned about information known by the company’s top management, not the employees at the bottom. Once again, the reason for this focus is the specific problem at issue: strategic behavior by top management who have the power to pinpoint their offerings to use their temporary informational advantage over the market.\(^{81}\)

(3) The disclosure obligation focuses on information that represents a significant departure from expectations and excludes information that merely confirms expectations. The latter type of information, as explained later, can be material as well. However, the point is to mandate disclosure that would deter fraud, as opposed to merely ensuring that information is produced. Knowing information that merely confirms market expectations most likely would not give company managers an adequate informational advantage so as to induce them to commit fraud.\(^{82}\)

good or bad. To the extent bad information that is produced has to be disclosed and subjects the company to a cost, good information that is produced will give the company a benefit. Second, I am only talking about the quarter in which the company is doing its public offering. The decision as to whether or not to produce information is going to be taken with respect to all the quarters.

Professor Radin, equally legitimately, also pointed out that there are levels of knowledge. Depending on what the legal rule defines as knowledge, a company, in theory, could attempt to stop producing information when it has bad information but that information would not constitute known information under the law. While this is a theoretical possibility, a court would undoubtedly find it awfully suspicious if a company that normally produces information every quarter for internal purposes suddenly decides not to produce information this quarter because of initial indications of bad news. A court, seeing this in light of the regulation’s objective of deterring strategic behavior of this very type, is likely to decide that the case needs further legal scrutiny by sending the case into discovery to determine whether the company’s management truly did not have knowledge. As described later, the level of legal scrutiny that is applied in these cases is crucial because it decides whether or not the case gets past the motion to dismiss hurdle.

81. The proposed disclosure obligation, therefore, would not cover cases in which internal information flow biases produce inaccurate (but not knowing) disclosures by top officials. Cf. Langevoort, supra note 46, at 130–63 (describing how such biases can exist).

82. The disclosure standard, as it stands, forces the company to warrant that it does not have a certain type of information. In theory, one might worry about companies who might prefer (from an efficiency point of view) to avoid making such a warranty. I am hard pressed, however, to think of legitimate business reasons why companies and potential purchasers of securities would want to contract around a legal obligation to disclose known operating results during an offering. Not only are these results that would have to be disclosed in a few weeks anyway, but also this does not appear to be the type of information that would provide a competitor with an advantage or hurt a merger or some other such transaction. Cf. In re Canandaigua Sec. Litig., 944 F. Supp. 1202, 1210–11 (S.D.N.Y. 1996).

There is a significant difference between events and trends affecting “operations,” such as the closure of a plant or the increase in costs of raw materials, and competitive marketing strategies and plans. The former are information concerning the extrinsic operational situation that management faces, and needs to be disclosed, while the latter are competitive business judgments that management makes to improve the business, and need not be disclosed. Id.; Ayres, supra note 32, at 950–53 (discussing the merits of a default rule warranting honesty by the corporation versus one not doing so).
To reiterate, the proposed disclosure standard, as I have structured it, comes into play only when circumstances indicate that a company’s management acts strategically to induce the public to purchase securities at a higher price than they would otherwise by withholding negative information that the company knows would significantly alter the market’s expectations about the future prospects of the company. Unlike much of the SEC’s regulatory scheme relating to public offerings, the regulation I suggest does not focus on the production of information, but rather the deterrence of fraudulent behavior. The choice of whether and when to produce the information is left to the company’s discretion. Such an obligation makes economic sense because it avoids forcing companies to produce information when it would be too costly, but also gives companies who produce the information a disincentive to use it for strategic purposes.

F. Institutional Pressures and Gatekeepers

Reputational sanctions on managers, however, are not the only safeguards in place to provide checks against the strategic nondisclosure of unripe information. There are the institutional pressures that come to bear on public companies in the form of underwriters, independent boards of directors, outside lawyers, private regulatory agencies, and holding companies. Just as the appli-
cable legal rule or standard should be structured to take into account contexts in which reputational pressures work to ensure full and accurate disclosure, it stands to reason that the legal regime should also take into consideration circumstances in which institutional pressures serve to ensure that strategic nondisclosure has not taken place.

I focus the discussion primarily on the circumstances in which intermediaries such as underwriters, auditors, and lawyers serve to ensure that a company’s managers are not cheating the market and suggest that a court should apply only a low level of scrutiny to plaintiffs’ claims in such cases. The logic of that discussion, however, is equally applicable in circumstances in which institutional pressures, such as a strong and independent board of directors, powerful institutional investors, or a private stock exchange’s scrutiny, suggest that the company’s managers have little room to act strategically. I focus on the pressures that underwriters and lawyers can apply on companies because these are the parties that do the due diligence of closely examining the information that companies have as of the offering date. Further, the intermediaries such as underwriters and lawyers are subject to both legal liability and reputational costs if they are negligent in their due diligence.

I begin with the case of a firm-commitment underwriting. If the offering is a firm-commitment underwriting, the underwriters effectively purchase the securities from the company and then resell them to the public. If the company is not being honest in its disclosure of information, the underwriters bear some of the risk that the undisclosed negative information may get leaked and the underwriters will be stuck with the securities. Further, the underwriters themselves are subject to liability for

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86. Due diligence is equivalent to nonnegligence. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976); Glassman v. Computervision Corp., 90 F.3d 617, 627 n.12 (1st Cir. 1996); In re Software Toolworks, 50 F.3d 615, 621 (9th Cir. 1994). For a discussion of the incentives facing these gatekeepers, see Choi, supra note 6, at 945–49.


88. Some scholars have pointed out that the effect of underwriters bearing risk in these offerings is not as significant as it is often assumed to be because underwriters often presell large chunks of the securities they have agreed to buy. See Coffee, supra note 77, at 1169; David J.
material misstatements and nondisclosures in the prospectus and registration statement and are not likely to wish to assume the risk of liability (even when the law is unclear).\footnote{Denis, The Costs of Equity Issues Since Rule 415: A Closer Look, 16 J. FIN. RES. 77, 78 (1993) (suggesting that shelf offering transactions are more likely to be "bought" deals).} Finally, the underwriters have reputations at stake every time they do an offering.\footnote{See 15 U.S.C. §§ 77k, 77l (1994); Glassman, 90 F.3d at 627-28 (citing cases on due diligence); C. Steven Bradford, Transaction Exemptions in the Securities Act of 1933: An Economic Analysis, 45 EMORY L.J. 591, 604 (1996).} If the public perceives that it has been defrauded, it will not only blame the company's managers for the fraud, but also the underwriters for a failure to do adequate diligence in investigating the company (if not blaming them for collusion with the company managers).\footnote{See Randolph D. Beatty & Jay R. Ritter, Investment Banking, Reputation, and the Underpricing of Initial Public Offerings, 15 J. FIN. ECON. 213 (1986); James R. Booth & Richard L. Smith, II, Capital Raising, Underwriting and the Certification Hypothesis, 15 J. FIN. ECON. 261 (1986); K.M. Holland & J.G. Horton, Initial Public Offerings on the Unlisted Securities Market: The Impact of Professional Advisers, 24 ACCT. & BUS. RES. 19 (1993); cf. Karl S. Okamoto, Reputation and the Value of Lawyers, 37 CORP. PRAC. COMMENTATOR 818-20 (1995) (describing the analogous effect in the case of lawyers who work on public offerings).} Hence, if the underwriters know there is likely to be undisclosed, but material, negative unripe information they will request: (1) a lower initial price for the securities, and (2) disclosure of the information or a forecast that will convey the gist of the information. Therefore, even if the company's management is in its final period and has an incentive to withhold material unripe information, the underwriters serve a gatekeeping function in ensuring that this does not happen.

But even the gatekeeping checks by the underwriters are not perfect. Occasionally, market pressures do not allow underwriters to do as thorough a due diligence review as they would prefer and force them to take the company's representations at face value.\footnote{See BREALEY & MYERS, supra note 25, at 351 (noting the significant amounts of monetary and reputational capital that underwriters have at stake in most offerings); Coffee, supra note 77, at 1169 (finding that the function of underwriters in a public offering is to certify the quality of the offering); cf. COX ET AL., supra note 4, at 236-37 (noting that empirical research on initial public offerings shows that the initial prices are systematically lower than short-term aftermarket prices, arguably because underwriters fear lawsuits and want to ensure that the offering is oversubscribed).} One situation in which commentators have perceived the failure of the underwriters' gatekeeping function is the context of an S-3 offering.\footnote{Cf. Lynn Nicholas, The Integrated Disclosure System and Its Impact upon Underwriters' Due Diligence: Will Investors Be Protected?, 11 SEC. REG. L.J. 3, 17-29 (1983) (discussing factors militating against adequate due diligence by underwriters); see also SEC. Rel. No. 33-6499 (Nov. 17, 1983), 48 Fed. Reg. 52,889 (1983).} One situation in which commentators have perceived the failure of the underwriters' gatekeeping function is the context of an S-3 offering.\footnote{See, e.g., David W. Blackwell et al., Shelf Registration and the Reduced Due Diligence Argument: Implications of the Underwriter Certification and the Implicit Insurance Hypothesis, 25 J. FIN. & QUANTITATIVE ANALYSIS 245 (1990); Merritt B. Fox, Shelf Registration, Integrated
certain large, well-established, and highly capitalized firms are allowed to use, enabling them to do their offerings quickly and cheaply.\textsuperscript{94} Competition to underwrite such offerings is intense (in part because the securities of the companies in question are easy to sell) and because of the speed at which the offerings are done, there is little time to do diligence.\textsuperscript{95}

In particular, S-3 companies are allowed to do what are called “shelf offerings.” In a shelf offering, the company prepares a registration statement for a certain amount of securities. It then has the option of offering all of its securities at the same time, or taking the securities down from the shelf in discrete chunks whenever the timing is best.\textsuperscript{96} The fact that S-3 companies have to make only limited disclosures\textsuperscript{97} allows for the take-downs from the shelf to be done in a matter of days (and hence with little time for updates of underwriter due diligence). In fact, one goal of permitting the S-3 offerings was to enable companies to pinpoint the best time for them to do their offering and take advantage of market conditions.\textsuperscript{98} Unfortunately, this ability to pinpoint, streamline disclosure, and have no more than a limited amount of diligence results in a situation in which a company can time its offering to begin before the end of a quarter whose results are looking to be far worse than those in prior quarters.\textsuperscript{99}

Hence, although there are nonlegal checks in place, such as reputational sanctions on managers and underwriter monitoring, there are still circumstances in which these checks fail to prevent companies from acting

\textsuperscript{94} See Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1208–09 (1st Cir. 1996) (describing the requirements for being eligible to use the S-3 registration form); see also LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 361–63 & n.90 (3d ed. 1989).

\textsuperscript{95} See Shaw, 82 F.3d at 1208–09; JENNINGS ET AL., supra note 27, at 288; Coffee, supra note 77, at 1148 (noting that there is insufficient time in an S-3 shelf offering for traditional due diligence); David S. Kidwell et al., Shelf Registration: Competition and Market Flexibility, 30 J.L. & ECON. 181 (1987).

\textsuperscript{96} See Shaw, 82 F.3d at 1208–09.

\textsuperscript{97} S-3 companies’ periodic disclosures, such as their 10-Qs and 10-Ks, are incorporated by reference into the registration statement, without the need for additional disclosure in the offering documents. See id. The underlying assumption is that these companies are closely followed and the market already has incorporated the existing information about them into the price. See id.

\textsuperscript{98} See CLARK, supra note 21, at 751. In contrast, the SEC’s requirements for offerings done on other forms, such as the S-1 that applies to initial public offerings (IPOs), are far more cumbersome, making such offerings harder to pinpoint. See JAMES D. COX ET AL., SECURITIES REGULATION 45–49 (1997) (describing the registration process).

\textsuperscript{99} See Shaw, 82 F.3d at 1209 (noting that the lack of a duty to disclose certain intraperiody data in this context allows a company “anticipating a negative earnings announcement the ability to time its offerings of securities from the shelf to be completed prior to the public release of the known negative news”); cf. Gordon & Kornhauser, supra note 93, at 812–20.
strategically to cheat the market. Given the expense of a system of legal liability in the securities context, it would be optimal to have a legal regime that kicked into place only when it appeared that nonlegal sanctions were not working.

In the preceding discussion, based on the low-monitoring, high-wage model, I identified circumstances under which managers had an incentive to cheat the market. These incentives, in the majority of cases, however, are kept in check by institutional mechanisms, such as underwriters, lawyers, independent boards of directors, institutional investors, and the rules of the private exchanges. Hence, although there is a need for a duty to disclose certain known intraquarterly data in the offering context (that is, extreme departures from market expectations), there is a need for no more than a narrow duty. I suggest that the duty be applied so as to scrutinize carefully only those claims brought under circumstances (1) that suggest the existence of motive and opportunity for strategic behavior on the part of the managers, and (2) when the institutional monitoring mechanisms such as those operating through underwriters and lawyers are not able to perform adequately.

Theory aside, however, the next question is how such a duty to disclose might arise under the existing doctrinal structure.

III. DOCTRINE: AN EXISTING BASIS FOR REQUIRING DISCLOSURE

A. Half-Truths and the Duty to Update

The materiality of information does not, without more, create a legal duty to disclose.\(^{100}\) The duty to disclose must arise out of either a statute or regulation, a breach of fiduciary duty, or a misleading statement.\(^{101}\) In addition, there might exist a duty to update past disclosures if those past disclosures have remained alive in the minds of reasonable investors.\(^{102}\) The

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100. See In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1432 (3d Cir. 1997); In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact."). The oft-stated mantra is: "Silence, absent a duty to disclose, cannot be actionably misleading." Shaw, 82 F.3d at 1202; see also Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988); Backman v. Polaroid Corp., 910 F.2d 10, 13 (1st Cir. 1990) (en banc).

101. See Shaw, 82 F.3d at 1202 n.3 (citing language from Roeder v. Alpha Industries, Inc., 814 F.2d 22, 27 (1st Cir. 1987)).

heart of the interim disclosure claim is that the disclosure of past quarterly successes, although literally true, was actionably misleading because of the nondisclosure of the negative results for the quarter in progress. Therefore, putting aside fiduciary and statute/regulation-based duties, I look first to the question of whether truth about the results from past quarters can, in and of itself, create a legal duty to disclose interim data from the quarter in progress. The two possible sources of such a duty are the duty to update and half-truth doctrines.

