The Muddled Duty to Disclose Under Rule 10b-5

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Because the federal securities laws are, at heart, about disclosure, the question of whether and when there is a duty to disclose is often the central question in any given case. Certainly, the Securities & Exchange Commission (SEC) has broad powers to compel disclosures by issuers and certain others and has crafted a mandatory disclosure regime that creates many explicit duties. For a variety of reasons, however, this explicit regime falls short of a comprehensive answer to the duty question. For some sixty years now, the hardest duty questions have been addressed under the rubric of fraud, mainly under Rule 10b-5, the principal antifraud provision of the securities laws.¹

Over those years, some questions have been settled. For example, a person who chooses to speak in a manner reasonably calculated to influence investors assumes the duty to speak truthfully.² The difficult duty questions arise mainly when there is silence about some material fact, either because the person in question has said nothing at all or because what was said was not a clear misrepresentation of the truth.

There is a considerable amount of confusion in the case law on the duty question, which motivates this Article.³ This confusion is surprising precisely because duty is so central and because the courts (and the SEC) have had so long to work on it. The story is one of twists and turns. Prior to 1980, the courts and commentators were struggling with the affirmative duty to disclose mainly by invoking flexible, open-ended obligations.⁴ This was so both in insider trading -

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¹ The authority for Rule 10b-5 is Section 10(b) of the Securities Exchange Act of 1934. For background on Section 10(b), see generally Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385 (1990).
⁴ Jeffrey D. Bauman, Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose, 67 Geo. L.J. 935, 936 (1979) (“Although no case has so held, a few courts have suggested that there is a general duty to disclose.”); Milton H. Cohen, “Truth in Securities” Revisited, 79 Harv. L. Rev.
the area that generated the largest number of duty questions - and in other settings, such as the issuer's duty to disclose some facts immediately rather than wait for its next mandatory filing. This approach shifted abruptly in *Chiarella v. United States*, when the Supreme Court announced in dicta that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak" and that such a duty arises only when one party has information "that the other is entitled to know because of a fiduciary or similar relation of trust and confidence between them." Ever since, the lower courts have struggled to make sense of what the Court meant. Was the Court restricting the means of duty creation only in the insider trading area, or did it mean to cover the entire space under the Section 10(b) tent, including issuer obligations, broker-dealer duties, mutual fund behavior, and so on? Many have taken the Court at its word, so that fiduciary-type duties are the only avenues along which affirmative duties to disclose may be found. The result in a

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number of lower court decisions has been a cutback on duty in cases that extend well outside the insider trading context. Other courts have taken different approaches. The confusion has turned to a hopeless clutter, which we try to help clean up.

To do so, we first have to understand why the law shifted away from the broad, flexible duties that existed both at common law and in the first generations of federal securities cases. One possible answer — connecting our project to others in this Symposium — is that, as in so many other doctrinal moves during the same time period, the law showed an increasing judicial hostility to expansive interpretations of the federal securities laws, especially in the context of private securities litigation and fraud-on-the-market lawsuits. There is probably some truth to this. But we should be careful. After all, the affirmative duty to disclose has been an extraordinarily hard subject in contracts and torts for centuries. Discussions of the question of when silence amounts to an affirmative misrepresentation are contained in the Talmud, as well as the writings of Cicero, Pothier, and Aquinas. Modern legal academia has produced a number of classic articles on the affirmative disclosure question, without reaching any clear consensus. Perhaps the courts' confusion is simply a product of the legitimate difficulty of the questions.

seen as setting the parameters for the lower courts as to what the possible sources of the affirmative duty to disclose might be — that is, fiduciary or fiduciary-type relationships); Robert A. Prentice, Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b), 75 N.C. L. Rev. 691, 721 (1997) (explaining, in the context of third party suits for misrepresentations, that the Supreme Court has been viewed as allowing only one exception to the general rule that omissions are not actionable— the fiduciary duty one).

7. One of the more expansive readings of the duty analysis came recently in In re Initial Public Offering Securities Litigation where Judge Scheindlin appeared to see Chiarella's fiduciary-based duty as but one possible source of the duty to disclose. 241 F. Supp. 2d. 281, 380-84 (S.D.N.Y. 2003). In a case where the Underwriters allegedly failed to disclose certain compensation that they were receiving in the offering context, the court found that a duty to disclose existed because (a) there was a presumption of honest behavior and the failure to disclose all forms of compensation was manipulative; (b) the SEC and NASD rules mandated disclosure of this compensation; and (c) because the Underwriters were in effect engaging in insider trading of the type prohibited by Chiarella's disclose or abstain rule. Id.


9. See, e.g., W. Page Keeton, Fraud—Concealment and Non-Disclosure, 15 TEX. L. REV. 1, 2-5 (1936); Anthony T. Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. LEGAL STUD. 1, 26-27 (1978); Kim Lane Scheppele, 'It's Just Not Right': The Ethics of Insider
Our goal here is not to propose a grand normative theory of how to solve these confusions and contradictions. In other words, we do not take the standard law review route of seeking to articulate a general theory of how judges should decide disclosure questions so as to maximize efficiency, fairness, or some other criteria. Instead, this Article is an exercise in judicial process. We are most interested in identifying the inconsistencies in the cases, which—after Part I's introduction of what we consider some useful typology—we do in Part II. Part of the effort, therefore, is just descriptive, because we think there is a value in demonstrating the degree of confusion. But we do have a normative goal, which is pursued in Part III. Our sense is that the confusion has grown to a point where courts today confronting a duty issue have a difficult time even seeing how the issue fits into the 10b-5 case law, or what precedent and authority might be misleading rather than helpful. We hope to reorient legal analysis so that some of the clutter disappears and the real choices at least appear more clearly.

I. SETTING THE STAGE

A. Materiality versus Duty

Two central and required elements in any securities fraud case are materiality and duty.\textsuperscript{10} In court opinions on the fraud question, it is often hard to determine whether the judge is basing her decision on materiality or duty.\textsuperscript{11} We suspect that that is because the distinction between the two elements is fuzzy at the margins. Conceptually though, in order to provide a meaningful discussion about the duty


\textsuperscript{10} For a detailed treatment of the materiality concept, its relationship to duty, and its central role in the securities antifraud jurisprudence, see JAMES COX ET AL., \textit{SECURITIES REGULATION} ch. 11 (4th ed. 2004).

\textsuperscript{11} Basic Inc. v. Levinson, 485 U.S. 224, 233 n.10 (1998) (noting that, in determining whether the disclosure of preliminary merger talks was required, lower courts often did not make clear whether their decisions were based on materiality or duty determinations); see also Steven A. Fishman, \textit{Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions}, 12 J. CORP. L. 252, 281-83 (1987) (discussing a number of cases that find Section 10(b) liability but do not explain the source of the duty to disclose).
question, we have to separate it carefully from the materiality question. Materiality refers to the matter of whether a piece of information would likely be important to the reasonable investor. Duty, by contrast, refers to whether there is an obligation to disclose a certain category of information. As the courts state repeatedly, the former is usually a factual question and the latter a question of law. There are many facts (such as preliminary merger negotiations) that can fall within the definition of materiality yet do not have to be disclosed.

As a practical matter, however, the concepts are not so easily separated. One reason is that in deciding whether a certain duty to disclose is broad enough to include a particular type of information, the court often has to consider how and why the information at issue would have been important to investors. This is because the underlying rationale for the construction of the disclosure duties (by Congress, the SEC, or the courts) is that this type of information is likely to be important to investors. For example, take the duty to update, which at least some courts have articulated as being a function of investor expectations—that is, one has a duty to update if one's prior statement implicitly suggested a promise to update.

If the information at issue is extremely important—for example, involving a major change in a company's fortunes, such as a merger—then courts seem comfortable finding a duty to update the initial announcement. Put differently, the duty analysis gets wrapped up in an evaluation of heightened materiality. But this intersectional area aside, it is important to keep the two concepts separate. This is because of two foundation stones in the securities

12. COX ET AL, supra note 10, § 10.4
13. Id.
14. For example, in its discussion of the duty question, one court recently said: "In the end, the central question [on whether there exists a duty] remains whether disclosure of the information would have had a significant effect on the decisions of a reasonable shareholder." Baron v. Smith, 285 F. Supp. 2d. 96, 103 (D. Mass. 2003). Whether the information has an effect on the decision of the reasonable shareholder, of course, is a rough articulation of the materiality standard. Or, more explicitly, as explained by the Court in Shaw, the "task of deciding whether particular information is subject to mandatory disclosure is not easily separable from normative judgments about the kinds of information that the securities laws should require to be disclosed, which depend, in essence, on conceptions of materiality." Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1202-1203 (D. Mass. 1996).
15. See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1431 (3d Cir. 1997).
16. Id. One sees similar reasoning in the test for intra-quarterly disclosure articulated in Shaw, which is that interim information as to a quarter in progress has to be disclosed if it amounts to an "extreme departure" from expectations. Shaw, 82 F.3d. at 1210. In both these cases we see how the courts construct duties to disclose as a function of some heightened materiality; the underlying rationale being that while investors do not expect disclosure of all routine material information, they expect to be told when there are major changes.
disclosure architecture. First, not all material information has to be disclosed.\textsuperscript{17} Second, immaterial information is often required to be disclosed (although not under Rule 10b-5).\textsuperscript{18} Any suggestion that materiality and duty are the same would disturb these foundational elements.