1. The Duty to Update

One could argue that the request for intraquarterly offering data falls into the duty-to-update box because investors are requesting that information about past quarters be updated with information from the current quarter. The question, therefore, is whether the scope of this judicially created duty is broad enough to encompass the disclosure of intraquarterly data.

Two recent cases, Stransky v. Cummins Engine Co.,103 from the Seventh Circuit, and In re Burlington Coat Factory Securities Litigation,104 from the Third Circuit, have made clear that (1) to the extent it exists, the scope of such a duty is extremely narrow,105 and (2) such a duty would apply only to forward-looking statements, and not to statements of historical fact like accurate reports of the results for past quarters. The only duty that applies to statements of historical fact is a duty to correct. However, as the term implies, that duty applies to errors in the statement itself.106 The Burlington court stated: "Well settled is the principle that an accurate report of past successes does not contain an implicit representation that the trend is going

103. 51 F.3d 1329 (7th Cir. 1995).
104. 114 F.3d at 1410.
105. While the court in Stransky rejected the existence of any duty to update, see 51 F.3d at 1331–32, In re Burlington allowed that there may be a narrow set of circumstances—those involving a fundamental change for the company—that might cause the failure to update to be misleading, see 114 F.3d at 1434. The theory being that, while investors do not expect to be told if ordinary earnings forecasts are not going to turn out exactly right, they may expect to be updated if there are fundamental changes to previously announced company projects or policies. See id.; see also Weiner v. Quaker Oats Co., 129 F.3d 310, 315–18 (3d Cir. 1997) (finding a duty to update on a fundamental change in capital structure); In re Time Warner, 9 F.3d at 267–68 (finding a duty to update on a fundamental change in capital-raising strategy).

In contrast, in a recent article, Professor Dale Oesterle suggests that scope of the updating duty has become extremely broad. See Dale Arthur Oesterle, The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?", 20 CARDOZO L. REV. 135, 137 & 156–57 (1998). Professor Oesterle’s interpretation is less plausible if Weiner, the Third Circuit opinion that forms the basis for his argument, is read in the context of In re Burlington, a Third Circuit opinion issued only a few months prior.
106. See In re Burlington, 114 F.3d at 1431.
to continue, and hence does not, in and of itself, obligate the company to update the public as to the state of the quarter in progress."\textsuperscript{107} The narrow duty to update recognized by the courts thus far, therefore, does not create an obligation to disclose intraquarterly data.

2. The Duty Not to Speak in Half-Truths

Alternatively, the request for interim disclosure can be conceptualized as a complaint that the company violated its obligation not to speak in half-truths.\textsuperscript{108} The argument here would be that disclosing full-quarter information regarding past quarters without disclosing the most recent part-quarter information could lead investors to conclusions different from those which the full-quarter information would lead them, providing the investors, in effect, only half the truth.

While intuitively the accurate disclosure of a long line of past successes without the disclosure of the disastrous results from the current quarter constitutes a half-truth, it is unlikely that courts will expand the half-truth theory that far. I make this prediction for two reasons. First, to the extent courts have found a duty to speak the full truth, it has only been with respect to statements that were arguably false in and of themselves. For example, in \textit{Virginia Bankshares}, the statement that the Supreme Court characterized as a half-truth was a statement by the company's board of directors that the price offered in a minority shareholder buyout was "fair" and provided "good value." The reason the Court found this to be a half-truth was that the board did not disclose that in actuality the company was undervalued as compared to its book value and that the market price system was actually a thin market dominated by the company's holding company.\textsuperscript{109} In sum, the statement that the price was "fair" was in and of itself close to

\textsuperscript{107} \textit{Id.} at 1432; see also \textit{Shaw} v. \textit{Digital Equip. Corp.}, 82 F.3d 1194, 1202 (1st Cir. 1996); \textit{Gross} v. \textit{Summa Four, Inc.}, 93 F.3d 987, 994 (1st Cir. 1996); \textit{Raab} v. \textit{General Physics Corp.}, 4 F.3d 286, 289 (4th Cir. 1993); \textit{In re Boston Tech.}, Inc. \textit{Sec. Litig.}, 8 F. Supp. 2d 43, 54 (D. Mass. 1998).

The above language from cases such as \textit{In re Burlington} and \textit{Shaw} indicates why the courts do not see the obligation of companies to file posteffective amendments to a registration statement as creating a duty to disclose intraquarterly data. This obligation, recognized in the infamous case, \textit{SEC} v. \textit{Manor Nursing Centers, Inc.}, 458 F.2d 1082 (2d Cir. 1972), applies explicitly to S-3 companies using the shelf process and is triggered by a change in the information in the previously filed registration statement. See \textit{Jennings et al., supra} note 27, at 269. When the registration statement contains no more than accurate reports as to prior quarters there is no change in the previously disclosed information.

\textsuperscript{108} \textit{See} \textit{Virginia Bankshares, Inc.} v. \textit{Sandberg}, 501 U.S. 1088, 1094 (1991) (holding that literally accurate statements can give rise to liability if they are no more than half-truths).

\textsuperscript{109} \textit{See id.}
being false. In contrast, an accurate statement of a series of past quarters’ earnings does not have the same suggestion of impropriety.

Second, and more important, not only would such an expansion of the half-truth doctrine nullify language such as the above quoted language from In re Burlington that accurate reports of past successes do not obligate companies to describe the state of the quarter in progress, but also it would expand the disclosure duties to an extent that would produce a danger of converting the SEC’s system of specific disclosure into a general and vague system in which all material information has to be disclosed.110 It is unlikely that courts will let this happen.

Because the courts are unlikely to expand the judicially created half-truth or duty-to-update doctrines to create a duty to disclose interim quarterly results, we have to look elsewhere in the disclosure apparatus. There are two other possible sources of this duty to update within the existing regulatory scheme. First, a public offering is no more than a sale of a security by the owner, and the traditional insider-trading rule of “disclose [all material information] or abstain [from trading]” might arguably apply. Second, there are special heightened disclosure regulations that pertain to the offering context that by themselves could create the duty.

Before we get to the source of the legal duty, however, there is a threshold bar to cross. That is, the assumption of certain courts and the defendant’s bar that to mandate the disclosure of material unripe data would, in effect, amount to requiring the disclosure of internal company forecasts. And companies are not required to disclose their forecasts, although both the SEC and the investing public would like them to do so.111

B. Is Requiring the Disclosure of Unripe Data the Same as Requiring the Disclosure of Forecasts?

Both defendants’ lawyers and courts have characterized plaintiffs’ claims for unripe data as no more than claims that companies should disclose their internal forecasts for current quarter results.112 There is a

111. See In re Burlington, 114 F.3d at 1433; Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996).
112. As noted earlier, in Zucker, Judge William Bassler dismissed the request for intraquarterly data, in part, on the ground that such a request was no more than a request for internal forecasts. See Zucker v. Quasha, 891 F. Supp. 1010, 1015–18 (D.N.J. 1995). Similarly, in the district court opinion in Steckman, Judge Judith Keep concluded that the claim that a negative trend in intraquarterly data should have been disclosed failed because such a claim was a request for forecasts. See Steckman v. Hart Brewing, Inc., No. CIV.96-1077-K, 1996 WL 881659, at *3–*4
grain of truth in the defendants' claim but not enough to foreclosure any possible obligation to disclose intraquarterly data.

Hard data about a small fraction of a quarter does not become a forecast as to the full quarter, just because the quarter is not complete or because the quarterly results have not been fully compiled or verified. Data (or a trend) concerning what happened in the first half of a quarter is still data about the first half, and not a forecast as to the full quarter. Data regarding the first half can help someone forecast full-quarter results, but making that forecast is up to the investor.

The confusion with unripe hard data and forecasts of full-quarter results arises out of what companies will do, in practical terms, if they are under an obligation to disclose material unripe data in the offering context. In practical terms, a company will prefer to disclose its internal forecasts of the full-quarter results than to disclose the partial-quarter unripe data itself. For example, take a company that decides to do its offering in the ninth week of an ongoing and particularly disastrous quarter (as far as initial indications predict). Assume now that a duty to disclose material unripe data applies. What will the company do? It has two options: It can disclose the hard negative indicators (for example, the relevant information may be that the orders received in the quarter so far are 50% less than what they were in the corresponding quarter the previous year), or it can disclose a forecast that results for the quarter might not be quite as good.

There is reason to expect companies to do the latter. In practical terms, therefore, the duty to disclose unripe data will result in companies disclosing their forecasts. As I explain, however, this is because it is in their interests to disclose forecasts and not because they are being forced to do so. In other words, requiring that companies update their ripe full-quarter disclosure with information regarding extreme material changes visible in

(S.D. Cal. Dec. 24, 1996); Steve Bailey & Steve Syre, July Correction Spooks Investors in Mutual Funds, BOSTON GLOBE, Aug. 8, 1996, at D14 (quoting a defense attorney as characterizing the First Circuit's decision rejecting an intraquarterly disclosure claim as "confirm[ing] that a company's failure to predict the future is not the basis for a lawsuit"); Hale & Dorr, supra note 27 ("[D]efendants argued that requiring disclosure would amount to requiring companies to disclose projections"); cf. In re Verifone Sec. Litig., 11 F.3d 865, 869-70 (9th Cir. 1993) (rejecting the argument that a company may have a duty to disclose trends because such a duty would be inconsistent with the fact that companies are not obliged to disclose forward-looking data).


114. Cf. Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 BROOK. L. REV. 763, 777 (1995) ("[The] Securities Act . . . is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that he is as competent as anyone to predict the future from given facts.").
intraquarterly data will give them an incentive to disclose their internal forecasts as to the quarter in progress. And getting companies to disclose forecasts voluntarily is something the SEC has sought to do for years.115

Take the example of the company that is choosing whether to disclose the hard indicators alone (which is all that it would be required to disclose under my proposed intraquarterly disclosure standard) or to disclose its internal forecasts for the quarter. If it discloses the indicators alone, the market will draw its own conclusions from the indicators. Here, the company has no way of knowing what conclusions the market will draw. Plus, if there are material omissions or misstatements in the data disclosed, the company will face liability under the federal disclosure laws. Finally, the company will have to incur the expense of putting the data into disclose-ready form by hiring accountants and lawyers to verify and quantify the information.

The company's other option, however, is to disclose its rough interpretation of the unripe data, without disclosing the unripe data itself. As long as the interpretation is reasonable and couched in cautionary language, the company will not be liable for the forecasts.116 The market may interpret the forecast as being too optimistic and discount it, but the company will still have some control over the interpretation people draw—control that it would not have if it disclosed the hard information alone. As long as the forecast was reasonable (a wide standard and one difficult for a plaintiff to show), a plaintiff will not be able to sue on the theory that the underlying material data was not disclosed. This is because the duty to disclose I have posited is only a duty to disclose certain extreme changes in the data and not a duty to disclose any specific types of information. The fact that the company gave the investor a reasonable forecast should obviate the need for specific disclosure of the hard underlying information.117 Therefore, given the

115. See, e.g., In re Burlington, 114 F.3d at 1432; Stranisky v. Cumming Engine Co., 51 F.3d 1329, 1333 (7th Cir. 1995). But cf. Romano, supra note 30, at 2378 (describing the SEC's position on the disclosure of forecasts as "guarded").


117. For example, the court in Shaw said:

[H]ad DEC chosen to disclose projected results, such a disclosure (if reasonable) could very well have rendered the "hard" interim information underlying the projection immaterial as a matter of fact or law, unless the market would have had some reason to discredit the projection, thereby creating a substantial likelihood that a reasonable investor might still have found the underlying information important to the total mix of information available.

Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1211 (1st Cir. 1996). The principle articulated in Shaw—that disclosure of a forecast might cause the underlying hard information to be immaterial and, therefore, not required to be disclosed—is but an extension of the truth-on-the-market
benefits to companies of disclosing soft forecasts of the forthcoming full-quarter results as opposed to disclosing the hard, unripe intraquarterly data—(1) escaping liability for material omissions from the specific hard information that they reveal by disclosing a safe-harbor protected forecast that makes the underlying, undisclosed, hard, unripe data immaterial; (2) exerting some degree of control and influence over the interpretations that the market makes about their disastrous quarter thus far; and (3) avoiding the cost of converting intraquarterly data into disclose-ready form—companies will choose to disclose their intraquarterly forecasts as opposed to the unripe intraquarterly data. But companies are not being forced to disclose their forecasts.\textsuperscript{118}

C. Is This Insider Trading?

One way of understanding how a duty to disclose interim unripe data might arise in the public offering context is to conceptualize a public offering as an insider’s sale of securities. A company issuing securities without disclosing material bad news about operating results is certainly trading with an advantage in terms of its possession of material nonpublic information. The question, then, is whether the company can be conceptualized as an insider with a duty to disclose.

There is no doubt that the federal securities laws prohibit an individual corporate insider in possession of material nonpublic information from trading on that information unless he makes a disclosure.\textsuperscript{119} He must either disclose the information or abstain from trading.\textsuperscript{120} A justification for this “disclose or abstain” rule is to deny corporate insiders the opportunity to profit from the inherent trading advantage they have over the rest of the market by reason of their superior access to information.\textsuperscript{121} Arguably, the

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\textsuperscript{118} The SEC, in turn, is unlikely to expend its scarce resources in penalizing a company that, although arguably not strictly complying with the SEC’s disclosure requirements, is disclosing the type of information (forecasts) that the SEC would like it to.


\textsuperscript{120} See Chiarella v. United States, 445 U.S. 222, 226–28 (1980); SEC v. Adler, 137 F.3d 1325, 1332 (11th Cir. 1998); Shaw, 82 F.3d at 1203; SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc).

\textsuperscript{121} See O’Hagan, 117 S. Ct. at 2210 (justifying the misappropriation theory on the grounds that “[a]n investor’s informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck . . . [and] is a disadvantage that cannot be overcome with research or skill” (citing Victor Brudney, Insiders, Outsiders, and Informational
rule both eliminates the incentives that insiders would otherwise have to delay the disclosure of material information and minimizes any efficiency losses associated with the diversion of resources by insiders to "beating the market." As Judge Easterbrook and Professor Fischel put it: "The lure of trading profits may induce people to spend a lot of effort and other resources 'beating the market'; . . . the prompt disclosure of information by the affected firm will extinguish the trading opportunity. When everyone knows the truth, no one can speculate on it." \(^{123}\)

The articulated rationale for the disclose or abstain rule carries over to contexts in which a corporate issuer, as opposed to an individual, is the party contemplating a stock transaction. Courts have consistently shown the willingness to treat a corporation trading in its own securities as an insider for purposes of the disclose or abstain rule. \(^{124}\) To not apply the disclose or abstain rule to corporate issuers would allow them to exploit their informational trading advantage by delaying the disclosure of negative non-public news until after completion of the offering. \(^{125}\)

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The "trading advantage over the market" justification, however, has been criticized as inconsistent with the Supreme Court's rejection of the "equal access to information" theories in Chiarella and Dirks v. SEC, 463 U.S. 646 (1983). See Adler, 137 F.3d at 1335 n.24; cf. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Ban*, 52 WASH. & LEE L. REV. 1189, 1238–45 (1995) (arguing that insider-trading laws, as they stand, are inconsistent with the goals of investor protection and maintenance of confidence in the markets); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 174–75 (1998) (arguing that misappropriation theory is, at best, "tangential" to the goals underlying the securities laws).

122. *Shaw*, 82 F.3d at 1203. But cf. Bainbridge, supra note 121, at 1236–37 (arguing that efficiency losses connected with insider-related delays in disclosure would be minimal). Note, however, that Professor Stephen Bainbridge's argument focuses on individual insiders, not companies, as Shaw did.

123. EASTERBROOK & FISCHEL, supra note 22, at 288. Judge Easterbrook and Professor Fischel, however, reject the beating-the-market concern as a justification for mandatory disclosure. As noted earlier, they argue that companies will voluntarily disclose material bad news because, among other things, if a company consistently fails to make such disclosure, the market will discount the value of the company's securities by the increased probability that it is in possession of undisclosed material negative information, thereby increasing the company's long-run costs of raising capital. See id. at 288–89. However, as the authors also recognize, the argument for voluntary disclosure becomes considerably weaker when the short-term interests of the company's managers differ from its long-term interests. An example of this may occur when management is under high pressure to engineer a rapid turnaround in the company's financial performance. See id. at 169.

124. See Shaw, 82 F.3d at 1203–04 (citing cases); see also Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990); Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987); In re Fidelity/Micron Sec. Litig., 964 F. Supp. 539, 545 (D. Mass. 1997).

125. See Shaw, 82 F.3d at 1203–04.
Thus far, however, none of the cases applying the disclose or abstain rule to corporations has applied it in the context of a corporation selling securities to the public; the cases have all involved stock buy-backs from shareholders.126 But a number of commentators suggest that there is no reason to treat the two sets of cases any differently.127 After all, both types of cases involve company transactions with shareholders. To the extent one thinks about this in terms of duties to disclose, why should a company owe any less of a duty to disclose to a shareholder who is about to sell than to one who is about to buy?128

There is a fly in the ointment, however. In order to find an insider-trading violation under section 10(b), there first has to be a breach of a fiduciary duty.129 In the case of a corporation repurchasing stock from its shareholders without full disclosure of all material information, the breach of fiduciary duty arises in the following manner. The information that is the source of the trading advantage is the property of the company, which means the shareholders.130 To use this informational advantage against the existing shareholders is for the managers to, in effect, steal their informa-

126. See, e.g., Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966); McCormick v. Fund Am. Cos., Inc., 26 F.3d 869, 876 (9th Cir. 1994) (collecting cases) ("[T]he corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them."); Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963); Green v. Hamilton Int'l Corp., 437 F. Supp. 723, 728–29 (S.D.N.Y. 1977).

127. See 18 DONALD C. LANGENVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 3.02[1][d], at 5 (3d ed. 1994) ("Conceptually, extending the insider trading prohibition to instances of issuer insider trading makes perfect sense."); VII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1505 (3d ed. 1991).

128. As Professor Jill Fisch points out, the Supreme Court in Chiarella cited to the reasoning of Judge Learned Hand that "it would be a sorry distinction to allow [the insider] to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one." Chiarella v. United States 445 U.S. 222, 227 n.8 (1980) (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951)); see Jill E. Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, 26 GA. L. REV. 179, 194 & n.62 (1991); see also Alison Grey Anderson, Fraud, Fiduciaries, and Insider Trading, 10 HOFSTRA L. REV. 341, 357 (1982) (noting, nevertheless, that the Chiarella Court was careful not to adopt the reasoning of the SEC that would have extended the common-law duties of corporate insiders).

Further, Professor Joel Seligman observed that Justice Ginsburg, in effect, paraphrased that same Learned Hand language in her majority opinion in O'Hagan when she wrote: "[I]t makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result." United States v. O'Hagan, 117 S. Ct. 2199, 2210–11 (1997); Joel Seligman, A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems, 23 DEL. J. CORP. L. 1, 22 (1998).

129. See O'Hagan, 117 S. Ct. at 2207; Anderson, supra note 128, at 346; Fisch, supra note 128, at 194.

130. See O'Hagan, 117 S. Ct. at 2207.
tation from the shareholders.\textsuperscript{131} It is less clear when the breach of fiduciary duty occurs when the corporation is \textit{selling} securities to investors who are not yet owners of the corporation.\textsuperscript{132} In fact, in a case in which the negative information is not disclosed prior to an offering, one might say that the incumbent shareholders \textit{profit} by inducing the new share purchasers to pay a higher price than they would otherwise. And to the extent that one justification underlying insider-trading regulation is to protect property rights in information, permitting the owners of the information (the corporation and its current shareholders) to enter into transactions without disclosing, it would be consistent with such a justification.\textsuperscript{133}

One could counter that any profit to the existing shareholders would be short lived. The argument would be that, while the company may get more capital in the short run, having cheated shareholders should increase its long-run cost of raising capital (to the extent the market discovers the cheating) and hurt stock prices today. This would thus hurt the existing shareholders and benefit only the managers.\textsuperscript{134}

\begin{itemize}
\item[131.] Cf. Bainbridge, supra note 121, at 1252 (describing the property rights rationale underlying insider-trading law); Seligman, supra note 128, at 18 (noting Justice Ginsburg's use of the property rights theory in O'Hagan).
\item[132.] Note that the magic footnote in Chiarella, asserting that it would make no sense for the insider's duties to shareholders to apply only in cases in which the investors against whom the corporation was trading were existing shareholders, was citing to a section 16(b) case in which the insider's obligations explicitly go both ways under the statute. See Chiarella, 445 U.S. at 227 n.8; see also Fisch, supra note 128, at 194 n.62. I am grateful to Professors Fisch and Theil for pointing out that the incipient shareholder theory of fiduciary duties lies on a shaky foundation.
\item[133.] Cf. O'Hagan, 117 S. Ct. at 2207 ("[A] fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." (emphasis added)); Bainbridge, supra note 121, at 1252.
\item[134.] It is worth noting, however, that the basic economic justification for granting a property right in information to someone (that one needs to do so in order to incentivize them to produce the information) does not apply here because the concern is with information that has already been produced for other reasons. See Anthony T. Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. LEGAL STUD. 1, 11-14 (1978).
\end{itemize}

\textquote{However, as Professor Ayres points out, midrepresentations cannot increase a firm's cost of capital if the firm does not need to borrow from the external capital markets. A large proportion of corporate investment comes from the accumulated retained earnings of corporations. In the 1980s, for example, between sixty and eighty percent of all corporate investment came from internally generated cash. Ayres, supra note 32, at 961.
In sum, although the insider-trading analogy suggests that there should be a duty to disclose material negative information as to interim operational results, it is unclear whether such an extension could fit within the existing structure of insider-trading law with its requirement that there be a breach of fiduciary duty (or a similar relationship of trust and confidence). Further, to recognize a fiduciary duty-based duty to disclose running from corporations to prospective shareholders would, in effect, produce a duty to disclose all material information in an offering because the nondisclosure of any material information would give rise to a claim that the company traded on material nonpublic information.\textsuperscript{135} Such an expansion of the duty to disclose would, to a considerable extent, nullify the specific offering-based disclosure requirements of the Securities Act of 1933. It is unlikely that there will be such an expansion of the disclosure laws.\textsuperscript{136} Therefore, I proceed to search for an alternative basis in the disclosure laws that might produce the legal standard of disclosure that I suggest should exist.

D. The Statutory and Regulatory Scheme for Public Offerings

The viability of an insider-trading claim aside, one should note that an insider-trading claim is a Rule 10-b fraud claim for which a plaintiff is required to plead scienter and reliance.\textsuperscript{137} The statutory and regulatory framework that applies to public offerings, however, provides for companies to be strictly liable for material omissions and misstatements in a prospectus or registration statement. Complaints made under sections 11 and 12(2) of the 1933 act do not need to allege scienter or reliance and are generally not subject to the strict pleading requirements that apply to claims of fraud.\textsuperscript{138}

\textsuperscript{135} See \textit{In re Sofamor Danek Group, Inc.}, 123 F.3d 394, 403 (6th Cir. 1997), cert. denied, 118 S. Ct. 1675 (1998) (making the same point) (citing Jordan Eth & Michael Dicke, \textit{Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious}, 1 STAN. J.L. BUS. & FIN. 97, 109 (1994)).

\textsuperscript{136} But the following language from Justice Ginsburg's majority opinion in O'Hagan could be read to suggest otherwise: "In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." O'Hagan, 117 S. Ct. at 2207 (emphasis added).


\textsuperscript{138} See, e.g., \textit{Shaw}, 82 F.3d at 1217.
1. Liability Provisions

It is important to keep in mind that the rationale for suggesting a duty to disclose interim unripe data is to deter fraud, not to induce the production of information. Given that the only claims I argue should be permitted are, in effect, fraud claims—these would have to be pled with particularity whether under sections 11 and 12(2) or Rule 10b-5. But that discussion is for later. First, the basis for the duty and liability.

Sections 11 and 12(2) are the primary enforcement mechanisms for the mandatory disclosure requirements of the Securities Act of 1933. Section 11 imposes liability on signers of a registration statement and on underwriters, if the registration statement “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”139 Section 12(2) provides that any person who “offers or sells” a security by means of a prospectus or oral communication containing a materially false statement or that “omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading” shall be liable to any “person purchasing the security from him.”140 On its face, section 12(2) appears to apply only to misstatements and omissions therein, whereas section 11 covers omissions generally. Because the nondisclosure of interim information is an omission claim and not a half-truth claim, I shall focus on section 11.

The prospectus and registration statement become actionably misleading if investors reasonably expect certain information to be disclosed (i.e., material changes in unripe information) and it is not. What investors reasonably expect to have disclosed is the information “required to be stated” in the registration statement that is spelled out in Schedule A to section 7(a) of the Securities Act,141 and in the associated rules and regulations promulgated by the SEC. Specifically, section 7(a) of the Securities Act provides: “[T]he registration statement . . . shall contain such other information, and be accompanied by such other documents, as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.”142 Item 303 of Regulation S-K is the applicable SEC regulation.

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140. Id. § 77l(2).
141. Id. §§ 77g(a), 77aa.
142. Id. § 77g(a); see also id. § 77j(d) (granting the SEC similar authority with respect to prospectuses); id. § 77s(a) (granting the SEC authority to “make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this [act], including rules and
2. Item 303: Source of a Duty to Disclose

Regulation S-K covers information that registrants are required to disclose in both their offerings and their Exchange Act filings (such as their 10-Ks, 8-Ks, and 10-Qs). Item 303 covers the "Management's Discussion and Analysis of the financial condition and results of operations." Among other things, it requires that a registrant "describe any known trends or uncertainties [in operational results] that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues from continuing operations." Finally, these "material trends and uncertainties" have to be current as of the date of the offering because the effective date of the registration statement for purposes of Securities Act liability is the "speaking date" of the final prospectus.

I argue that the requirements of Item 303 (to disclose "known trends or uncertainties") can be read as covering material but unripe or intraquarterly data on operational results. More than one court, however, has suggested that disclosure claims brought on the basis of Item 303 fail because the provision does not give rise to a private right of action. That, however, confuses the issues. The question is not whether Item 303 gives rise to a private right of action; it is whether it produces a duty to disclose on the part of the company. If it produces a duty to disclose, then liability in the offering context arises under section 11 of the 1933 act, and in the non-

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143. Kitch, supra note 114, at 801-03 (describing Item 303 and its evolution).
144. 17 C.F.R. § 229.303(a)(3)(ii) (1998) (emphasis added). Section 303(a) refers to information relating to full fiscal years, while section 303(b) applies 303(a) to interim periods.
145. Glassman v. Computervision Corp., 90 F.3d 617, 631-32 (1st Cir. 1996); see Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1205 n.11 (1st Cir. 1996); see also HAROLD S. BLOOMENTHAL ET AL., SECURITIES LAW HANDBOOK § 5.05[2][f] (20th ed. 1997). Registrants who file using Form S-3 can satisfy the SEC's requirements by incorporating by reference their most recent 10-Ks and 10-Qs—they are not required separately to furnish in the prospectus the information required by Item 303 of Regulation S-K—but they are subject to the disclosure requirements of Item 11(a) that requires the issuer (registrant) to describe "any and all material changes in the registrant's affairs which have occurred since the end of the latest fiscal year for which certified financial statements were included in the latest annual report to security holders and which have not been described in a report on Form 10-Q or Form 8-K filed under the Exchange Act." Item 11(a) of General Instructions to Form S-3 in JENNINGS ET AL., supra note 4, 417-18 (emphasis added).

MD&A (including Item 303) requirements apply to the quarterly and annual financial filings of companies (their 10-Qs and 10-Ks) done on a periodic basis outside of the context of an offering. However, with this disclosure it is explicit that data are about the past and there is no representation that the information is current as of the date of the filing.

offering context under section 10(b) and Rule 10b-5 of the 1934 act. One
does not need to ask the question of whether there is a private right of
action under Item 303 because one already exists under section 10(b) and
section 11.