\textit{B. Tort Thinking versus Property Thinking}

The duty to disclose has two distinct, if overlapping, dimensions. In elaborating these distinctions, we try to distinguish between contexts (including both speech and acts) that mislead by implication and those that do not.\textsuperscript{19} The first—which we refer to as the “tort” dimension—is based on the intuition that certain categories of nondisclosure are sometimes actually misleading. That is to say, when there is (or has been) a pattern of communication between the source and one or more investors, reasonable expectations may evolve so that an omission of a certain fact does or does not deceive. Usually discussed under the rubric of “materiality,” as noted above, we find an almost full set of rules for explicit categories of conversation that do and do not deceive, rules that specify what reasonable persons expect from conversations in the market.

The other dimension can be described as a “property” construct. Harking back to the earliest formulations of the affirmative duty to disclose, many expressions of the duty are designed to create property-like entitlements to information on the part of the counter-party to the transaction or to a larger class of investors. Whether based on concerns of fairness or efficiency, the effort here is to create expectations as a matter of law rather than protect pre-existing ones. To be sure, the distinction is not always a clear one, but many cases illustrate the separation fairly well. Take insider trading as an example. The insider’s conduct in directing trades is done anonymously and without any real communicative content. Hence, imposing a duty to disclose is simply a mechanism for depriving the

\textsuperscript{17} E.g., Baron, 285 F. Supp. 2d at 103; see supra note 14.

\textsuperscript{18} Although the rationale for the construction of the various disclosure obligations of companies—such as their periodic filing obligations in Forms 10-Q and 10-K—is that the information is likely to be important to investors, not every piece of information required is going to be important in every instance.

\textsuperscript{19} The distinction between speech and implication is one that we borrow from Grice’s classic work. PAUL GRICE, STUDIES IN THE WAY OF WORDS ch. 2 (1989). To our knowledge, even though Grice’s work is recognized as classic and foundational in the study of language and meaning more generally, it has received but limited application in law schools. For an application of Grice’s work to the question of fraud based on nondisclosure or silence, see Peter Tiersma, The Language of Silence, 48 RUTGERS L. REV. 1, 12 n.34, 50-57 (1995).
insider of the profits and giving them to some other group. This is plainly property-type thinking.

We suspect that many modern judges are uncomfortable with property-based duties to disclose under Rule 10b-5, and most of the muddles in the law are the product of this discomfort. At base, the cause of the discomfort is the difficulty of determining optimal disclosure rules. The familiar trade-offs between promoting fairness and efficiency—which may call for aggressive information sharing—and rewarding information discovery and protecting legitimate needs for secrecy are difficult to make. This, we believe, has led many courts to doubt their own institutional competency and to look for reasons to shift responsibility elsewhere. Two excuses are particularly appealing. One, with a sound statutory basis, is that Congress has given to the SEC the primary responsibility for creating the property-like entitlements, at least as to issuer disclosure. If the SEC has not created a duty, why should the courts? The other is federalism. Property-type reasoning takes the court closer and closer to the concerns historically relegated to the states, so that it might also be convenient to use federalism as an excuse for being conservative in creating disclosure duties.

II. SOME MUDDLLED DUTY QUESTIONS UNDER RULE 10B-5

With this background, we turn to the case law. Our effort for now is simply to identify some major areas in which there is inconsistency on the basic duty question, either as between different cases or in the internal justification for a particular line of authority.

A. Duties out of SEC Line-Item Disclosure Requirements

One of the main places where the duty law is confused arises from explicit SEC disclosure requirements. Does failure to disclose information called for in a line-item requirement operate as a breach of duty actionable under Rule 10b-5?

Courts display the greatest comfort giving an affirmative answer in the public offering context. Those who purchase in the actual offering itself can sue directly under Section 11 of the Securities Act. But also there may be investors who purchased securities other than those issued pursuant to the registration statement (such as when the registered offering was for a class other than the common

May these traders sue under Section 10(b) for omissions in the offering documents? At least some courts answer this question in the affirmative. The analysis used explicitly is the tort-type analysis described above—that there is a presumption that reasonable investors rely on the accuracy and completeness of the formal disclosure documents connected with public offerings, such that failures to comply can be assumed to mislead.

The confusion begins when we turn to contexts not involving a public offering. Public companies are required to make disclosures under a variety of SEC rules including those governing proxy statements, quarterly reports, and annual reports. Naturally, the question here is whether the failure to satisfy these rules can give rise to a private action under Section 10(b). The courts could simply follow the tort-type analysis described above and determine whether investors expect these disclosure requirements to be satisfied and, therefore, are misled when they are not fulfilled. This is the approach...


22. See, e.g., Shaw v. Digital Equip. Corp. 82 F.3d. 1194, 1221 (1st Cir. 1996); In re Initial Pub. Offering Sec. Litig. 241 F. Supp. 2d. 281, 382 (S.D.N.Y. 2003). The analyses in these cases that involve omissions of statements (that is, duty questions), build upon the analysis in classic Second Circuit cases such as Fischman v. Raytheon Manufacturing Co., 188 F.2d 783 (2d Cir. 1951) (Frank, J.). See Shaw, 82 F.3d at 1222 (citing In re Ames Dept. Stores Stock Litig., 991 F.2d 963, 963 (2d. Cir. 1993) and invoking Judge Frank and his analysis in Fischman). Judge Frank, a former SEC Chairman, explained in Fischman that investors other than those specifically targeted in an offering could be misled by falsities in the registration statement for that offering. 188 F.2d at 786-87.

There are other courts, however, that have shown a reluctance to allow Section 10(b) plaintiffs to piggyback on violations under Section 11, at least when the Section 11 violations have been premised on failures to comply with the requirements of Item 303. For example, in Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998), the Ninth Circuit was willing to recognize that allegations of violations of SK-303 were sufficient to satisfy a Section 11 claim. But, the court made clear their reasoning did not extend to Rule 10b-5 claims. Id. (citing In re VeriFone Sec. Litig., 11 F.3d 865, 870 (9th Cir. 1993)). Note, however, that the court in Steckman is not clear on whether it is talking about the duty question (which should presumably be the same for Section 11 and Section 10(b) claims) or the matter of a violation under those statutes generally (which would be different for the two statutes because Section 10(b) has additional requirements such as scienter). 143 F.3d at 1293.

23. Both Shaw and In re Public Offering explicitly invoke the reliance of investors on the accuracy and completeness of disclosures made in the offering/registration in finding duties to disclose. Shaw, 82 F.3d at 1222 n.37; In re Initial Public Offering Sec. Litig, 241 F. Supp. 2d at 380-382. Interestingly though, both cases also demonstrate the judges' discomfort with using the tort-type analysis, because they also invoke property-type thinking in drawing analogies to the insider trading context (and Chiarella and Dirks) suggesting that there would be a finding of duty under that analytical method as well. The implications of which method is used, however, as we explain, are significant.
courts take when affirmative misrepresentations are alleged in 10-K's and 10-Q's.

But as noted above, this is not the route that many courts have taken when there is nondisclosure. A number of courts have held that line-item do not give rise to fraud-based duties. They do not, however, tend to make their positions on this matter clear. For purposes of the discussion that follows, we will take the line-item disclosure requirement that has been the subject of almost all of the litigation on this matter, Item 303 of Regulation S-K, which covers the obligation to disclose "known trends... and uncertainties" in 10-K's and 10-Q's. Putting aside the opinions that do not make clear their rationale for refusing to recognize a duty arising out of a failure to comply with this rule (other than to say that other courts have been reluctant to find such a duty), we will focus on the judicial opinions that do attempt a meaningful explanation. Working through the variety of explanations that courts have used for denying that Item 303 can be the basis for a duty to disclose, we will demonstrate the discomfort that courts have with this question.

The first explanation is based on analogy. In In re Pacific Gateway, for example, the court looked to cases holding that stock exchange disclosure requirements did not provide a basis for Section 10(b) claims to conclude that neither should SEC rules such as Item 303. Tapping into what we suspect are concerns about excessive

24. See, e.g., Anderson v. Abbott Labs., 140 F. Supp. 2d 894, 908 (N.D. Ill. 2001) (explaining that SEC disclosure rules, while perhaps informative, do not produce a duty to disclose for purposes of Section 10(b)).