To the extent a rationale for rejecting a duty to disclose based on Item
303 is discernible, the rationale appears to be that Item 303’s standard for
disclosure is not merely what a reasonable investor would consider impor-
tant—the standard test for materiality—but what the company thinks is rea-
sonably likely to have a material effect.\textsuperscript{147} In other words, the Item 303 duty
of disclosure is not triggered merely because the information is material, but
only if management reasonably perceives it to be material. Management, in
effect, gets a business judgment layer of protection.\textsuperscript{148} But the fact that Item
303 has a standard for what is required to be disclosed that is above ordinary
materiality does not mean that it does not or cannot create an actionable
duty to disclose such information.\textsuperscript{149}

What a number of courts have done here is to confuse ripeness with
materiality. The set of information that Item 303 defines asripen and ready
to be disclosed is a subset of the set of all material information. But that is
okay. SEC regulations do not purport to require the disclosure of all mate-
rrial information. Instead, they choose the types of information of which dis-
closure is required, and if that information is material, private parties can
sue. But to say that an SEC regulation requiring disclosure can be ignored
because it imposes a higher standard for disclosure than that of ordinary
materiality is incorrect.\textsuperscript{150}

\textsuperscript{147} See Alfus, 764 F. Supp. at 608.

\textsuperscript{148} The link between the timing of corporate disclosure and the business judgment rule
was suggested back in 1968 by the Second Circuit in Texas Gulf Sulfur, in which the court said in
footnote 12:

\textquote{We do not suggest that material facts must be disclosed immediately; the timing of dis-
closure is a matter for the business judgment of the corporate officers entrusted with the
management of the corporation within the affirmative disclosure requirements promul-
gated by the exchanges and by the SEC.}


\textsuperscript{149} Cf. Gollub, supra note 146, at 316, 382 (noting that Item 303 provides for “enhanced”
disclosure requirements vis-à-vis the materiality standard articulated in Basic, Inc. v. Levinson, 485
U.S. 224 (1988)).

\textsuperscript{150} Exceptions to this line of cases include Wallace v. Systems & Computer Technology

This Article focuses on whether intraquarterly disclosure can be required in the offering con-
text. However, Simon, like a number of the other district court cases to have addressed the Item
303 question, arose in the nonoffering context. The district court in Simon held that because Item
303 created a duty to disclose that was actionable under Rule 10b-5, it must, under Shaw, require
intraquarterly data known at the time the 10-Q was filed to be disclosed. Simon, 945 F. Supp. at
431. The question in the nonoffering context, however, is not as easy as Chief Judge Ronald
Section 11 gives rise to a private right of action for the omission of information "required to be disclosed" in the registration statement. Section 7(a) of the Securities Act, apart from enumerating certain types of information that has to be disclosed, states that the registration statement "shall include" information required by the SEC in its regulations. The words "shall include" are within the ambit of "required to be disclosed" and hence should give rise to an actionable violation of a disclosure duty under section 11.\textsuperscript{151} Apart from the fact that such a reading is mandated by the statutory language, it makes sense from a public policy standpoint as well. Section 11 seeks to enable the public to adopt a role in the enforcement of complete and accurate securities disclosure.\textsuperscript{152} The complex nature of the securities markets and the vastly varying types of securities and investors make it wasteful to have every offeror of securities disclose the same quantity and type of information.\textsuperscript{153} Congress, in section 7(a), enumerated the basic types of information that had to be disclosed in a broad category of offerings, but it made sense for it to leave the more specific delineation of disclosure requirements for the different types of offerings up to the regulatory agency with the expertise. Item 303 falls under the category of types of information the SEC has specified are required to be disclosed, and hence nondisclosure should produce an actionable violation of the duty to disclose.

A second objection raised to suits based on Item 303 pertains to the language "known trends and uncertainties." Critics point to the words "known trends and uncertainties" and say that these words refer to forecasts or forward-looking statements and, hence, are not required to be disclosed.\textsuperscript{154} The phrase "known trends and uncertainties," as a general matter, undoubtedly includes forecasts and forward-looking statements. But the SEC had not forgotten its safe-harbor provisions when it enacted Item 303.

\textsuperscript{151} The same rationale should apply to claims brought under section 10(b) and Rule 10b-5. \textit{But cf.} Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998) (declining to decide whether Item 303 based claims, while sufficient to support sections 11 and 12(2) based liability, are sufficient to support liability under section 10(b)).


\textsuperscript{153} \textit{See Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1204 (1st Cir. 1996)} (citing cases).

\textsuperscript{154} \textit{Cf. JENNINGS ET AL., supra} note 27, at 234 (noting the confusion in interpreting the SEC's MD&A requirements).
To the contrary, the SEC makes it clear in the instructions to Item 303 that it is referring not to the disclosure of forecasts, which are covered by Rule 175’s safe-harbor provisions. The instructions further make clear that the “uncertainty” that is referred to is that in forthcoming results—full-quarter or full-year data—and that the information required to be disclosed is hard data that is currently known but might lead an investor to perceive uncertainty/changes in forthcoming full-term data that a reasonable investor would not perceive from the already disclosed information. Hence, it requires disclosure of certain unripe information.

To rephrase, Item 303’s requirement that “known trends and uncertainties” have to be disclosed should be read in the context of the SEC’s clear instructions that forecasts do not have to be disclosed, but hard information about the current or immediate past that might materially change an investor’s perception of the company’s future does have to be disclosed. The word “uncertainties” must mean uncertainty vis-à-vis full-quarter or ripe information that will later be released in proper form. This information will help investors forecast the results for the current quarter and more, but that does not mean that the firm has to disclose its forecasts—just the underlying hard information. To read Item 303’s requirement of disclosure of “known trends or uncertainties” as meaning that forecasts have to be disclosed would contradict the instructions of Item 303 itself, which explain that the firm’s internal forecasts do not have to be disclosed.

E. What Should Companies Do?

As things stand today, companies are uncertain as to whether or not they have to disclose information about intra-quarterly results and even if so, how and how much. However, with a legal regime that imposes a duty to disclose intra-quarterly data that indicates an extreme departure from previ-

155. See 17 C.F.R. § 229.303(a), Instruction 7 (1998); see also Kitch, supra note 114, at 803 (noting Item 303’s requirements have to be read in light of the safe-harbor provisions of Rule 175).

156. Instruction 3 states that “[t]he discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.” 17 C.F.R. § 229.303(a), Instruction 3.

Instruction 7, in turn, states that “[r]egistrants are . . . not required to supply forward-looking information. This is to be distinguished from presently known data which will impact upon future operating results, such as known future increases in costs of labor or materials. This latter data may be required to be disclosed.” Id. at Instruction 7.

ously anticipated results, the answer as to what companies should do is easy; they should disclose their internal forecasts when these forecasts show that the results for the quarter in progress are likely to be significantly out of line from those in the past. Disclosing the data in the form of a forecast will put the company squarely within the safe harbor for forecasts and absolve it from possible liability so long as the forecast is reasonable.\footnote{158}

But companies and their lawyers will no doubt ask: (1) Does this new duty mean that when we do offerings we will have an affirmative duty to collect our intraquarterly information and examine it to see whether or not it is material? (2) What if we, for internal cost-related reasons, do not collect and evaluate information until the quarter is over? (3) Does this obligation apply only to end-of-quarter offerings? (4) Are we exempt if we time our offerings to be at the beginning of a quarter?

The disclosure of information by public companies, in and of itself, is beneficial. The more information investors have, the better able they are to make optimal investment choices. The more information the market has, the more likely it is that capital will flow to the projects with the best risk-return trade-offs. Disclosure of accurate and full information is especially crucial in the offering context because here the market directly evaluates whether to fund a company, its managers, and their proposed projects.

\footnote{158. Technically, under the new Securities Act, a forecast does not have to be reasonable (let alone be made in good faith) for it to fall into the statutory safe harbor. It is enough that the forecast be surrounded by cautionary language that makes it clear that the investors should be aware that the forecast is an uncertain projection about the future and might not actually turn out to be true. See Kuehne, supra note 79, at 132. This elimination of the reasonableness requirement has been criticized by some, including President Clinton, as creating a situation in which completely fraudulent forecasts can be made without fear of liability. Cf. Jennifer O’Hare, Good Faith and the Bespeaks Caution Doctrine: It’s Not Just a State of Mind, 58 U. PITT. L. REV. 619, 621 (1997) (discussing the absence of a state of mind requirement in the new statutory safe harbor).

In the context I focus on, however, the forecast made by the company will still have to be reasonable in order to protect the company from liability. The reason for this is that here the plaintiff’s attack will not be on the reasonableness of the forecast itself, but on whether disclosing the forecast made disclosure of the underlying unripe information immaterial. If the forecast was unreasonable, it might be protected by the safe harbor itself, but it would not cause the underlying undisclosed unripe information to be insulated from liability.

In any event, it is unclear that giving forecasts the protective cloak of the “bespeaks caution” doctrine really does protect companies from liability for fraudulent statements. The basis of the bespeaks caution doctrine is the rationale that if your forecast is couched in enough cautionary language an investor will know not to attach undue weight to it. However, what sort of cautionary language would make a totally fraudulent statement immaterial? It is hard to imagine anything except a statement that says: “This forecast is a lie and is here for the sole purpose of misleading you into buying when you should be selling.” Extracautionsary language may protect a company when it makes forecasts outside the reasonableness ball park, but it does not appear to me to extend (at least in the case of ordinary boilerplate cautionary language) to fraudulent statements.
for the future.\textsuperscript{159} If the market does not like the company's future prospects, it can send a signal by refusing to fund the offering. In the secondary market context, in which a company is evaluated on the basis of its periodic disclosures (such as its 10-Ks and 10-Qs), the market still sends a signal to the company and its management through its demand for the stock (via the stock price), but the impact on management is more attenuated.\textsuperscript{160}

Although disclosure of material information is, on its own, beneficial, Item 303's focus is not on maximizing disclosure per se. Instead, its focus is on avoiding fraud or strategic nondisclosure by companies. Companies that have not processed their information, and hence do not know that there is a material trend or uncertainty, are not obligated to disclose—their obligation is merely to collect the information and process it within the time specified by the SEC. Therefore, the obligation under Item 303 attaches to companies who, for reasons independent of the SEC's requirements, have produced information.

Item 303 says that it is known trends and uncertainties that have to be disclosed, not unknown ones. Knowledge that a material trend or uncertainty exists is crucial for the duty to disclose to apply. The company, however, is not required to incur expenditures, over and above what it would otherwise, to produce this information. Instruction 2 to Item 303(a) states: "The information provided pursuant to this Item need only include that which is \textit{available to the registrant without undue effort or expense} and which does not clearly appear in the registrant's financial statements."\textsuperscript{161}

In addition, the SEC's 1989 release detailing the Management's Discussion and Analysis obligations explains that the SEC contemplates companies going through a two-step process. Step one is triggered when the company's management (not just any employees) "knows" that there is a "trend, demand, commitment, or uncertainty." What step one triggers in terms of step two is a "duty to assess the known information and evaluate whether the trend or uncertainty is likely to come to fruition."\textsuperscript{162}

\textsuperscript{159} See discussion \textit{infra} note 247.

\textsuperscript{160} Although the market does not directly withhold funding from the company (as it would in the case of the market not funding an offering), the company's stock price can probably affect secondary sources of funds such as the private debt market.

\textsuperscript{161} 17 C.F.R. § 229.303(a), Instruction 2 (emphasis added).

\textsuperscript{162} The difference between the SEC's step one and step two confirms an earlier conclusion, which was that "known trends and uncertainties" refers to hard intraquarterly data and not the companies' internal forecasts—the word "uncertainty" referring to the fact that the quarter was not over as yet. The reason the division of the evaluative process into step one and step two supports my analysis is that in step one management recognizes that it has hard information (i.e., data as to the "known trend or uncertainty"), and then in step two it evaluates that "known" information in terms of a forecast, by asking whether the known trend or uncertainty is likely
answer to the forecast made in step two is “no,” the company has to go no further; if the answer is “yes,” the company must disclose the underlying hard information that made it likely that the trend would come to fruition.\textsuperscript{163} In sum, the SEC clothes companies in two layers of protection. First, the duties of Item 303 are only triggered if a company “knows” it has information as to a trend or uncertainty, and, second, it is only obliged to disclose the information if the company, in its business judgment, determines that information to be material.

Therefore, what the SEC’s regulations impose in terms of disclosure of unripe information is not a duty to disclose all material information, but only a duty to disclose information that the company knows and recognizes to show an extreme departure from what was otherwise expected for the quarter in progress.\textsuperscript{164} To the extent this interpretation of Item 303 is plausible, therefore, the disclosure rule that arises is the one that I suggested would optimally deter fraud while not causing companies to incur unneeded expenditures in producing information.

Thus far, I have identified both a theoretical framework in which to understand the duty to disclose intraquarterly data and a regulatory basis for requiring such disclosure. The next question is how, in practical terms, a court can, and should, draw the line between offerings in which the disclosure of intraquarterly operational results should have been made and those in which it need not have been made.


To rephrase, “known trend or uncertainty” refers to hard unripe information and “whether or not this will come to fruition” is the company’s internal evaluation as to whether this unripe information could cause the full-quarter information to be a material departure from what was expected.

\textsuperscript{163} The company is required to make an internal forecast of what full-quarter results will be in order to evaluate the value/materiality of the underlying hard information. It is not required to disclose that forecast, but rather only the underlying information.

\textsuperscript{164} The extreme departure standard was announced by the First Circuit in Shaw v. Digital Equipment Corp., 82 F.3d 1194, 1210 (1st Cir. 1996), and reiterated in Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996). Cf. also In re Sofamor v. Danek Group, Inc., 123 F.3d 394, 402 (6th Cir. 1997), cert. denied, 118 S. Ct. 1675 (1998) (dismissing a claim brought on the basis of Item 303 because the company could not have known with the degree of assurance contemplated by the instructions to Item 303 that the merchandising practices in question would have had an adverse impact on future operating results). But cf. Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1298 n.1 (9th Cir. 1998) (expressing a need for caution in interpreting Item 303’s language as articulating the equivalent of an “extreme departure standard”).
IV. LINE DRAWING BETWEEN THE CASES: SHAW AND GLASSMAN

A. Factors Indicating Motive and Opportunity to Act Strategically

The line drawing to be done is between those cases (complaints) that deserve judicial scrutiny and those that should be thrown out at a threshold stage. The theoretical story in Part II identified certain circumstances that might indicate the likelihood of a firm’s strategic nondisclosure, such as the existence of final-period problems and the use of a shelf offering to do an offering late in a quarter. In this part, I describe the factors that might suggest strategic behavior of the kind hypothesized and then look at the use of these factors in the two circuit cases that have tackled the issue in greatest detail, Shaw v. Digital Equipment Corp. and Glassman v. Compuvision Corp.

1. Suspicious Timing

The obvious factor indicating a company’s likely knowledge of significant information concerning the quarter in progress is the closeness of the offering date to the end of the quarter. First, other things equal, the closer the offering date is to the end of the quarter, the more likely it is that the company knows what the quarterly results are likely to be. Second, the closer the offering date is to the actual announcement of the negative information, the more likely it is that the company knew of the information as of the offering date. For example, if the offering was done three days before the end of the quarter, and three days after the end of the quarter the company announces that quarterly results for the quarter just concluded are going to be terrible, the circumstances are suspicious. Hence, timing is important in two ways: first, the closeness of the offering date to the end of

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165. 82 F.3d at 1194.
166. 90 F.3d at 617. Judge Bassler’s holding in Zucker v. Quasha, 891 F. Supp. 1010, 1015 (D.N.J. 1995), that there was no duty to disclose intraquarterly data was appealed to the Third Circuit. A panel comprised of Judges Walter Stapleton, Anthony Scirica, and Robert Cowen affirmed the district court’s opinion in an order without even hearing oral argument. See Zucker v. Quasha, 82 F.3d 404, 408 (3d Cir. 1996). The implication of such a “without comment” affirmation, under the circuit’s internal rules, is that the panel thought the issues of the case squarely decided by existing case law and not worthy of an opinion that might clarify the issues for the public. See Mitu Gulati & C.M.A. McCauliff, On Not Making Law, 62 J.L. & CONTEMP. PROBS. (forthcoming 1999) (discussing the disposition in Zucker); U.S. Ct. of App. 3d Cir. App. I, IOP 5.3, 28 U.S.C.A. (1998). The plaintiffs subsequently filed a certiorari petition, which also was denied. See Zucker v. Quasha, 117 S. Ct. 85 (1996).
the quarter and, second, the closeness of the information release date to the end of the quarter. 167

Note, however, that timing alone cannot be indicative of the company’s knowledge that there was material information. To have such a rule would force companies that do not produce internal updates of information to either do so or only do their offerings at the beginnings of quarters. If they do not constrain themselves to doing offerings at the beginnings of quarters alone, plaintiffs will be able to induce legal scrutiny solely by the fact that the offering was done close to the end of a quarter. To force all companies that do offerings at the end of quarters to produce information or postpone their offerings would contradict the SEC’s intent in enacting Item 303, which was to impose disclosure obligations only on those companies that knew the information. Therefore, while timing can and should be an important factor in a court’s decision to impose scrutiny, it should not be conclusive.

2. Internal Forecasts Showing Extreme Departures from Expectations

Remember that the SEC’s release envisioned a two-step process for the disclosure of material unripe data. First, the company had to have information indicating a trend or uncertainty. Next, it had to evaluate whether or not that trend or uncertainty was likely to come to fruition and was material. The second stage, when the company evaluates whether or not the trend or uncertainty will come to fruition, is when the company makes an internal forecast using its unripe data to see whether it produces an estimate of end-quarter results that is an extreme departure from what was otherwise expected. In other words, the company’s recognition, through its own forecasts, that the intraquarterly hard information produces an extreme change in expectations is key in the Item 303 disclosure process. 168 Hence,

167. I acknowledge, however, that a company recognizing that a court will look to how close the offering date was to the announcement date of the information can easily delay announcement. Hence, the lack of proximity of the announcement date to the offering date should not be a factor that is given too much weight. But if a company makes the mistake of timing its announcement very soon after the offering date, this can be a basis to impose heightened scrutiny.

168. There is a second and more subtle point that relates to materiality and the requirement that an extreme departure be demonstrated. Item 303’s disclosure requirements focus on material changes in what the market expects. But there can be material information that does not represent a change in expectations. Under the duty to disclose that I have identified, this type of material information is not required to be disclosed. See Steckman, 143 F.3d at 1298 (ruling that, in an IPO conducted less than three weeks prior to the end of the fourth quarter, a company was not obliged to disclose data as to a fourth-quarter slowdown when the slowdown did not look different from the regular pattern of fourth-quarter slowdowns).
if a plaintiff plausibly can allege that the company had internal forecasts predicting extreme departures from what was expected, then that should indicate a likelihood of some undisclosed hard information that should have been disclosed, but was knowingly concealed.

But one has to be careful here. Companies often make a myriad of internal forecasts based on all sorts of hypothetical and highly unlikely scenarios. That one or two forecasts show an extreme departure is not likely, by itself, to mean that the company had intraquarterly information suggesting extreme changes in the current quarter's results vis-à-vis earlier expectations. Rather, one needs to watch for the situation in which most of the company's forecasts, if not all, showed an extreme departure. 169

Think, for example, of a horse race. At the beginning of the horse race, one might have an expectation that the horse "Cigar" will win. The race begins. Nine-tenths of the race is complete. Cigar is performing exactly as expected. He is leading by two lengths, with only a tenth of the race to go. Now, if I were an investor/bettor, I would not be indifferent to the information that Cigar was leading by two lengths, even if this is exactly what I had expected. It would be valuable to me to know that my expectations were being confirmed. Further, given a choice between placing my bet at the beginning of the race or after nine-tenths was over, I would choose the latter. Why? Because at the latter stage there is only a tenth of the race left for something contrary to my expectations to happen (for example, the jockey could feel ill, Cigar could trip, etc.).

Economists explain this in terms of mean and variance. It is not just the expected return on an asset that is important to investors, but also the variance. Information that one's expectations are being confirmed reduces variance and makes an asset more valuable. Hence, information that things are going precisely as expected, nine-tenths of the way through a quarter, is likely to be material. But Item 303 does not require its disclosure. It is only material changes in expectations that have to be disclosed, and only changes that management could not reasonably ignore. Once one accepts that information that would produce material changes in expectations has to be disclosed, the argument can be made that nondisclosure is the equivalent to telling the market that there are no material changes in expectations. But this simplifies things too much. Think back to the horse race example. Nine-tenths of the race has passed and Cigar is leading by two lengths. What if your expectation was that when nine-tenths of the race was over Cigar would be leading by anywhere between one and three lengths? Assume now that my agreement (me being the person who is reporting the progress of the race to you) is that I report to you only if there is a change in expectations. So I do not tell you anything because Cigar's lead is within expectations. But would not it have been valuable to you to know the precise lead nine-tenths of the way into the race?

Not requiring disclosure of precise updates of intraquarterly information, even though such updates may be material, makes sense within the framework in which I have been thinking of the disclosure of unripe information. The focus of the particular disclosure requirements at issue is to avoid strategic nondisclosure on the part of the company (primarily of negative information), as opposed to serving a goal of enhancing the accuracy of the information available to investors. The company has far less of an incentive to act strategically if the information is within the range of investor expectations because the gains to management from any possible nondisclosure will be far less. 169. Courts, however, have been hostile to plaintiffs' arguments as to the existence of information based on the company's internal forecasts. See, e.g., Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996) ("Plaintiffs' nondisclosure claims fail because they base their allegations solely on discrepancies between actual (but undisclosed) intra-quarterly
3. Unusual Preoffering Trading by Insiders

In deciding whether to give a claim scrutiny, a court should look for signals indicating that the company knew that it had information predicting an extreme departure in the upcoming quarterly results. A significant amount of preoffering/disclosure trading by insiders indicates that at least some portion of the management had information unavailable to the public. This factor should not be dispositive, however, because it is quite possible that an insider knew of information and traded on it, but the company's top management did not know of it.170 Remember that "knowledge" means knowledge by the top managers. Because the goal is to deter strategic behavior by managers who may be facing final-period problems, the focus should be on examining the trades of the same top management that also has the power to time the offering.171

Further, insiders could be trading because they believe that they can predict the company's fortunes better than the market (with the same information and [the company's] undisclosed internal projections." (citing In re VeriFone, 784 F. Supp. at 1484)); In re VeriFone Sec. Litig., 784 F. Supp. 1471, 1484 (N.D. Cal. 1992) (finding that, in order to assert a valid claim under the federal securities laws, plaintiff must "establish a link between a misleading statement or implication in the prospectus and an actual fact, not a speculation about the future, omitted from the document"); see also In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1419 (9th Cir. 1994). The logic appears to be that because companies do not have to disclose internal forecasts, it is unfair for plaintiffs to use the internal forecasts to require the disclosure of other information. This logic is wrong.

The fact that information changes a forecast is what makes the information important to an investor. The duty to disclose intraquarterly data that I have identified is contingent on the company's knowledge that this information is material. The best way to show that the company knew that this was material is to show that it used the information to produce forecasts showing extreme departures from expectations.

Perhaps what the courts are saying here is that it is not enough for plaintiffs to point to internal forecasts revealing extreme departures, but rather that they have to allege that those internal forecasts were based on hard information that was undisclosed.

170. In most instances a company is likely to look unfavorably at company insiders doing trades that the market perceives as unfair.

amount of information). To the extent that insiders are not acting strategically to take advantage of an informational advantage vis-à-vis information for which there is a duty to disclose, allowing them to trade serves the useful purpose of incorporating into the price their predictions about the future of the company. But to the extent that, prior to the offering date, top managers are trading on undisclosed and significantly negative intraquarterly data, their trades should be one indication that strategic nondisclosure may be occurring.

4. Indicia of Managerial Desperation

So far I have discussed signals that might indicate that the company knew that it had unripe information that was required to be disclosed. As Part II discussed, however, courts need to keep in mind that there is an effective system of nonlegal sanctions that polices disclosure in all but a small subset of cases. These cases are composed primarily of those situations in which the management perceives itself to be facing the final period of its managerial life. In this context, the high-wage managers are in danger of being labeled failures and hence getting eliminated from the high-wage managerial market as a whole. These conditions can manifest themselves when the management as a whole is facing termination, such as takeovers, bankruptcy, or a purge of existing management by the shareholders themselves. Hence, courts evaluating claims that a company knowingly did not disclose information regarding extreme changes in its trends for the quarter thus far should review the evidence and consider the final-period problem.

172. This boils down to an insider’s informational advantage in forecasting ability, as opposed to one in hard material information. It is the latter about which I am concerned. In reality, insiders are always likely to have small pieces of fuzzy information that could lead them to trade a few shares (e.g., information that the CEO has been looking sleepy, tired, and upset lately). See Fried, supra note 21, at 317–25 (describing the “excess returns” that company insiders have consistently earned on their trades). Once again, however, my concern in this Article is not with these small pieces of information.

173. There is the danger that if companies perceive themselves to have an increased vulnerability to legal liability when their insiders make preoffering trades, companies might bar such trading altogether (including the socially valuable trading that is based on soft information alone).

174. As Professor Jesse Fried notes, company insiders do trade profitability on advance information. See Fried, supra note 21; see also David Yermack, Good Timing: CEO Stock Option Awards and Company News, 52 J. FIN. 449, 450–51 (1997). There is reason to expect, therefore, that plaintiffs in legitimate suits (even without the benefits of discovery) will be able to include evidence in their complaints (of unusual insider trades) indicating that the company was hiding negative information. An interesting question that I have not addressed is whether trading by an insider might create, on the part of the company, a duty to disclose the nonpublic information on which the insider traded. Such a duty was suggested in both Roeder v. Alpha Industries Inc., 814 F.2d 22, 27 (1st Cir. 1987), and Shaw, 82 F.3d at 1202 n.3, but to my knowledge no court has applied it as yet.
5. Reduced Effectiveness of Gatekeepers

Just as managers behave in accordance with the wishes of the nonresident shareholders because of their fear of reputational sanctions from the market (both the managerial labor market and the firms’ capital market), so also do the underwriters, auditors, and lawyers. The underwriters, auditors, and lawyers who sell their services to the firms doing public offerings are in a sense selling their reputations. An investor purchasing stock in an offering underwritten by Goldman Sachs (who has hired Cravath, Swaine & Moore as counsel and Arthur Anderson as accountants to help prepare the offering documents) is likely to believe that the deal is safer than ones that do not have such marquee names on the offering documents. Because a large part of what the underwriters, auditors, and lawyers sell is their reputation, they have an incentive to police potential wrongdoing by the company. Further, if they ignore signals indicating that the company is hiding something from them, they are violating their duty to investigate. Failure to perform a proper investigation will not only hurt the reputations of these service providers, but also subject them to legal liability for a failure to do due diligence. However, as with the reputational sanctions on lawyers, the incentives that underwriters (or lawyers or accountants) have to act as gatekeepers against strategic behavior by the company can break down.

One such situation is the one Shaw identified, which was the case of an S-3 shelf offering in which competitive pressures and the short window of time available to do diligence made it impossible to do a thorough investigation of the company. In contrast, the situation in Glassman, which involved an initial public offering (IPO), was one in which the court saw the underwriter/lawyer gatekeeping role as working effectively.

6. The Ability to Precisely Time One’s Offering

Public offerings are expensive propositions. Further, in most offerings, companies do not have much control over the precise timing of the offer-

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175. See, e.g., supra note 84 (citing studies).
177. See Glassman, 90 F.3d at 628.
178. See Shaw, 82 F.3d at 1208–10.
179. See Glassman, 90 F.3d at 630.
ing. Offerings can be delayed (as they sometimes will be if the market is particularly weak), but these delays can be enormously expensive because they usually require the updates of diligence and the information already in the prospectus (and in some cases the SEC may require the filing of an entirely new registration statement). The point is that, in general, companies do not have much control over when they do their offerings. Hence, it is unlikely that a company doing an IPO (i.e., filing on a Form S-1, the most cumbersome of the forms) will be able to control the disclosure of negative information just prior to an offering. For this opportunity to arise, it must be a coincidence that the offering becomes ready late in a quarter in which the results are far worse than what they were in the past. But so far I have emphasized that the focus of the interim disclosure requirement is on deterring strategic behavior. Strategic behavior tends to be planned, not coincidental (although I do not rule out the possibility of the latter). A prime candidate for strategic behavior is a company that uses Form S-3 to do a shelf offering. S-3 is a streamlined form designed precisely to allow companies to time their offerings to take advantage of market conditions. The streamlined nature of the form and the fact that updates can be done easily and cheaply enables a company to postpone doing its offerings (or parts thereof) until the conditions are right. As discussed, the SEC gave companies this ability to time their offerings so that they could take advantage of factors like interest rates swings and perhaps even high spirits on the stock market, but not to take advantage of the ability to hide negative news while selling securities. Thus, at the very least, courts should be somewhat suspicious when a company with the ability to time its offering decides to pinpoint it right before the end of a quarter whose results turn out to be terrible.