25. See, e.g., In re Quintel Entm't Inc. Sec. Litig., 72 F. Supp. 2d 283, 293 (S.D.N.Y. 1999) (refusing to hold that a failure to satisfy Item 303 can be the basis of a Section 10(b) claim because of the lack of authority to support that position); Newby v. Lay (In re Enron Corp. Sec. Derivative & ERISA Litig.), 258 F. Supp. 2d 576, 632 n.63 (S.D. Tex. 2003) (holding that a violation of Item 303 does not establish a duty to disclose that may give rise to liability under Section 10(b)); Kafenbaum v. GTECH Holdings Corp., 217 F. Supp. 2d 238, 249 (D.R.I. 2002) (determining that even if the plaintiffs are able to prove that defendants violated Item 303's disclosure requirements, a violation of those requirements does not necessarily lead to the conclusion that such disclosure would have been required under Rule 10b-5). For earlier cases expressing skepticism regarding whether there can be a private right of action under Section 10(b) that draws the duty violation out of Item 303, see In re Canandaigua Sec. Litig., 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996) (explaining that "it is far from certain that the requirement that there be a duty to disclose under Rule 10b-5 may be satisfied by importing the disclosure duties from S-K 303," but withholding decision on the relationship between S-K 303 and 10b-5 actions because of finding that there was no duty to disclose under S-K 303); Alfus v. Pyramid Tech. Corp., 764 F. Supp. 598, 607-08 (N.D. Cal. 1991) ("[D]emonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty to disclose must be separately shown.").

private litigation, cases such as this explain that creating private rights of action is a serious matter and that SEC rules, like exchange listing standards, do not give rise to them automatically. The problem with this analysis is twofold. First, it errs in asking whether there is a private right of action under the SEC rule. That is beside the point. The statute in question is Section 10(b), and the question of whether there is a private right of action was decided in the affirmative years ago. The only question here is the propensity of nondisclosure in a filing to deceive and hence be fraudulent. In any event, the analogy to exchange rules is a false one. Given that primary authority in this area was delegated to the SEC, the SEC rules should be more likely than the stock exchange rules to produce a duty violation.

A different route that the district and circuit courts in In re Verifone used is to look to the nature of the Item 303 disclosure requirement. It requires the disclosure of certain “trends and

27. See, e.g., Freedman v. Louisiana-Pac. Corp., 922 F. Supp. 377, 387 n.6 (D. Or. 1996) (citing Chiarella for the proposition that there are two bases for the duty to disclose: (1) the presence of a fiduciary-type duty; and (2) unfairness). The second basis seems extremely broad and we are not aware of any other court that has read this second basis into Chiarella (Plus, given that Justice Powell was supposedly trying to cabin the reach of Section 10(b), it seems unlikely that he would have created such a broad duty). The Freedman court then, in another bizarre turn, also cites to the long-forgotten “flexible duty” as a possible basis for the duty under Section 10(b). Id. In the end, the court rejects the argument that the exchange rules or Item 303 can be the basis for a duty analysis under Section 10(b). Id. at 390. Although, in yet another bizarre analytical move, the court says that those violations could be the basis for a determination of scienter. Id.

28. The source of this analogous treatment appears to be In re VeriFone Sec. Litig., 784 F. Supp. 1471 (N.D. Cal. 1992), aff'd 11 F.3d. 865, 870 (9th Cir. 1993), where the argument was in fact somewhat more subtle. In the VeriFone cases, as we read them, the basis for rejecting the duty claim based on Item 303 was the rationale that since the information at issue was arguably forward looking, the fact that disclosure of forward looking information was optional under Rule 175, Instruction 7, obviated any possible duty to disclose. Id. The reason that the exchange rules came up at all in the VeriFone cases was that they were being alleged as an independent source of a possible duty to disclose. Id. at 868. That said, at least one other court has read VeriFone as standing for the proposition that there is no duty to disclose that arises out of SEC disclosure rule violations. See Kriendler v. Chemical Waste Mgmt, Inc., 877 F. Supp. 1140, 1150, 1157 (N.D. Ill. 1995) (citing VeriFone, 11 F.3d 865, for the proposition that SEC Regulation SK-303, which requires companies to report certain events, uncertainties and trends, does not provide a private right of action).

29. The exchange rules cases are themselves interesting, although one can understand the reluctance of courts to recognize their broad disclosure standards as giving rise to fraud liability. Using tort-based reasoning, one could readily say that because the exchanges have not historically enforced their disclosure standards, reasonable investors in fact have no expectation that they actually generate the disclosure that their text demands.

30. See supra note 28 (discussing the VeriFone cases). The “these are forecasts” logic of the VeriFone cases is picked up in other cases. See, e.g., In re Sofamor Danek Group, Inc. v. Sofamor Danek Group, Inc., 123 F.3d 394, 402 (6th Cir. 1997) (holding that information issued by defendant regarding certain merchandising practices was “forward looking information” that
uncertainties.” Trends and uncertainties, these courts explain, are, in effect, forecasts, and the SEC has, in other places, said that the disclosure of forecasts or forward-looking statements is voluntary.\textsuperscript{31} This argument is problematic in light of the fact that the SEC specifically requires “trends and uncertainties” to be disclosed (and that specific requirement should, presumably, trump the more general exception).\textsuperscript{32} But putting the matter of statutory construction aside, there is the threshold question of whether there is some way in which trends and uncertainties can be disclosed without violating the safe harbor for forward-looking statements. If so, then one would think that the courts would utilize that. And, indeed, there is a method for such disclosure. Let us say that there is some reason why Item 303 applies to the data as to the first eight weeks of a quarter in progress (for example, there is a public offering that is done at that point, as in Shaw v. Digital Equipment Corp\textsuperscript{33}). Data for the first eight weeks of the thirteen week quarter is presumably enough to produce something of a trend. A company does not have to make a forecast to say something like “our earnings for the first eight weeks of the quarter are 50 percent less than those for what they were for the comparable quarter last year.” Or it could say: “Our preliminary results for the quarter in progress have been disappointing. But we don’t know what the full quarter results will reveal.” Those are disclosures of trends and uncertainties, but not forecasts.\textsuperscript{34}

There is also a third route. Recently, a number of courts have invoked the explanation set forth in the Third Circuit’s opinion in Oran v. Stafford.\textsuperscript{35} Here, the explanation rests on problems with Item

\textsuperscript{31} Supra note 28 (discussing the VeriFone cases’ invocation of Instruction 7 of Rule 175).

\textsuperscript{32} One of the canons of statutory interpretation is that when there is a more specific statutory provision that is inconsistent with a more general one, the former is interpreted as an exception to the latter. WILLIAM N. ESKRIDGE, JR. ET AL., LEGISLATION AND STATUTORY INTERPRETATION 274-75 (2000).

\textsuperscript{33} 82 F.3d 1194, 1200-1201 (1st Cir. 1996).

\textsuperscript{34} Some courts have recognized this point. In re Retek, Inc. Sec., No. Civ. 02-4209, 2004 WL 741571, at *8 n.12 (D. Minn. Mar. 30, 2004) (making this point explicitly); see also Shaw, 82 F.3d 1194, 1205-06 (allowing an Item 303 claim).

\textsuperscript{35} See, e.g., Newby v. Lay (In re Enron Corp. Sec., Derivative & ERISA Litig.), 258 F. Supp. 2d 576, 632 n.63 (S.D. Tex. 2003) (citing Oran for the proposition that Item 303 does not produce a duty to disclose for purposes of Section 10(b)); Kafenbaum v. GTECH Holdings Co., 217 F. Supp. 2d 238, 250 (D.R.I. 2002) (citing Oran for the proposition that a violation of Item 303, while probative, is not enough to produce a duty to disclose for purposes of Section 10(b)); In re Pacific Gateway Exchange, Inc., Sec. Litig., No. C-00-1211 PJH, 2002 WL 851066, at *13 n.10
303's materiality standard. The Oran court explained that because the rule (Item 303) has its own materiality standard that is different from that articulated by the Supreme Court for securities fraud determinations generally, noncompliance with the rule cannot automatically produce a violation of Section 10(b). That much of the analysis makes a degree of sense. If the materiality analysis for the rule is different (lower) from that for Section 10(b), of course, one has to do an additional materiality analysis to determine whether the statute was violated. But the next step of the Oran court is problematic. That is the suggestion that there is no duty to disclose under the rule because the materiality standard of the rule differs from that of the statute. This is an illustration of courts confusing duty and materiality. The duty question is simply whether violations of this category of disclosure requirements have the potential to mislead. If so, then one goes to the question of whether the particular violation was material, so as to create liability under Section 10(b). Surely there are some trends and uncertainties that would be of importance to investors. For example, if the company is telling investors that the results for its past three quarters were the best in years, investors would probably like to know that the quarter in progress is looking to be the worst in the company's history.