The foregoing discussion laid out some of the signals to which courts could look for an indication that management had both the motive and opportunity to cheat the public. To summarize, in terms of opportunity, courts could look to factors such as the timing of the offering and the firm’s practices regarding the production of up-to-date information for internal purposes—these will serve as indicators of whether top management knew

180. See Bradford, supra note 89, at 605–06.
181. Cf. id. (noting that SEC review of the initial registration forms in an S-1 offering is quicker than that for S-3 and S-2 offering registrations). Note that an issuer may not finalize sales until its registration statement has passed SEC scrutiny and been declared “effective” by the regulators. See 15 U.S.C. § 77e(a) (1994).
that the quarter's results were going to be extremely bad before the date of the offering. Further, courts should look to institutional factors, such as the level of gatekeeper scrutiny or the independence of the board of directors, that indicate the existence of room for the managers to act strategically in not disclosing known negative information prior to the offering.\(^{183}\) In terms of motive, courts could look for circumstances indicating desperation on the part of top managers as a whole to either preserve their high-wage jobs or to extract a large final payment before being terminated.

I next examine the two circuit court decisions that have most closely examined the duty to disclose interim results in the offering context in light of the preceding factor analysis.

B. Shaw and Glassman

The First Circuit's two recent opinions on intraquarterly disclosure in the offering context illustrate the tricky problem of line drawing between cases that should receive legal scrutiny and those that should not. The opinions illustrate a desire to deter frivolous litigation, but also recognize that the nonlegal sanction/gatekeeping mechanisms can break down on occasion.


Shaw involved a 1994 public offering of $400 million in securities by Digital Equipment Corporation, one of the world's most prominent manufacturers of mainframe computers.\(^{184}\) A major player on the world computer markets in the 1980s, Digital's fortunes had taken a sharp turn for the worse in the 1990s, in part, as a result of technological advances in personal com-

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183. In addition to the disclosure regulations of the SEC, the private exchanges themselves have disclosure rules for their member companies. These internal exchange rules require the disclosure of all material information. As an initial matter, my sense is that while the exchanges can exercise muscle to punish small, new companies that do not fully disclose all material information, they are reluctant to exercise this muscle with the IBMs of the world. It is the IBMs of the world, however, that I am worried about in the context of the nondisclosure of negative intraquarterly data.

In terms of internal exchange rules, the NYSE rules provide that a corporation "is expected to release quickly to the public any news or information which might reasonably be expected to adversely affect the market for its securities." NEW YORK STOCK EXCHANGE LISTED CO. MANUAL S 202.05 (1993). Similarly, the NASD requires that issuers on NASDAQ disclose to the public "any material information which might affect the value of its securities or influence investors' decisions." NATIONAL ASSN OF SECURITIES DEALERS MANUAL, sched. D, pt. II, S 16 (1995).

puters. However, publicly, Digital’s management was showing signs of turning things around at the time of the offering in question. After a number of quarters of large negative earnings, losses were becoming smaller and Digital’s management was forecasting that the company would soon “break even.”

The upturn in the company’s fortunes was good news for the existing management because the company had been going through massive layoffs, including the firing of its CEO. In addition to appearing to be stemming the flood of losses, management had the innovative new “Alpha” technology that it hoped would change Digital’s fortunes for the better. Being a well-established, highly capitalized firm that had not defaulted on any of its debt, Digital was eligible to do its public offering pursuant to the SEC’s Form S-3.

Against this background, on January 21, 1994, Digital filed a shelf registration statement with the SEC giving it the option to issue up to $1 billion in debt and equity. Then, eleven days before the end of the third quarter of 1994, Digital did a take-down of $400 million of securities from the shelf. The offering closed a week later, four days before the end of the quarter. Less than three weeks later the company announced a third-quarter operating loss of over $183 million. The loss was far greater than what analysts had been expecting and bucked the positive trend of reduced losses under the company’s new management. The announcement resulted in the price of Digital’s stock dropping by approximately a third within a day.

There was more. Along with its announcement of disappointing third-quarter earnings, Digital also announced that instead of the previously projected $443 million restructuring charge disclosed in the offering prospectus, it instead planned to take a $1.6 billion charge for the fiscal year 1994. Disappointed shareholders filed suit shortly after the stock price dropped, alleging, among other things, that Digital had withheld material

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185. See id. at 1199–200.
186. Id.
187. See id.
188. See id.
189. See id.
190. See id.
191. See id.
192. See id.
193. See id.
194. See id.
195. See id.
intraquarterly data and that its statement about reserves was a misstatement.196

As tends to be the situation in such cases, the battle in Shaw was fought around the motion to dismiss.197 The district court judge, Chief Judge Joseph Tauro, granted the motion to dismiss, finding that Digital had violated no duty to disclose and that none of Digital’s statements had been misleading.198 The First Circuit then reversed, in part, on the duty-to-disclose material unripe information issue and the statement about reserves.199 In finding that the plaintiffs had made out a claim adequate to cross the motion to dismiss threshold, the court identified the factors that were important in its decision to reverse.

The court emphasized that this was an S-3 offering in which the offeror had the ability to pinpoint the offering date.200 The court recognized that in such offerings underwriters are not always able to perform their gatekeeper functions adequately, owing to the short amount of time they have to prepare the offering.201 The court acknowledged that, in many cases, firms will disclose information voluntarily, but pointed out the existence of final-period problems.202 Although the court did not explicitly fit the facts of this case into the final-period problem box, the fact that management was getting fired at the highest level made it look like a desperate situation. Plus, management appears to have needed capital to both fund a restructuring (which was not announced until after the offering) and the development of the new Alpha technology. The opportunity was ripe because results from Digital’s past few quarters had made the market optimistic about its future. That optimism was likely to change once the results of the third quarter of 1994 came out showing a loss far beyond what had been expected based on the past year’s results. Hence, the offering, timed to end just four days prior to the end of one of the worst quarters Digital had seen in a long time, looked suspicious. Soon after raising the $400 million in the offering (and on the same day that it announced that third-quarter losses were going to be in the realm of $183 million), Digital

196. See id. at 1201.
197. Cf. Jared L. Kopel, Procedural Reforms, in SECURITIES CLASS ACTIONS, supra note 132, at 107, 129 (noting how once plaintiffs in securities actions are able to cross the motion to dismiss threshold into the realm of imposing discovery costs on defendants, they are likely to be able to extract settlements).
198. See Shaw, 82 F.3d at 1201.
199. See id at 1201, 1225.
200. See id. at 1204, 1208–09.
201. See id at 1208–09.
202. See id.
announced a four-fold ($1.2 billion) increase in its restructuring reserves.\textsuperscript{203} Given these factors: (1) the ability to time the offering; (2) the probable lack of gatekeeping; (3) the timing of the offering at the end of a quarter that was by far the worst in recent memory; (4) management’s fear of job loss; and (5) the need to take the company down a completely new path in terms of long-term strategy (and, presumably, the need for funding for this new strategy), the case simply looked suspicious. Digital’s top management had both the motive and the opportunity to behave strategically by using its previously earned goodwill to dupe the market into thinking that the company was continuing its recent resuscitation.

2. \textit{Glassman v. Computervision Corp.}

In \textit{Glassman}, in contrast to \textit{Shaw}, the First Circuit rejected the plaintiff’s appeal of the district court’s grant of a motion to dismiss.\textsuperscript{204} Unlike \textit{Shaw}, \textit{Glassman} involved a company issuing securities on the public market for the first time. The offering was done pursuant to the cumbersome and expensive Form S-1 as opposed to the streamlined Form S-3.

The company in \textit{Glassman} was Computervision Corporation, the world’s leading manufacturer of CAD/CAM software. Computervision had had nothing but large losses in its previous three years, but was doing its offering on the claim that the future was brighter.\textsuperscript{205} Its offering documents disclosed that it planned to switch strategies from both software and hardware to focusing on software alone.\textsuperscript{206}

Among Computervision’s primary owners was Shearson Holdings, which was also a primary debt holder of the company.\textsuperscript{207} The offering was explicitly meant to produce funds that would, in part, retire some of the debt owed to Shearson.\textsuperscript{208} Shearson did, however, warrant to the market that to avoid any incentive it might have to deceive the public in the offering, it would promise not to sell any of its equity in the company until one year after the offering date (by which time, presumably, any negative information about the company that Shearson might have been hiding would have come out).\textsuperscript{209} In addition, because one of the underwriters for the offering, Shearson Lehman Brothers, was an affiliate of Shearson

\begin{itemize}
\item \textsuperscript{203} See id. at 1201.
\item \textsuperscript{204} See Glassman v. Computervision Corp., 90 F.3d 617, 620 (1st Cir. 1996).
\item \textsuperscript{205} See id. at 620 n.5.
\item \textsuperscript{206} See id. at 620.
\item \textsuperscript{207} See id. at 620 & n.4.
\item \textsuperscript{208} See id. at 620.
\item \textsuperscript{209} See id.
\end{itemize}
Holdings, special independent underwriters were appointed to do the underwriting.210

The IPO was done on August 14, 1992. Computervision sold $600 million of securities in a firm-commitment underwriting.211 This was approximately midway (seven weeks) through the quarter in progress.212 Six weeks later, on September 29, and right at the end of the quarter, the company announced that earnings were likely to be less than expected. The stock price plummeted 30% in a day, and, almost instantaneously, shareholders filed suits in federal courts in both New York and Boston.

The shareholders’ primary complaint was that material intraquarterly information, known to the company at the time of the offering, was neither disclosed nor incorporated into the offering price.213 The district court judge, Judge William Young, rejected the claims and granted the defendants’ motion to dismiss, finding that the plaintiffs’ claim reduced to no more than a complaint that the stock price had fallen and that the company should have disclosed its internal forecasts.214

This time, unlike in Shaw, the First Circuit upheld the district court’s decision. Both cases involved claims that material unripe information regarding the quarter in progress was not disclosed in the offering documents. Although Glassman has been interpreted as a cutback on Shaw,215 it is actually consistent with Shaw’s focus on imposing heightened legal scrutiny when there are indicia of a breakdown in nonlegal checks and managerial desperation.

Glassman involved an IPO with heavy underwriter due diligence (in fact, extra due diligence because of NASD regulations pertaining to offerings underwritten by an affiliate of a primary owner of the company).216 The offering was done during the middle of the quarter, not right at the end, as in Shaw.217 Finally, there was no indication of a final-period problem. In all, the circumstances surrounding the offering in Glassman did not suggest that the company’s management had either the motive or opportunity to hide important negative information strategically from the investing public.

In addition, to the extent the plaintiffs alleged that the undisclosed hard information showed a departure from expectations, they failed to

210. See id. at 630 & n.16.
211. See id. at 620.
212. See id. at 621.
213. See id. at 621–22.
214. See id.
215. See Bailey & Syre, supra note 112.
216. See Glassman, 90 F.3d at 620.
217. See id. at 630.
allege that the departures were more than minor ones. The court, however, ruled that indicia of minor departures from past results, half-way through a quarter, were not enough of a basis for plaintiffs' claim that there was hard information that would have enabled a reasonable investor to predict an extreme departure in the current quarter's results.\textsuperscript{218}

The difference between these opinions was that, while a bad odor emanated from management's actions in Shaw, there was a lack of such signals in Glassman. Further, in Shaw, the court emphasized that the circumstances were ripe for the breakdown of the usual nonlegal checks, such as reputational sanctions and underwriter gatekeeping. In contrast, in Glassman, these nonlegal checks appeared well in place. Hence, the line that was drawn between cases that would receive increased judicial scrutiny and those that would not was one of context and circumstance. The key question was: Did circumstances surrounding the offering suggest that the company might have been acting strategically to hide interim information that would have been important to investors?

The above discussion focused on the factors courts should examine in determining the degree of legal scrutiny to apply to plaintiffs' securities claims. In practical terms what I mean by degrees of legal scrutiny is the district court's decision about whether to grant a defendant's motion to dismiss or to allow the case to go into discovery. The question addressed next is the legitimacy of a court applying the multifactor test of circumstances indicating motive and opportunity for managerial strategic behavior at the motion to dismiss stage. Here the legitimacy of testing the plaintiffs' factual allegations comes into question because the ordinary Rule 12(b)(6) standard for a complaint to survive a motion to dismiss is merely that the complaint contain "factual allegations, either direct or inferential, respecting each material element necessary to sustain recovery under some actionable legal theory."\textsuperscript{219}

C. Fraud in the Essence: The Applicability of Rule 9(b)'s Heightened Scrutiny

The real battle in securities nondisclosure/misrepresentation cases is often fought at the motion to dismiss stage.\textsuperscript{220} Oftentimes, plaintiffs' lawyers

\textsuperscript{218} See id. at 631.
\textsuperscript{219} Gooley v. Mobil Oil Corp., 851 F.2d 513, 515 (1st Cir. 1988).
see that a public company's stock price has dropped soon after an offering and then file suit alleging that the offering documents were misleading and omitted information that was required to be disclosed. In the rush to the courthouse to be the first to represent a class, suits tend to be filed with little information other than the fact that the stock price dropped.

Because the complaints are filed with little to no information, and alleging a drop in stock price alone is not a legally sufficient basis for a securities claim, defendants typically move to dismiss the complaints for a failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). If, however, defendants fail on their motions to dismiss, the case typically settles. Few defendants are willing to incur the costs of discovery, let alone trial. Hence, the standards the court applies at the motion to dismiss stage are crucial.

The general standards applying to a complaint are generous. Rule 12(b)(6) requires little more than giving the defendant "notice" of your claims. In fact, taken together, Rules 8(a) and 8(e)(1) require that one's pleading be short and concise, and allow for the complaint to be dismissed if it is too long and complicated. But those are the general rules applying to pleading standards. Courts, recognizing that the real battle in securities

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222. Under the new securities act, however, the class certification procedures have been altered significantly. See Note, Investor Empowerment Strategies in the Congressional Reform of Securities Class Actions, 109 HARV. L. REV. 2056, 2057 (1996) (discussing the new act's emphasis on mechanisms that will transfer control of private securities lawsuits from lawyers to investors, such as discouraging the use of token lead plaintiffs).

223. See Bohn & Choi, supra note 221, at 904-05 (mentioning the classic case in which the plaintiffs in their rush to be the first to file suit against Philip Morris failed to take out allegations in their complaint that accused Philip Morris (one of the largest cigarette manufacturers in the world) of misrepresenting trends in the "toy" industry); cf. James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497, 499-508 (1997) (arguing that data on the subject are conflicting).

224. Presumably, plaintiffs' lawyers (typically on contingency fees) also prefer to settle. For discussions of the incentives to settle early, see, for example, Ralph K. Winter, Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 DUKE L.J. 945, 948-53 (1993). Cf. Cox et al., supra note 4, at 48.

225. Cf. Note, Pleading Securities Fraud Claims with Particularity Under Rule 9(b), 97 HARV. L. REV. 1432, 1435 (1984) (complaining that the imposition of strict pleading requirements on securities cases has resulted in dismissal of a number of meritorious cases).

226. See FED. R. CIV. P. 12(b)(6).

cases was at the motion to dismiss stage and that being generous to plaintiffs at this stage would result in a large number of frivolous strike suits brought solely to extract settlements, began to apply a more rigorous 12(b)(6) standard to securities cases.\(^{229}\) That practice, however, came to an end—or, at least, should have—with *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*.\(^{230}\) In *Leatherman*, the Supreme Court held that courts could not create heightened pleading standards for special categories of cases without specific authorization from the legislature.\(^{231}\)

The question then is whether the entire prior section—about factors that courts should look at in considering whether to allow a complaint to go into discovery—was pointless. Given Rule 12(b)(6)'s liberal pleading requirements, isn’t it enough that the plaintiffs allege that unripe material information indicating an extreme departure in expected results was not disclosed in the offering documents? If the duty to disclose material unripe information causes a great increase in the number of frivolous lawsuits, shouldn’t Congress, not the courts, remedy the situation? Perhaps so, but the situation is not quite so bleak.

First, Rule 12(b)(6) itself is not entirely toothless. One cannot cross Rule 12(b)(6) with nothing more than a conclusion of law, for instance that material unripe information was not disclosed.\(^{232}\) Notions of notice pleading aside, a plaintiff’s complaint must give the court a basis to think that the plaintiff has facts underlying her allegations and that she is not merely hypothesizing.\(^{233}\) The longer the motion to dismiss process takes and the more sophisticated the plaintiff’s lawyers, the less sympathetic a court is likely to be to complaints that are factually weak.\(^{234}\)

\(^{229}\) Cf. Note, *supra* note 226, at 1440–44.

\(^{230}\) 113 S. Ct. 1160 (1993).

\(^{231}\) See id. at 1163.

\(^{232}\) Cf. Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1216 (1st Cir. 1996) ("In deciding a motion to dismiss under Rule 12(b)(6), [we] must take all well-pleaded facts as true, but [we] need not credit a complaint’s ‘bald assertions’ or legal conclusions.” (citations omitted)).

\(^{233}\) Cf. Dewey v. University of N.H., 694 F.2d 1, 3 (1st Cir. 1982) ("It is not enough to allege a general scenario which could be dominated by unpleaded facts . . . ."); cf. also Glassman v. Computervision Corp., 90 F.3d 617, 628 (1st Cir. 1996); Gooley v. Mobil Oil Corp., 851 F.2d 513, 515 (1st Cir. 1988) (stating that the complaint must contain "factual allegations, either direct or inferential, respecting each material element necessary to sustain recovery under some actionable legal theory").

\(^{234}\) See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1435 (3d Cir. 1997); In re Exabyte Corp. Sec. Litig., 823 F. Supp. 866, 873 (D. Colo. 1993) (similar logic); In re VeriFone Sec. Litig., 784 F. Supp. 1471, 1486 & n.23 (N.D. Cal. 1992) (dismissing certain claims with prejudice when the complaint reflected "the best efforts of at least ten distinguished law firms that specialize in this area" and stating that "it would be unwise and an unfair burden on shareholders to give these law firms more than two bites at an apple they have not been able to get their teeth into"); cf. Glassman, 90 F.3d at 628 (imposing a heightened Rule 12(b)(6) standard when the case was at motion to dismiss stage after over three years of litigation and full discovery).
But more importantly, Rule 12(b)(6) may not be all that applies. The bane of securities plaintiffs' lawyers, Rule 9(b), is likely to apply in most, if not all, cases in which the knowing nondisclosure of unripe material information is alleged. Rule 9(b) applies to allegations of fraud and requires that they be pled with particularity.\textsuperscript{236} This particularity requirement translates into a requirement that plaintiffs not just plead a general theory of fraudulent behavior, but that they plead particular circumstances that give rise to an inference that defendants knew of the existence of, and materiality of, the undisclosed unripe information.\textsuperscript{237} The particularity requirement cannot be avoided "simply through a general averment that plaintiffs 'knew' earlier what later turned out badly."\textsuperscript{237}

\textsuperscript{235} Rule 9(b) provides that, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." FED. R. CIV. P. 9(b).

Rule 9(b) requires a plaintiff to plead (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his damage.


Rule 9(b) has been explained as having the following purposes: (1) to provide the defendant with notice of the plaintiff's claims so as to mount a defense; (2) to protect the defendant's reputation from harm; and (3) to prevent the filing of strike suits. See Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 987 (10th Cir. 1992); In re Urcarco Sec. Litig., 148 F.R.D. 561, 564 (N.D. Tex. 1993).

First, with regard to factor (2), in the high-wage, low-monitoring, scarce job world of corporate managers that I have posited, there is a strong interest in protecting against frivolous suits that could falsely hurt management's reputation. Both the reputation of the management (vis-à-vis the managerial labor market) and that of the firm (vis-à-vis the capital market) are in peril when a suit is brought that alleges that management knowingly withheld important negative information in order to preserve its jobs. Second, with respect to factor (3) and the filing of frivolous lawsuits, academics may argue over empirical estimates of the exact percentage of these strike suits, but what is clear is that there is a problem. Compare Gross v. Summa Four Inc., 93 F.3d 987, 991 (1st Cir. 1996); Hershfang v. Citicorp, 767 F. Supp. 1251, 1259 (S.D.N.Y. 1991); Ferber v. Travelers Corp., 785 F. Supp. 1101, 1106 n.8 (D. Conn. 1991); John Shad, Introduction, in SECURITIES CLASS ACTIONS, supra note 132, at 1, 1–3, with David J. Bernhard et al., A Dissenting Introduction, in SECURITIES CLASS ACTIONS, supra note 132, at 5, 30.

\textsuperscript{236} See In re Westinghouse, 90 F.3d at 710 ("[T]he circumstances constituting the fraud must be stated with particularity."). This requirement has been articulated as a burden on the plaintiffs to allege in their complaint the "who, what, when, where and how" of the alleged fraud. See also Weisburgh v. St. Jude Med., Inc., 158 F.R.D. 638, 641 (D. Minn. 1994), aff'd, 62 F.3d 1421, 1422 (8th Cir. 1995); Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard of '33 and '34 Act Claims, 76 WASH. U. L.Q. 537, 549–51 (1998).

\textsuperscript{237} Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992); see also Dileo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (stating that a plaintiff may not simply contrast a defendant's past optimism with less favorable results and contend that the difference must be attributable to fraud); Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978) (stating that a securities plaintiff cannot plead "fraud by hindsight").
Recall that I mentioned that these suits tended to be brought within days, if not hours, of a drop in the stock price. If this is the case, it is unlikely that the plaintiffs will know much more than the fact that the price dropped. But that alone is unlikely to get them past Rule 9(b)'s requirement that the circumstances of the fraud be pled with particularity.\(^{238}\)

The catch here is that a claim that material unripe information was not disclosed in the offering documents is unlikely to be brought under section 10(b) of the Exchange Act; the fraud cause of action that requires the pleading of scienter and reliance, and that too with particularity.\(^{239}\) Instead, such a claim will be brought under section 11 of the Securities Act that provides plaintiffs with a strict liability cause of action for material omissions and nondisclosures in the offering documents.\(^{240}\) Hence, claims brought under section 11 do not have to demonstrate either scienter or reliance. However, courts have held that if a claim brought under section 11 "sounds in fraud"\(^{241}\) (if fraud is at the "core" of the action), clothing the

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\(^{238}\) See, e.g., In re Burlington, 114 F.3d at 1422; cf. Note, supra note 226 (complaining that some meritorious cases fail to get by Rule 9(b)).

The central element of a claim that the company withheld unripe information that it was supposed to disclose is that the company knew that the information would have helped investors predict an extreme departure in operating results for the quarter in progress. Plaintiffs are unlikely to have particular information going to the company's knowledge at the time of the price drop (and therefore at the time they file their initial complaints). Knowledge constitutes a state of mind and prior to the Reform Act it used to be arguable that even under Rule 9(b) knowledge could be pleaded generally. See FED. R. CIV. P. 9(b) ("Malice, intent, knowledge, and other condition of mind of a person may be averred generally."); Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1439 (9th Cir. 1987). But see O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991) (stating that a plaintiff under Rule 9(b) is required to plead specific facts that provide a strong inference of scienter); Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991); Dileo, 901 F.2d at 629.

However, Congress, in the recently enacted Private Securities Litigation Reform Act of 1995 made clear that claims of scienter had to be pleaded with particularity. See 15 U.S.C. § 78u-4(b)(2) (Supp. 1996); In re Burlington, 114 F.3d at 1418 & n.6.

\(^{239}\) The court in Westinghouse explained:

To state a securities fraud claim under Section 10(b) and Rule 10b-5, a private plaintiff must plead the following elements: (1) that the defendant made a misrepresentation or omission of (2) a material (3) fact; (4) that the defendant acted with knowledge or recklessness and (5) that the plaintiff reasonably relied on the misrepresentation or omission and (6) consequently suffered damage.

In re Westinghouse, 90 F.3d at 710; see also Shapiro, 964 F.2d at 280.

\(^{240}\) Cf. Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1223 (1st Cir. 1996) (noting how a plaintiff avoids grounding its sections 11 and 12(2) claims in fraud in order to escape the particularity requirements of Rule 9(b)); cf. also Glassman v. Computervision Corp., 90 F.3d 617, 621 n.6 (1st Cir. 1996) (noting that plaintiffs withdrew their section 10(b) claims in order to avoid Rule 9(b)'s strict pleading standards).

complaint in the language of section 11 does not enable one to avoid the particularity requirements of Rule 9(b).242

The nondisclosure on which this Article focuses is, at its core, fraud. At common law, fraud tended to grow out of face-to-face transactions in which there was a misrepresentation about the value of a good sold.243 In a securities case, the case of failure to disclose material information in an offering is the closest one gets to the classic face-to-face transaction. In a public offering, the company and its underwriters attempt to persuade investors to buy their securities on the basis of the information in the prospectus and registration statement. As discussed earlier, there is a close analogy to an insider-trading claim under section 10(b)—a fraud cause of action—indicating that this nondisclosure claim is, in essence, a fraud claim, even if brought under section 11. To bring a claim vis-à-vis unripe information, a plaintiff must allege that the company knew that the information was material but still did not disclose it in the context of inducing investors to purchase securities in an offering.244 Of all the elements of a section 10(b) fraud claim, knowledge is the most crucial and most difficult to allege.245 The reliance element is less difficult to allege in a securities

242. See Glassman, 90 F.3d at 628 n.3; In re Stac Elecs. Sec. Litig., 89 F.3d 1399, 1404–05 (9th Cir. 1996); Shaw, 82 F.3d at 1223; Melder v. Morris, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); Shapiro, 964 F.2d at 288; Sears v. Likens, 912 F.2d 889, 892–93 (7th Cir. 1990); Hayduk v. Lanna, 775 F.2d 441, 443 (1st Cir. 1985); Hershey v. MNC Fin., Inc., 774 F. Supp. 367, 375 (D. Md. 1991); see also In re Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1104 (D. Nev. 1998); Haft v. Eastland Fin. Corp., 755 F. Supp. 1123, 1133 (D.R.I. 1991) (“It is the allegation of fraud, not the ‘title’ of the claim that brings the policy [of applying Rule 9(b)] to the forefront.”); McKinney v. Store, 693 N.E.2d 65, 72 (Ind. 1998).

The Eighth Circuit, in an opinion by Judge Richard Arnold, rejected the sounds-in-fraud theory on the grounds that any allegations that sound in fraud in a section 11 action would be “mere surplusage.” In re NationsMart Corp. Sec. Litig., 130 F.3d 309, 315 (8th Cir. 1997), cert. denied, 118 S. Ct. 2321 (1998); see also Sale, supra note 236, at 72–73 (scrutinizing the sounds-in-fraud doctrine on the grounds that it screens out nonscienter-based claims). Judge Arnold explained that “[t]he only consequence of a holding that Rule 9(b) is violated with respect to a § 11 claim would be that any allegations of fraud would be stripped from the claim.” In re NationsMart, 130 F.3d at 315. Judge Arnold’s argument, however, does not work in our context. A claim that interim disclosure was not made would have to allege that the company knew of information (and reliance would be presumed with an S-3 type company). In other words, a plaintiff would not be able to plead a negligence claim easily.