If the bases for finding that line items do not give rise to fraud liability are confusing, the explanations found in the many cases that go the other way are not much better. To fine tune the point about judicial discomfort on this matter, consider the leading case on disclosure duties out of Item 303 in the public offering context, Shaw v. Digital Equipment Inc. Shaw finds that Item 303 produces a duty to disclose that can be the basis for a Section 10(b) claim. Then, it goes...
on gratuitously to say that it is *not* reaching the issue of whether there is a private right of action under Item 303.\textsuperscript{39} There was no need for this, though, because once again, the plaintiffs were not claiming that they should be able to sue under Item 303. In other words, the issue that the court claimed that it was not reaching did not exist. The plaintiffs’ suit was under Section 10(b) and Rule 10b-5.\textsuperscript{40} The effect of the gratuitous disclaimer in *Shaw*, though, was to confuse the matter and make the issue of whether Item 303 did produce a duty unclear.\textsuperscript{41}

Other cases that suggest that there might be a duty to disclose stemming from Item 303, obfuscate in their own way. So, if one goes to the cases that do suggest that Item 303 (or line-item requirements, more broadly) can give rise to a duty to disclose—and there are a number of these cases—many of them simply assume that a duty exists. Cases like *In re Scholastic Corp. Securities Litigation*\textsuperscript{42} are in

\begin{itemize}
\item \textsuperscript{39} Id.
\item \textsuperscript{40} The case also contained claims under Section 11, where the duty issues were easier. Id. at 1204.
\item \textsuperscript{41} One illustration of the confusion caused by the gratuitous statement in *Shaw* is that one sees later that it gets cited in the same breath as prior cases such as *In re Canandaigua*, where the court explicitly declined to find a duty to disclose for Section 10(b) purposes stemming from Item 303, even though the two cases say precisely the opposite thing on whether there is a Section 10(b) duty under Item 303. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, n.7 (3d Cir. 1997) (citing both, *In re Canandaigua Sec. Litig.*, 944 F. Supp. 1202, 1209 at n.4 (S.D.N.Y. 1996) and *Shaw*, 82 F.3d at 1222, for the proposition that it is not clear that there is a private right of action under Item 303). A more concrete illustration of the problems caused by the waffling language in *Shaw* is that there are still courts in the First Circuit that are unclear on whether Item 303 creates a duty to disclose under Section 10(b). In *In re Boston Tech, Inc.*, 8 F. Supp. 2d 43, 67 (D. Mass. 1998), the district court goes so far as to cite to a district court case in *Shaw* (that *Shaw* reversed on this precise issue) for support that there is no duty to disclose that is created under Item 303 for purposes of a Rule10b-5 suit; see also *Oran*, 226 F.3d 275, 288 (also citing the district court in *Shaw* for support on the Item 303 duty issue).
\item \textsuperscript{42} 252 F.3d 63, 70-75 (2d Cir. 2001). See also *In re Blockbuster Inc. Sec. Litig.*, No. 3:02-CV-0398-M, 2004 WL 884308, at *10 (N.D. Tex. Apr. 26, 2004) (granting defendant's motion to dismiss, with leave to amend portions of the complaint, but appearing to accept the duty to disclose argument based on Item 303); *Druskin v. Answerthing, Inc.*, 299 F. Supp. 2d 1307, 1319 (S.D. Fla. 2004) (same). Cf. *State of N.J. v. Sprint Corp.*, 314 F. Supp. 2d 1119, 1135-38 (D. Kan. 2004) (appearing to accept that line-item disclosure rules, in this case, items 103, 401(e), and 10(b)(3)(ii) of Regulation S-K and 8(e)(3) of Regulation 14A, can give rise to actionable duties to disclose under Section 10(b), but providing little explanation); *In re SeaChange Int'l Inc.*, No. Civ. A. 02-12116-DPW, 2004 WL 240317, at *10-12 (D. Mass. Feb. 6, 2004) (appearing to accept that Item 103 and Item 303 of Regulation S-K can produce duties to disclose for Section 11, but also providing little explanation).
\item Perhaps best illustrating the muddled nature of the inquiry in this area is *Kafenbaum v. GTECH Holdings Co.*, which managed to both say that Item 303 created a duty to disclose for purposes of Section 10(b) and then also say that it did not. 217 F. Supp. 2d 238, 249-250 (D.R.I. 2002) (confusing the duty and materiality issues into the duty analysis); see also *Wallace v. Sys. & Computer Tech. Corp.*, No. Civ. A. 95-CV-6303, 1997 WL 602808, at *22 (E.D. Pa. 1997) (finding that Item 303 produces a duty to disclose, but then saying that such a duty is not "inevitable").
\end{itemize}
this vein: they recognize the duty creation effect of the SEC's line-item rules, but they fail to meaningfully engage the cases that appear to resist the duty, thereby providing little basis for other courts to understand their reasoning.

It may be that there is something specific about Item 303 that courts find problematic, such as its forward-looking aspect or its heightened materiality standard, but then we would expect courts to say that this line-item disclosure requirement is special and explain that the duty arises readily under the other line-item requirements. But, for the most part, they do not. What we see instead is that many courts are willing to twist and turn in a variety of directions to avoid finding a duty stemming out of SEC rules. And even when they do find a duty, they confuse the matter. Why is there this reluctance to allow for an affirmative duty to disclose arising out of SEC disclosure requirements? The puzzle has at least two elements. First, there is courts' unwillingness to draw authority from what seems to be the obvious source of authority. After all, the SEC is the administrative agency to whom authority for implementing the securities laws was delegated. Moreover, virtually none of the courts, no matter how they rule, observe that for all the straining on the nondisclosure question, there is clarity that a misrepresentation in a line-item disclosure does lead to 10b-5 exposure. With all that struggle and muddling, could one possibly justify conceptually a regime in which affirmative misstatements lead immediately to fraud liability but silence never does?

Perhaps courts sense that they are being asked to create new property entitlements (where companies are forced to part with their proprietary information). But they are not. The question of whether companies have to part with the information was already decided by the SEC in the affirmative. The only question before the courts with regards to noncompliance with the SEC's line items is whether investors were entitled to rely on their completeness (or, whether the...
incompleteness would have been misleading). This latter analysis is routine tort-type analysis.

**B. Fiduciary Duties**

Ask any law student who has just completed a basic corporations or securities class what the primary source of the duty to disclose for purposes of Section 10(b) is and we suspect she will answer: “fiduciary duties.” The reason for this likely answer is that the only occasions on which the Supreme Court has explicitly tackled the “when is silence fraudulent?” question has been in the insider trading cases. And in those cases, as noted earlier, the Court explicitly said that it was looking to fiduciary principles in finding violations of Section 10(b).

Ironies abound in this determination, not the least of which is that the Court was promoting fiduciary obligation to the forefront of Rule 10b-5 reasoning just a few years after holding in *Santa Fe Industries v. Green*—with strong reference to federalism principles—that a breach of fiduciary duty is not, for that reason alone, a breach of the Rule. Fiduciary duties are mainly the province of state law, and the message of *Santa Fe* seemed to be that the federal courts were not going to intrude there. But intrude they did. At first cut, Justice Powell’s incorporation of the common law in *Chiarella* looks to have been consistent with *Santa Fe*’s teachings in that he appeared to be


46. For a recent discussion, see Carol Swanson, *Insider Trading Madness: Rule 10b-5 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 172-175, n.138-n.145 (2003) (describing the emergence of the Court’s use of the fiduciary principle to cabin the “disclose or abstain” principle that had arisen out of the SEC’s determination in *Cady Roberts* and the Second Circuit’s decision in *Texas Gulf Sulphur*).


48. For example, Theresa Gabaldon writes:

 Gabaldon, *supra* note 45, at 160.
restricting the duty to disclose in insider trades to what was perhaps the most well established basis for the duty from the common law: that is, the presence of a fiduciary-type relationship. And, many lower courts have read Chiarella to say precisely that duty creation in the Section 10(b) context is restricted to those relationships that are recognized as fiduciary or fiduciary-type at common law.49 But, as many commentators have pointed out, closer examination reveals the reverse. Justice Powell’s duty creation in Chiarella deviated from the common law in two important ways: it was at once both under- and over-inclusive.50 First, Justice Powell extended the fiduciary principle to a context in which the common law did not recognize it (the case of trades on impersonal exchanges).51 Second, he failed to acknowledge that the common law recognizes many other bases for an affirmative duty to speak, including some suspiciously close to the “fairness” rule that Powell was intent on rejecting.52 His incorporation was extremely selective.53

The irony was extended in the Court’s insider trading decision in United States v. O’Hagan.54 In endorsing the misappropriation theory of liability, the Court accepted a proposition of startling breadth: that an agent’s concealed breach of fiduciary duty operates as a fraud based on the agent’s failure to disclose his own faithlessness.55 Here, again, we see a strange inversion of normal reasoning. While one might think that the primary source of duties to disclose for purposes of the federal securities laws would be the disclosure rules

49. E.g., SEC v. Cochran, 214 F.3d 1261, 1264-1265 (10th Cir. 2000); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472 (4th Cir. 1992); Windon Third Oil & Gas Drilling Partnership v. FDIC, 805 F.2d 342, 347 (10th Cir. 1986); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986).

50. See supra note 6 (citing articles discussing Chiarella’s relationship to the common law).

51. Id.

52. See Richard Painter et al., Don’t Ask, Don't Tell: Insider Trading After O'Hagan, 85 Va. L. REV. 153, 208-11 (1998) (describing state of the common law disclosure duties at the time of Chiarella). Indeed, as multiple commentators have pointed out, Justice Powell, in saying that he was drawing on the common law in Chiarella, cited to the Restatement of Torts as authority, but then only used one of the five different bases for a duty to disclose that the Restatement listed. See Langevoort, supra note 46, at 12; Alison Grey Anderson, Fraud, Fiduciaries, and Insider Trading, 10 Hofstra L. Rev. 341, 351 (1982); Donna M. Nagy, The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden, 67 U. Cin. L. Rev. 1129, 1195 n.310 (1999).


55. This incorporation of common law duties and the problems with it are described in Painter, supra note 52, 208-211.
promulgated by the SEC, instead we see an incorporation of common law duties occupying a role front and center in Rule 10b-5 jurisprudence.  

We will come back to some of the issues this kind of analysis raises shortly. For now, consider the following. Under state law, officers have a duty of candor vis-à-vis the board of directors. Say then that a CEO—perhaps, Enron’s Ken Lay—does not tell the board everything material about the state of his company. In reality, for example, he knows that apparent profitability may be based on accounting artifices. Now, also say that Lay receives a large portion of his salary in the form of stock and stock options granted by the board’s compensation committee. In theory, we have a deceptive act that is presumably a breach of fiduciary duty under state law. There is also the question of whether Lay’s deception occurred in the context of the purchase or sale of a security (an independent element under Section 10(b)), but the Court, with rulings such as its recent one in SEC v. Zandford, has been expansive here. Certainly one can presume that accurate knowledge of the company’s condition might affect the compensation decision, and so the fiduciary-duty-based claim seems compelling. But to allow such claims would seem to allow federal securities laws to swallow state corporate laws. And indeed, drawing  

56. In U.S. v. Dial, a case involving broker nondisclosure to customers, Judge Posner explained the rationale underlying the fiduciary basis for a duty to disclose at common law:  

[W]e think there was a scheme to defraud in a rather classic sense, which is obscured only because commodity futures trading is an arcane business — though not to these defendants. Fraud in the common law sense of deceit is committed by deliberately misleading another by words, by acts, or, in some instances — notably where there is a fiduciary relationship, which creates a duty to disclose all material facts — by silence. See Prosser and Keeton on the Law of Torts §§ 105-06 (5th ed. 1984). Liability is narrower for nondisclosure than for active misrepresentation, since the former sometimes serves a social purpose; for example, someone who bought land from another thinking that it had oil under it would not be required to disclose the fact to the owner, because society wants to encourage people to find out the true value of things, and it does this by allowing them to profit from their knowledge. See Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 195, 4 L.Ed. 214 (1817); Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. Legal Stud. 1 (1978). But if someone asks you to break a $10 bill, and you give him two $1 bills instead of two $5's because you know he cannot read and won't know the difference, that is fraud. Even more clearly is it fraud to fail to “level” with one to whom one owes fiduciary [duties]. The essence of a fiduciary relationship is that the fiduciary agrees to act as his principal’s alter ego rather than to assume the standard arm’s length stance of traders in a market. Hence the principal is not armed with the usual wariness that one has in dealing with strangers; he trusts the fiduciary to deal with him as frankly as he would deal with himself — he has bought candor.  

757 F.2d 163, 168 (7th Cir. 1985) (emphasis added).  


from Santa Fe's teachings, the lower federal courts regularly tell us that the securities laws are about the policing of disclosure, not mismanagement. So, the borrowing from common law, in the place where the borrowing seems most apt under Chiarella's teachings, is jarring when applied as broadly as it might be. Indeed, courts have not pushed this logic aggressively. Here, we think that the courts (correctly) perceive the need to be careful in creating an additional obligation on the part of the company to part with information that would otherwise be proprietary.

C. The Scope of Disclosure Obligations in a Repurchase or Sale by the Issuer

The foregoing issue discussion sets the stage for one of the most conceptually interesting ones under Rule 10b-5—does the issuer have a fiduciary duty to disclose when it transacts with company shareholders? Although fiduciary obligations in corporate law developed in terms of saying that officers and directors owe duties to the corporation (and indirectly, to the shareholders), modern securities law gives ample reason to believe that the issuer as an entity is also a fiduciary vis-à-vis the shareholders.

1. Repurchases

Most lawyers, we suspect, counsel their clients that issuers cannot engage in stock repurchases while in possession of material nonpublic information. But legally, in light of Chiarella, that would be so only if we assume the presence of a fiduciary duty on the part of the issuer—an assumption most commentators and courts seem

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60. Our expectation, for the federalism reasons articulated in the text, is that courts will not be amenable to finding broad disclosure obligations triggered by contexts such as the grants of options to senior executives. At least one commentator, however, has suggested that the courts can (and should) go the other way. Iman Anabtawi, Secret Compensation, 82 N.C. L. REV. 835, 889 (2004) (suggesting that disclosure requirements need not unduly restrict companies from awarding stock options).
prepared to make. As an aside, one should note that there are no SEC line-item disclosure rules that apply to an ordinary repurchase.

This assumption presents at least two problems. To the extent that the teaching of *Chiarella* is that courts are supposed to draw disclosure duties exclusively from those fiduciary type relationships recognized by the common law, it does not look like there is much support for finding a direct duty running from the issuer to the investors. If one looks to Delaware state law—after all, Delaware is surely the dominant player in terms of articulating state corporate law obligations—it tells us that issuers (as opposed to boards of directors) do not owe disclosure duties to shareholders. Second, even assuming that this duty exists, there is the problem of where the logic of such a position takes us. Would an issuer also have a fiduciary duty of full disclosure of all material information in the MD&A, regardless of how narrowly SEC rules articulate such a duty? Or is there a fiduciary duty to disclose all material facts in a proxy statement, even if the SEC’s rules do not specifically call for a particular item? In a sense, the lower courts’ reluctance to acknowledge the authority of the SEC’s disclosure rules (where present) in the context of 10b-5 duties to disclose, in favor of deference to a few sentences regarding fiduciary

62. In addition to the recent cases such as *Shaw*, 82 F.3d. at 1204, there are older cases such as: McCormick v. Fund Am. Co., 26 F.3d 869, 876 (9th Cir. 1994); Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966); see also Castellano v. Young & Rubican, Inc., 257 F.3d 171, 179 (2d Cir. 2001) (finding a similar duty in the context of a closed corporation’s repurchases). Treatises discussing this point include: WILLIAM K. WANG & MARC. I. STEINBERG, INSIDER TRADING § 5.2.3.3, at 297-98 (1996); DONALD C. LANGEVOORT, INSIDER TRADING, REGULATION, ENFORCEMENT AND PREVENTION § 3.02[1][d], at 3-6 to 3-7; LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3591-93 (3d ed. 1999). One set of commentators, Bromberg and Lowenfels, however, question this line of reasoning. ALAN R. BROMBERG & LOUIS D. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD §7.5 (811)(2), at 7:276-80; see also Harry S. Gerla, Issuers Raising Capital From Investors, 28 J. CORP. L. 111, 118-119 (2002) (discussing the contrasting views and, specifically, the Bromberg and Lowenfels objections). For the most part, the law review literature also assumes that issuers making repurchases are insiders for purposes of Chiarella’s “disclose or abstain” rule. Steven E. Bochner & Samir Bukhari, The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives, 7 STAN. J.L. BUS. & FIN. 225, 229 (2002); Nicholas J. Guttiella, Case Comment, Securities Regulation-Disclosure of Intra-Quarter Performance Information Constituting Extreme Departure from Public Information Required in Shelf Registration Prospectus-Shaw v. Digital Equipment Corp., 82 F.3d 1194 (1st Cir. 1996), 31 SUFFOLK U. L. REV. 1023, 1028-29 (1998); Donna M. Nagy, supra note 52, at 1177-78.


64. In *Arnold v. Society for Savings Bancorp. Inc.*, the Delaware Supreme Court refused to extend the fiduciary duties of disclosure owed by the corporation’s directors (in the context of a proxy fight) to the corporate defendant itself. 678 A.2d 533, 539-540 (Del. 1996); see also Jennifer O’Hare, Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti Fraud Provisions of the Federal Securities Laws, 70 U. CIN. L. REV. 475, 496 (2002).
duties out of the Supreme Court's decision in Chiarella, causes this result. But a determination that the issuer has a fiduciary's duty to disclose to its shareholders would be very powerful, perhaps overpowering, even if only applied in areas where the company was transacting with shareholders or seeking consent from them.\footnote{One recent case, State of New Jersey v. Sprint Corp., seemed to recognize this issue in its rejection of the plaintiff's request that Chiarella be applied to the issuer context. 314 F. Supp. 2d 1119, 1138-39 (D. Kan. 2004).}

So far as the repurchase question is concerned, the courts and commentators confirm that such a duty likely exists, though there is surprisingly little reflection on the conceptual problem.\footnote{See supra note 63.} In essence, then, the federal courts that so assume are not only setting the common law of fiduciary responsibility on its head, but also eliding a hard policy question. The issuer repurchase context is different from that of the classical insider trade; hence, a simple extension of the classical insider's duty might be problematic. This point becomes clearer if one thinks about what the implications of the "disclose or abstain" rule means in the classical insider versus issuer (doing a repurchase) contexts. Given that making full disclosure of all the material nonpublic information at her disposal is not a viable option for the classical insider (she would likely get promptly fired for revealing the company's confidential information), the rule amounts to a mandate that she abstain from trading when in possession of an informational advantage. In other words, it is the "abstain" part of the "disclose or abstain" rule that is at work. That seems acceptable, given that the position of the Court appears to be that classical insiders should not trade based on informational advantages gained as a result of their corporate positions.