244. See infra text accompanying notes 147–150.
245. Pleading knowledge on the part of the defendants satisfies the scienter requirement in a section 10(b) claim. See Trust Co. v. N.N.P., Inc., 92 F.3d 341, 351 (5th Cir. 1996) (“Strict intentional misconduct is not required to show scienter [for securities fraud]; it is sufficient to prove conduct that is an extreme departure from the standards of ordinary care and presents a danger of misleading buyers or sellers, as well as . . . knowledge of the danger . . .”); see also Provenz v. Miller, 102 F.3d 1478, 1490 (9th Cir. 1996), cert. denied, 118 S. Ct. 48 (1997) (stating that scienter can be proved by establishing either knowledge or recklessness); In re Software Toolworks, Inc. Sec. Litig., 38 F.3d 1078, 1088 (9th Cir. 1994); Ambrosino v. Rodman &
case, especially given that securities are being sold to the market on the basis of the prospectus and registration statement.246 Even if the individual investor does not read the offering documents, he can reasonably be assumed to depend on his sophisticated colleagues (i.e., the market) to have incorporated the information in the offering documents into the price.247

Surprisingly, neither Shaw nor Glassman applied Rule 9(b), even though in both cases the defendants urged the court to find that the sections 11 and 12(2) claims sounded in fraud.248 The court in Shaw, while acknowledging that such a claim as the one before it could sound in fraud, said that the complaint could not be thought to have been grounded in fraud, "absent any claim of scienter and reliance."249 But this is puzzling because the court also acknowledged that the complaint alleged knowledge of the missing information, on the part of the defendants. Knowledge constitutes scienter. As to the reliance element, the plaintiffs may not have pled the fraud-on-the-market theory of reliance in their section 11 claim, but the court, in granting the presumption, accepted this theory with respect to the secondary market purchasers who had brought their case on section 10(b) grounds alone.250

Further, one need only consider the factors the Shaw court emphasized in its analysis. Those factors, as discussed earlier, show circumstances indicating knowledge of material information on the part of the company, and motive and opportunity to withhold it.251 The court was looking for signs that the management of Digital had acted strategically to perpetrate a fraud on the public. In effect, Shaw, while saying that it was not applying Rule 9(b), found the criteria that would have satisfied Rule 9(b). If the Shaw

Renshaw, Inc., 972 F.2d 776, 788–89 (7th Cir. 1992); cf. Elaine E. Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 226 (1977) (arguing that the Court’s opinion in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), can be read to support any of three definitions of recklessness—intent, knowledge, or recklessness).

246. Cf. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972) (stating that if the omission is material, reliance will be presumed).

247. See Shaw, 82 F.3d at 1218; see also In re VeriFone Sec. Litig., 784 F. Supp. 1471, 1479 (N.D. Cal. 1992) ("The fraud-on-the-market theory thus shifts the inquiry from whether an individual investor was fooled to whether the market as a whole was fooled." (citation omitted)); EASTERTROOK & FISCHER, supra note 22, at 297.

248. See Shaw, 82 F.3d at 1223; Glassman v. Computervision Corp., 90 F.3d 617, 628 n.3 (1st Cir. 1996).


250. See Shaw, 82 F.3d at 1218.

251. See discussion supra notes 200–204.
claim was not rooted in intentional deception/strategic behavior, why look for and identify those signs that indicated such behavior?\textsuperscript{252}

The Glassman court displayed the same reluctance to apply Rule 9(b), even though it appears that it would have been appropriate to do so there too.\textsuperscript{253} The court's analysis in dismissing the plaintiffs' claims emphasized the lack of signs of motive or opportunity for strategic behavior on the part of the company's management. Nevertheless, the court was able to sidestep the issue of whether Rule 9(b) applied because there was an alternative route to imposing a heightened pleading requirement.\textsuperscript{254} The Glassman case had come up to the appeals court in an unusual manner. Even though the case was at the motion to dismiss stage, the parties had conducted full discovery and the complaint reflected the results of this full discovery.\textsuperscript{255} Based on reasoning in First Circuit precedent, which held that courts could impose a heightened level of scrutiny to complaints in which plaintiffs had had the benefit of full discovery and many years of litigation, the Glassman court held that the plaintiffs' complaints were insufficient on Rule 12(b)(6) grounds alone.\textsuperscript{256} It is unlikely, however, that future courts will be able to finesse the Rule 9(b) question as the First Circuit did in Glassman. Further, unlike in Shaw, it will not be quite as clear that the case would pass the Rule 9(b) threshold, whether or not it applied. The question for the courts will be whether the plaintiff's theory of the case sounds in fraud. Given that the plaintiff has to allege that there was knowledge on the part of the company that material unripe information existed at the time of the sale of securities, though it was not disclosed, it is hard to see how this would not sound in fraud. All of the factors that the panels in Shaw and Glassman noted as important are factors that indicate strategic behavior on the part of the company. It is conceivable that there will be cases in which the plaintiff has direct evidence in the form of internal memoranda or minutes of board meetings that reveals knowledge of the information by the company, but does not show any fraudulent intent. For example, a situation in which the company knew of the information but negligently forgot to disclose it. But how likely is it that (1) a plaintiff will have access to internal memoranda and/or minutes of board meetings,\textsuperscript{257} or (2) plaintiff's theory

\textsuperscript{252} Cf. Gart v. Electroscope, Inc., No. 97-1343, 1998 WL 757970, at *6 (D. Minn. Mar. 24, 1998) (rejecting plaintiffs' attempt to make a Shaw-based interim nondisclosure claim on the ground that plaintiffs were not claiming fraud).

\textsuperscript{253} See Glassman, 90 F.3d at 628 n.3.

\textsuperscript{254} See id. at 628.

\textsuperscript{255} See id. at 621–22.

\textsuperscript{256} See id. at 628–29.

will be that the company knew that certain information was material, but negligently forgot to disclose it? Not likely, especially because the plaintiff will not have been able to conduct discovery in order to obtain the memoranda and board minutes. In order to produce the inference that the company acted with scienter in knowingly failing to disclose material unripe information, plaintiffs will have to plead circumstances indicating that the company’s management was up to no good. But once it does that, it will have produced a complaint that sounds in fraud. In a sense, the plaintiff is caught in a catch-22 situation. In order to plead his claim adequately that unripe information was not disclosed, he will have to allege circumstances that will ensure that his complaint sounds in fraud and that Rule 9(b)’s particularity requirements apply. Perhaps it was recognition of some unfairness in the situation that induced the Shaw and Glassman courts to refrain from applying Rule 9(b). But both the theory and the doctrine that underlie such claims suggest that Rule 9(b)’s requirements should apply.

CONCLUSION

The question of whether or not a firm conducting an offering must make disclosure of intraquarterly operational results is a fundamental one. It is a question that arises in every offering because every offering takes place during a quarter that is still in progress. Yet, neither the courts nor the SEC has articulated a definitive approach to resolving the question. I have attempted in this Article to build a framework from which one might begin to resolve this question.

Central to the analysis is the distinction between ripeness, materiality, and temporal orientation. Ripe information is information that is complete, verified, and in disclose-ready form. Ripeness is neither a necessary nor sufficient condition of materiality. Furthermore, although the significance

258. The new securities bill contains explicit instructions from Congress that discovery in securities fraud cases is to be stayed pending the resolution of a motion to dismiss, except in extraordinary circumstances when certain evidence is in danger of being destroyed. See Sale, supra note 236, at 18, 25–26.

259. See Kopel, supra note 197, at 109–10.

260. Professor Hillary Sale, quite legitimately, points out that applying the sound-in-fraud doctrine along with stay-of-discovery provisions of the Reform Act will likely result in some number of legitimate claims failing. See Sale, supra note 236, at 88. In terms of achieving optimal deterrence, however, it does not matter that some fraction of fraudulent acts goes unpunished so long as the penalty on the actors who do get punished is high enough. My sense is that the risk of frivolous litigation and the penalty on defendants when claims do get through are high enough to justify the heightened standards. However, in fairness to Professor Sale, I acknowledge that what little data there is does not point clearly in any one direction.
of any particular piece of unripe information may rest in its forward-looking implications, it does not follow that the disclosure of unripe data is itself tantamount to the making of a forward-looking statement. Unripe information is neither necessarily forward looking nor immaterial per se.

The question that then arises is whether there is any need to create a legal rule mandating, in a public offering context, the disclosure of unripe material information. When markets work well, one would expect voluntary disclosure. Particularly when one considers that the only companies who can act strategically to time an offering so as to profit from an information advantage in terms of intraquarterly data are the largest and most well-established ones—those companies whose securities are traded in near-efficient markets—one might postulate that market mechanisms should work to impel such companies to disclose any information that investors might find useful. After all, no such company wants to be distrusted by the market.

In a world of high-monitoring, voluntary disclosure is likely to occur. But, drawing on insights from modern labor theory, it is highly plausible that the world of these high-profile companies is better characterized as a low-monitoring world, specifically, a low-monitoring world in which managers are paid exorbitant salaries so as to incentivize them to work hard despite the lack of monitoring. Solving the monitoring problem through high salaries creates room for final-period problems. These problems occur when unripe data from the current quarter tells managers that conditions are extremely bad and that they face a significant risk of losing their high-salary jobs, though the market expects otherwise. In such a situation, in which an infusion of fresh capital might help managers turn things around, management has an incentive to bring the company's securities to market at the highest price possible, without being publicly forthright about the company's true (interim) financial status.

By the same token, and again from the perspective of deterring strategic behavior, the less worrisome situations are those in which corporate managers are not aware of early information about a current quarter's outcome (even if such information could be obtained); and in which corporate managers are aware only of information indicating that the current quarter may depart slightly from market expectations. In these scenarios, the firm's capacity to translate informational asymmetry into cash will be minimal. I argue, therefore, that it makes sense from this perspective—and only from this perspective—to establish a rule that requires disclosure, in connection with an offering, of interim data known to management that indicates that the quarter in progress will produce an extreme variance from market expectations for that quarter.
The low-monitoring, high-wage model of corporate managerial behavior produces an important collateral consequence. Conventional wisdom asserts that the situations that courts and regulators should be most concerned about, from the viewpoint of achieving full disclosure of material information, are those involving IPOs. After all, companies that are initially going public are the ones about which the markets can be expected to have the least amount of information. To the extent that efficient market theorists have acknowledged the need for mandatory disclosure rules at all, they have done so most readily in the context of the IPO.

I think, however, that the IPO context, given the current state of regulatory law and practice, presents the least need to worry about the strategic nondisclosure of negative intraquarterly operational data. It is in the IPO context that the system of nonlegal institutional checks imposes the greatest scrutiny. Typically, companies contemplating an IPO receive intense levels of underwriter and legal due diligence, SEC scrutiny of the company’s disclosure documents, and even heightened scrutiny by the private exchanges. Furthermore, the high-wage element of my low-monitoring, high-wage model is less likely to obtain in the context of brand new public companies. And, just as importantly, it is less likely that the managers of such companies are facing a final-period problem—they are trying to get into the first period—and almost by hypothesis, they have little reputational capital built up at this time. Finally, especially in the current world of high-technology and market-niche IPOs, the managers of companies that are initially going public are likely to have firm-specific knowledge and skills without which the company could not survive; in such circumstances, managers will have little fear that a disappointing financial performance in any given quarter will lead to the loss of their jobs. In sum, given the intense outside nonlegal scrutiny in the IPO context, and given the relevant features of companies going public for the first time, there is a small risk of strategic nondisclosure of interim data because there is simply very little room and not much incentive for it.

At the other extreme are offerings conducted pursuant to Form S-3—in particular the S-3 shelf offerings. The firms that put forward these kinds of offerings are the big, established companies with the most highly paid managers and the greatest amounts of reputational capital. The efficient capital markets theorists have conventionally predicted that minimizing mandatory disclosure rules makes perfect sense for these firms because they are the most intensely watched companies in the market, and the markets

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261. See, e.g., Sale, supra note 236, at 82 (noting that informational asymmetries are most serious with IPOs).
for the securities of these firms are the ones in which one would be most likely to find that stock prices accurately reflect all up-to-date information about the companies. Given that all available information is already reflected in the price of these companies' securities, mandatory disclosure rules make little sense; they result only in needless expense and raise the cost of capital for these firms—or so conventional theory would predict.

I agree as a general matter that the S-3 type companies are the ones for which there is the least need for mandatory disclosure because it is the managers of these companies who have the most to lose from not being candid with the markets. Given that these companies are closely followed (“close” being a relative term in a low-monitoring world), managers will not be able to get away with too much. But these managers also face the biggest threat of being replaced based on the company's external performance measures. They, therefore, have the greatest incentive to engage in strategic behavior to minimize the risk of job loss, even at the expense of the investing public. Moreover, given that offerings conducted by these large firms are the contexts in which there are the fewest nonlegal institutional checks, these offerings also present the situations in which managers have the most room to be less than forthcoming with their disclosures of known information. Thus, contrary to conventional thinking, I argue that courts should be more attuned to cases of nondisclosure of interim quarterly information that arise from S-3 offerings as opposed to IPOs.262

A final note. I do not mean to suggest that all disclosure regulations are to be understood through the lens of deterring strategic behavior. Some disclosure regulations, such as the requirement that full-quarter information be periodically disclosed and be put into proper accounting form, for example, are undoubtedly geared towards enhancing the accuracy of information

262. One might point out that, to the extent that the market recognizes that S-3 shelf offerings present a higher risk of strategic nondisclosure by management, the market will discount these offerings appropriately. If the market applies this discount accurately, investors are not deceived by the strategic nondisclosures—after all, they expected them and priced them. There is some support for this argument because S-3 shelf equity offerings were initially underutilized and appeared to be made at a discount. See JENNINGS ET AL., supra note 27, at 279–80. However, as with much of economic analysis, one has no idea whether the discount empirically fits this particular risk. The more important point is that the risk inherent in these types of offerings may be resulting in the shelf offering process being underutilized (companies eligible to use the shelf process are using more cumbersome and expensive processes instead). To the extent the shelf procedure was put in place because of efficiency gains that it would bring, the rule I propose could eliminate one of the risks that may cause the underutilization of the procedure. It is worth noting that the reluctance to use the S-3 shelf process appears to have largely disappeared in recent years. In my sample of all the S-3 companies that did public offerings over the first six months of 1998, 80% of all the offerings made were shelf offerings (346/429) and 80% of all the companies who made offerings used the shelf process (297/369). See supra note 72; see also JENNINGS ET AL., supra note 27, at 280, n.5 (describing the recent increased use of the shelf process for equity offerings).
reflected in stock prices. An exclusive focus on this objective, however, fails to account for another important policy goal of securities regulation, and one that has been at the crux of recent court decisions: the policy of deterring strategic nondisclosure by corporate managers.\textsuperscript{263}

\textsuperscript{263} My Article addressed the disclosure question in the offering context. The theoretical justification for requiring interim disclosure in the nonoffering or secondary market context is much weaker. There is an extensive literature on this subject and I will do no more than mention it. Cf., e.g., Merritt B. Fox, \textit{Rethinking Disclosure Liability in the Modern Era}, 75 WASH. U. L.Q. 903 (1997); Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 ARIZ. L. REV. 639 (1996). First, the risk of the nondisclosure altering the flow of capital to the best projects is minimal because the company is not using the nondisclosure to raise more capital in an offering. Second, the nondisclosure is temporary—full disclosure occurs in a few weeks anyway. Third, traders are just as likely to be on the win side of a transaction as they are to be on the loss side.