But things are more complicated with an issuer repurchase. Here, the disclosure rule operates not as an injunction against trading, but as a real disclosure rule. In other words, there might be circumstances where the company actually needs to do a repurchase and, if so, it will have to figure out how to make disclosure of all material information, a difficult task to say the least.\footnote{There is an argument to be made that the disclosure requirements that the insider trading analogy imposes on companies results in disadvantaging a set of socially useful transactions. For example, both the SEC and the NYSE have acknowledged the important role that corporate buybacks serve in 'enhancing liquidity during extreme market downturns,' such as the crashes of October 1987 and October 1997. Matthew J. Gardella, Stock Buybacks: Legal Issues Under the Federal Securities Laws and Other Practical Considerations, 13 INSIGHTS: CORP & SEC. L. ADVISOR, Mar. 1999, at 2. In addition, repurchases are also thought to be a valuable mechanism of credible communication for the company vis-à-vis its investors (where the repurchase signals the company's view that its securities are undervalued). David Ikenberry et al., Market Underreaction to Open Market Share Repurchases, 39 J. FIN. ECON. 181, 183 (1995);}
time, there are a number of reasons why the issuer repurchase context brings up many of the same concerns that the classical insider trader context did. The transaction involves anonymous trading on an exchange; it is generally done in order to take advantage of an informational advantage over shareholders that is gained because of inside access; the result of the repurchase is to solidify the position of the corporate managers (and the wallets of a subset of the shareholders) at the expense of a less informed group of shareholders; and finally, as noted earlier, this is an area in which the SEC has not specified any disclosure rules. For now, our only point is to show how the interesting and important questions raised by recognition of this duty simply have been lost from sight.

2. Sales by the Issuer

Now let us switch directions and ask whether, assuming that the issuer does indeed have a fiduciary duty to disclose in a repurchase, that same logic leads to the conclusion that there is a comparable disclosure obligation when the issuer is selling. The problem is illustrated by asking whether, assuming that the issuer is a fiduciary, it has a comparably broad duty of disclosure when selling securities to investors. In Chiarella, the Supreme Court explained that it made little sense to distinguish between purchases and sales so far as fiduciary duty is concerned, suggesting that the corporate fiduciary has as much duty to disclose to those who become shareholders through their purchases as to those who were shareholders before their sales.68 If that is the case, and the Court really meant for the fiduciary principle that it articulated in the individual insider trading cases to apply to corporate issuers as well—it would seem that the issuer should have a duty of full disclosure of all material information in all offerings. When the offering is a registered public offering, the problem is confounded with the question of whether the SEC's already expansive requirements produce disclosure duties. That was the precise issue in Shaw, where the court's attempts to struggle through the disclosure problem in front of it brought to the surface the logical problems with applying the fiduciary principles in the offering context.

Shaw involved a public offering where the offering company failed to disclose that the results for its current quarter (that was

Cf. Heminway, supra note 63, at 1175-76 (suggesting that issuer repurchases enhance shareholder value by reducing the number of shares outstanding, causing the market price to rise, and avoiding the need to use dividends as a means of distributing earnings).

about three-quarters of the way complete at the time of the offering) were significantly worse than those for prior comparable quarters.\textsuperscript{69} Had investors known this information, they may well have perceived the company as going into a new slump as opposed to coming out of one. The problem for the investors who were suing, however, was that their primary basis for claiming that the information should have been disclosed came out of the SEC's disclosure requirements as stated in Form S-3.\textsuperscript{70} The case law at the time seemed to suggest that these line-item disclosure requirements did not produce duties to disclose.\textsuperscript{71} The First Circuit, which appeared sympathetic to the plaintiffs' claims, was faced with the task of justifying its determination that the SEC's line-item rules could indeed produce such a duty to disclose. In order to do that, the court had to deal with the mass of case law suggesting that the primary, if not only, source of the affirmative duty to disclose was the presence of a fiduciary type relationship. The Shaw court did that by constructing an argument that, even while finding a duty to disclose arising out of the SEC's line-item requirements, it remained consistent with Chiarella's prescription that the only basis for an affirmative duty to disclose under Section 10(b) was a violation of a fiduciary-type duty to speak. It is this secondary argument, which the Shaw court felt compelled to use, that produces complications.

To argue that it was remaining consistent with Chiarella's teachings, the Shaw court looked to issuer repurchase cases and to what the commentators had said regarding them. The cases and commentary seemed clear on the proposition that issuers owed shareholders from whom they were repurchasing securities a fiduciary duty to disclose all material information.\textsuperscript{72} If such a duty existed in the repurchase context, the Shaw court then reasoned, it made sense that an equally broad duty to disclose all material information existed in the public offering context.\textsuperscript{73}

\textsuperscript{70} Id. at 1205.
\textsuperscript{71} For a background to Shaw, see Mitu Gulati, When Corporate Managers Fear That a Good Thing is Coming to an End: The Case of Interim Nondisclosure, 46 UCLA L. REV. 675, 737 (1999); Guttila, supra note 62; Note, Living in a Material World, Corporate Disclosure of Midquarter Results, 110 HARV. L. REV. 923, 925-28 (1997).
\textsuperscript{72} Shaw, 82 F.3d. at 1204 (citing materials on the issuer's disclosure obligations in the repurchase context).
\textsuperscript{73} Shaw explains:

Just as an individual insider with material nonpublic information about pending merger or license negotiations could not purchase his company's securities without making disclosure, the company itself may not engage in such a purchase of its own stock, if it is in possession of such undisclosed information. By extension, a comparable rule should apply to issuers engaged in a stock offering. Otherwise, a
The problem now was that Shaw appeared to have opened Pandora's box. By making the point that the issuer was a fiduciary vis-à-vis the shareholders in the repurchase context, it followed logically that the issuer was also a fiduciary vis-à-vis prospective shareholders in the offering context. That, in turn, meant that all future plaintiffs would be able to cite to Shaw and claim that, at least in the offering context, they were entitled to sue for all material omissions and not just those that were mandated by the SEC's line-item rules.

This was what happened. In a number of cases, plaintiffs claimed that, at least in the offering context, they were entitled to sue for all material omissions. We suspect that a number of judges, faced with these claims, quickly realized that to recognize such a broad duty to disclose would eviscerate the SEC's extensive and detailed disclosure apparatus that applied to the various kinds of offerings. Hence, we then saw panels of both the First and the Eleventh Circuits, in Cooperman and Oxford Asset Management, respond that plaintiffs were reading Shaw too expansively. In the offering context, both panels explained, one had to look to whether a specific disclosure requirement was violated to determine whether plaintiffs could sue based on an omission.

There are multiple problems with the rejections of the broad readings of Shaw in the aforementioned cases. First, both courts cite to language in Shaw that "mere possession of material nonpublic information does not create a duty to disclose," but they take it out of context to support their conclusions. Id. at 1204 (citations omitted). There is at least one prior case from the Ninth Circuit that appears to directly support this reasoning, albeit in a footnote. See SEC v. Murphy, 626 F. 2d 633, 652 n.23 (9th Cir. 1980) (extending the "incipient shareholder" logic from Judge Hand's decision in Gratz v. Clauthon, 187 F. 2d 46, 49 (2d Cir. 1951) to negotiations by a promoter with prospective investors considering the purchase of limited partnership interests).

74. And some district court cases seemed to accept the argument that the public offering context did indeed create extremely broad duties to disclose. See Fitzer v. Sec. Dynamics Tech. Inc., 119 F. Supp. 2d 12, 26-27 (D. Mass. 2000); see also Cooperman v. Individual, Inc., No. Civ.A. 96-12272-DPW, 1998 WL 953726, at *12 (D. Mass. May 27, 1998) (accepting, in a Section 11 case, the plaintiffs' argument about the broad duty created in Shaw, but rejecting the claim on materiality grounds); Freedman v. Value Health, Inc., 958 F. Supp. 745 (accepting, in the merger context, the argument that Shaw appeared to create a broad duty to disclose, but also granting plaintiffs' duty to disclose argument on the basis of its claim that Item 10(b) created the necessary disclosure obligation).


76. Cooperman, 171 F. 3d at 49-50; Oxford Asset Mgmt, 297 F.3d at 1190-91.
context. *Shaw* does indeed say that, but it does so as a general proposition.\(^7\) The court then tackles the more specific context of the public offering, and that is where it develops the analogy to the repurchase cases and concludes with the broad proposition that in the context of an offering, all material information has to be disclosed.\(^7\) Neither *Cooperman* nor *Oxford Asset* go anywhere near an attempt to explain why the *Shaw* analogy to the repurchase cases was wrong. We suspect that they did not do so because attempting to reject the *Shaw* reasoning on this point would have required them to say that the application of the fiduciary logic from *Chiarella* to the issuer context was incorrect, and they were unwilling to go anywhere near an argument of that import.\(^7\) Thus, the issue of whether the conception of the issuer as a fiduciary is valid remains alive for purposes of duty questions. Are plaintiffs entitled to point to the repurchase cases and *Shaw* and claim that they are entitled to the disclosure of all material information in any public offering?

This issue is also important in defining the scope of the issuer's obligations in an exempt offering.\(^8\) If we assume the fiduciary duty, then there is a disclosure obligation that extends with much the same breadth as a public offering. If we deny the fiduciary obligation, we have to explain how that would square with the presumed rule as to issuer repurchases. To date, none of these uncertainties have been resolved.

For us, the repurchase/issuance distinction falls nicely into the property/tort distinction. With a company repurchase on the open market, it is hard to see how investors could argue that the transaction created an expectation of disclosure (assuming that the transaction was on an anonymous exchange). So in mandating disclosure here, the courts are working in the property realm (perhaps rightly, given the analogy to traditional insider trading). With an offering, by contrast, there is, in effect, a face-to-face transaction. The

\(^7\) The citation that *Shaw* provides on this point is to *Roeder v. Alfus*, a nonoffering context case. *Shaw*, 82. F3d. at 1201.

\(^8\) *Id.* at 1203-1204.

\(^7\) The recent case, *State of New Jersey v. Sprint Corp.*, 314 F. Supp. 2d 1119 (D. Kan. 2004), has much the same analysis. Like *Cooperman* and *Oxford Asset Mgmt*, the *Sprint* case also does not explicitly reject the *Shaw* analysis. But what it does do is to explicitly say that the *Chiarella* analogy does not work in the issuer context. *Id.* at 1138-39. Instead, the court suggests the SEC's explicit disclosure regulations govern in the issuer context. *Id.* at 1128-1138.

\(^8\) Harry Gerla, *Issuers Raising Capital Directly From Investors: What Disclosure Does Rule 10b-5 Require?*, 28 J. CORP. L. 111, 126-127 (2002) ("*Chiarella* need not stand as a barrier to a lower court's adoption of an intermediate standard of required disclosure, under Rule 10b-5, for issuers who sell securities to investors in transactions that are not otherwise subject to mandatory disclosure requirements.").
investor knows she is purchasing from the company and has certain expectations—based on SEC rules—that the court decides whether to protect. The latter is tort-type analysis. Drawing an analogy from the former context of property analysis to the latter, tort analysis is unlikely to work.

D. Duties Arising from a Prior or Contemporaneous Disclosure

We come now to another area of obvious confusion—situations where the alleged fraud arises from something the defendant actually said. Many nondisclosure cases are variations on the half-truth doctrine, where the inquiry is whether in light of what was omitted, what was said was misleading. As one of us has explained at length in a separate article, this is best seen as a "tort reasoning" question, not a property-type one.81

So understood, we see that the half-truth doctrine is a close cousin to the most controversial "duty" doctrine under Rule 10b-5, the duty to update.82 Here, the company makes a statement that is correct when made. Later, however, new information arises that shows the earlier statement to be problematic. For example, the company announces that things are going swimmingly with its new product. Later tests reveal, however, that there are some glitches in the product. If the earlier statement is deemed to still be "alive" in the minds of the investors—that is, investors continue to rely on the accuracy of the statement beyond the point at which it was actually made—some courts will find a duty to update.83 A brief description of


83. Ross v. A.H. Robins, 465 F. Supp. 904, 906-907 (S.D.N.Y. 1979) (explaining that a duty to revise/correct a statement that was accurate when originally made arises when the statement remains "alive" in the minds of investors and they continue to rely on its accuracy); In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1417 (3d Cir. 1997) (same).
evolution of the doctrine will help flesh out what courts understand it to be about.

The adoption of the duty in the securities context first occurred in a pair of cases in the district courts of New York that utilized much the same rationale as the common law. SEC v. Shattuck Mining involved a company that announced an imminent acquisition that subsequently did not pan out.84 Although the statement was accurate when made, the court held that the company had an obligation to update the public regarding the later development.85 Similarly, in Ross v. A.H. Robins, the company in question had made a number of positive statements about its contraceptive products and then failed to tell the public about subsequently arising products liability lawsuits and negative safety reports.86 The court explained that there was an obligation to revise the earlier statements, even if originally accurate, as long as investors in the market continued to rely on the accuracy of the first statement.87

Ever since the duty to update was recognized in these early cases, one question has continued to bother courts and commentators: What is its scope? In order to set up our discussion of the confusion in this area, we briefly mention some of the leading circuit court cases on the matter. Most prominent are the First Circuit’s two decisions in Backman v. Polaroid.88 The court initially articulated what was viewed as an extremely broad obligation to update.89 Polaroid had made but brief mention of its new product, Polavision, in an otherwise glowing third quarter report (although a photograph of the product was on the cover of the report).90 Subsequently, the company took steps to discontinue production on Polavision, but made no disclosure of the matter to the public.91 The original panel held that a jury could have found the company’s silence, in the face of its initial minimal

85. Id. at 475.
87. Id. at 906-907. As an aside, although both the Ross and Shattuck cases articulate the obligation of the company to revise its earlier statements as an obligation to “correct,” we classify them as update cases because the obligations in question arose even assuming that the original statements were accurate when made. Brill, supra note 82, at 620-22.
89. For commentary on the case from that period, see Edward Brodsky, The Duty to Update Information, N.Y.L.J., Mar. 7, 1990, at 3; Schneider, supra note 82, at 2; Thomas J. Dougherty, Backman v. Polaroid: The First Circuit Declines to Expand the Duty of Disclosure, 34 BOSTON B.J. 8, 8 (1990).
91. Id.
statement and the subsequent negative news, misleading. An en banc panel of the First Circuit, however, reversed the decision and held that the initial statement about Polavision had been too minimal to give rise to a duty to update. It also went on to say that while there might be "special circumstances" where the initial statement could induce continued reliance by investors, such a triggering statement would have to be forward looking.

The Second Circuit, in Time Warner, also recognized the possibility of liability for a failure to update. There, the company had hyped its strategic alliances as a source of debt financing. When this strategy fell through, the company began pursuing the possibility of doing an equity offering to raise the necessary capital. The court, while recognizing a duty to update, held that the initial statement regarding strategic alliances was insufficiently specific to give rise to a duty to update. The court stated, nonetheless, that a switch to an alternative method of financing might give rise to such a duty. Both Backman and Time Warner were struggling with the scope question: that is, exploring what types of initial statements produce the kind of investor reliance that requires updating.

Following on the heels of Time Warner, the Third Circuit issued two decisions that tackled the duty to update. In the first, Burlington, the court attempted a different approach from the one used in Time Warner and Backman, using a technique different even from the Third Circuit's own prior decisions on the matter, Greenfield and Phillips Petroleum. The prior approach had been to ask simply whether the failure to update had the potential to mislead reasonable investors; the work courts were doing in these cases involved separating the types of statements and circumstances that required updating, because investors might be misled, versus those that did not. Burlington flipped the question, and instead articulated the key question as whether the company's initial statement contained an implicit representation that the company would update investors or not. In a sense, the approach was more based in contract than tort.

92. Id. at *26-30.
93. Polaroid II, 910 F.2d at 17.
94. Id. at 17-18.
96. Id. at 262.
97. Id. at 267.
98. Id. at 268.
100. 114 F.3d at 1431.
But the *Burlington* court did not seem to think that it was doing anything different from the prior cases and cited to them as support. 101 After all, if there was a promise to update investors as to important developments, silence would suggest to investors that there had been no important developments. And if there was no initial promise to speak, silence would not be misleading. Ordinary earnings forecasts, the *Burlington* court concluded, did not contain an implicit promise to update, whereas statements about major events such as mergers, might. 102

A few months later, the Third Circuit had occasion to consider the duty to update again. But this panel of the Third Circuit appeared to find the *Burlington* court's approach wanting (in that it did not even cite it in its discussion of the updating question, even though it could have used the *Burlington* approach to arrive at the same result). 103 Instead, the second panel returned to the tort approach of simply asking whether investors had been misled. 104 The company in question had made repeated statements about its debt-to-equity ratio and its intentions to keep it within a certain range. 105 There was an impending merger, however, and the company failed to disclose to the public that it had decided to abandon its planned debt-to-equity ratio targets. 106 This failure to speak, the *Weiner* court held, violated the duty to update. 107

In sum, the dominant approach among the circuits that recognize the duty to update simply appears to be to investigate whether investors are misled by the failure to update a certain statement. There are some courts that answer this question more narrowly than others, but the analysis, *Burlington* and its progeny aside, tends to be tort-like.

The Seventh Circuit, rejecting the duty to update, has taken a different tack. At the heart of the duty to update is the question of how it can be fraudulent not to speak (or, here, to update). The Seventh Circuit has rejected the viability of the duty to update.

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101. *Id.* at 1431-34; see also *Oran v. Stafford*, 226 F.3d 275, 286 (3d Cir. 2000) (citing *Burlington* for both the proposition that the duty to update "concerns statements that, although reasonable at the time made, become misleading when viewed in the context of subsequent events" (the old standard), as well as the proposition that the prior statement only becomes actionable if it contained an "implicit factual representation that remained 'alive' in the minds of investors as a continuing representation") (citations omitted).

102. *Oran*, 226 F.3d at 286.


104. *Id.*

105. *Id.* at 316-319.

106. *Id.*

107. *Id.* at 316-318.
precisely because it could not think of an answer. But, as described, the courts that have recognized the duty have offered an answer: the earlier statement, so long as it remains alive, operates as a continuing representation of its accuracy. If there is a statement of this type, then there is detrimental reliance—a perfect example of tort-type thinking. So articulated, the duty to update would be firmly grounded but relatively narrow in scope, because most corporate statements are not the sort that could be viewed as a continuing representation. Most speak to the moment or for a very short period of time. In this sense, the Seventh Circuit's rejection of the duty to update might be overbroad but is understandable.

But the Seventh Circuit's rejection of the duty to update has not been simply a rejection of the idea that there exists a subset of statements that could remain alive beyond the point at which they were actually made. Instead, the circuit has looked to at least two different policy explanations. In *Stransky v. Cummins Engine Co.*, the court explained that the securities laws approached matters from an ex ante perspective that was inconsistent with the kinds of hindsight-based determinations that the duty to update required (at least, with respect to forward-looking statements). This concern about hindsight was restated by Judge Posner in *Eisenstadt v. Centel Corp.*, where the duty to update was rejected even more emphatically.

108. *Stransky v. Cummins Engine Co.*, Inc., 51 F.3d 1329, 1331-32 (7th Cir. 1995); *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir. 1997); *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001).

109. And indeed, along these lines, the Third Circuit, in *Burlington*, explained that there could be no duty to update routine forecasts, although there might be a duty to update statements about major transactions such as mergers. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1431 (3d Cir. 1997).

110. *Stransky*, 51 F.3d at 1331-32. The court explained that the policies underlying Section 10(b) "implicitly preclude basing liability on circumstances that arise after the speaker makes the statement." *Id.* Invoking the hindsight bias, the court asserted that "[t]he securities laws typically do not act as a Monday Morning Quarterback" and went on to explain that the securities laws " 'approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true.' " *Id.* (citation omitted). For a detailed treatment of invocations of the hindsight bias problem by courts in the securities fraud context more generally, see Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 796-813 (2003).

111. *Eisenstadt*, 113 F.3d at 744-746 (explaining that "Centel cannot be faulted for having failed to tell the stock market that there would be only seven bidders and their bids would be no good. Had it known this from the start, it wouldn't have announced an auction. Hindsight is not the test for securities fraud."). Judge Posner also suggests that the PSLRA might have signaled the death of the duty to update. But that is a difficult argument to make, given that while there is a point in the PSLRA where the provision explicitly says that nothing in that subsection is to be construed to create a duty to update, there is also nothing that disclaims the preexisting judge-created duty. Brill, *supra* note 82, at 657.
Taking a somewhat different approach in *Gallagher v. Abbott Laboratories*, Judge Easterbrook explained that creation of duty on this matter was the province of the SEC. The SEC currently requires periodic reporting at quarterly intervals. An updating duty would be, in effect, a court mandate that reporting be continuous, and the Seventh Circuit concluded that courts did not have the authority to impose that mandate—only the SEC or Congress did.

Among the interesting points evident in the contrast between the Seventh Circuit's approach to the updating duty and that of the earlier mentioned circuits is that while the Seventh Circuit looks to the big picture question of whether it would be appropriate to create a duty, the other circuits, for the most part, simply look to see whether investors were misled. The former seems more like property-type thinking and the latter is tort-type thinking.

This point about what the Seventh Court is doing, as compared with the approach of the other circuits, is clearer when one looks to the fact that even while rejecting the duty to update, the Seventh Circuit has embraced its sibling, the duty to correct. The duty to correct is an obligation to correct statements of historical fact that were erroneous when made, although unknowingly so. As with the duty to update, there was no fraud at the time that the original statement was made. It is the failure to report the subsequent arrival of new information, showing the earlier statement to be erroneous, that is said to be potentially fraudulent. The duty to correct, like the duty to update, requires taking an ex post perspective (indeed, one also susceptible to the hindsight bias problem) and has not received explicit SEC approval as constituting part of its periodic disclosure apparatus. Yet, even though these difficulties with the duty to correct were among the reasons given by the Seventh Circuit for rejecting the duty to update, that court is comfortable with the duty to correct.

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112. *Gallagher*, 269 F.3d at 808.
113. Id.
114. In doing so, the court implicitly examined what the costs of making error-prone hindsight decisions are versus the benefits in terms of fraud prevention.
115. Although the Fourth Circuit's decision in *Hillson Partners v. Adage* is not quite the explicit rejection of the duty to update that is contained in *Stransky, Eisenstadt*, and *Gallagher*, it also used policy reasons— that a duty to update would simply be too onerous for companies to comply with—to back up its rejection of the updating claim. 42 F.3d 204, 219 (4th Cir. 1994).
116. It appears that the Fourth Circuit may be taking an approach similar to that of the Seventh Circuit. Id.
The explanation for the Seventh Circuit's comfort with the duty to correct and not the duty to update presumably derives from some judgment that the former involves few costs and more benefits than that latter; perhaps the hindsight bias problems are fewer and the inconsistency with the SEC's periodic reporting system smaller. That judgment may be correct. Indeed, one can tell a plausible story about how the person who makes the mistake is the one best able (and most likely) to ferret it out or, alternatively, that there needs to be a disincentive for people who may be tempted to claim that they innocently made mistakes. The point we hope is clear here, though, is that all of the aforementioned justifications for the Seventh Circuit's position rest on efficiency or fairness estimations about the value of one disclosure rule versus another. In other words, the Seventh Circuit is engaging in property-type thinking when deciding to create expectations regarding correction and to negate expectations regarding updating. That, then, is in contrast with the approach of

118. We are skeptical, though. In practice, it seems hard to distinguish between a correction case and an update case, and both seem susceptible to the hindsight bias. The following example will help illustrate:

Take a publicly traded drug company that has a new hair loss prevention drug about which investors are excited. The CEO makes a statement that the company is optimistic about the company's financial prospects as a result of the success that the drug is expected to have. At the time that the statement is made, the company has before it a study suggesting that a small fraction of the patients in the trials had developed serious intestinal disorders. Subsequently, as more tests are done, it turns out that there is a causal link between the use of the drug and the intestinal disorder. In hindsight, it looks like ignoring the initial warning sign was a mistake. Does the company have a duty to correct? After all, they did have the information about some intestinal disorders showing up at the time of the initial disclosure. In addition, what if it turns out that some years prior there had been an article in the JAMA that had reported a possible connection between hair loss and intestinal disorders? The company's researchers had been unaware of the article at the time of the CEO's statement but discovered it later as they began investigating the matter more. At least to us, it seems unclear whether this is an update case or a correction case. And it is even less clear why one should produce liability and the other should not. Indeed, there is one recent case where the Seventh Circuit itself appeared to struggle over this classification problem. In In re HealthCare Compare Corp., the company had made an optimistic statement that was thought to be correct at the time made (or, at least, there was not evidence to demonstrate otherwise). 75 F.3d 276, 281-83 (7th Cir. 1996). At the time the statement was made, however, the company was collecting the necessary information and when that was compiled, it showed the prior statement to be in error. Id. at 281. The defendants pointed to the Seventh Circuit's earlier cases, such as Stransky, saying that there was no duty to update forward looking statements. Id. at 282. The court, however, explained that this was not a case where some unexpected event had occurred to make an earlier made optimistic statement incorrect. Instead, this case involved the routine collection of information and, therefore, disclosure of the new information was required under the duty to correct. Id. at 283. The Seventh Circuit, in order to make the distinction between the duty to update and correct, had to make another distinction between unexpected intervening events and expected ones. And it is not clear that this is a useful distinction (that is, saying that expected events have to be reported on, but not unexpected ones).
the other circuits to take expectations as given and ask whether the silence in question was misleading.

E. The "Flexible Duty" and How it (Almost) Got Lost

Starting with the Ninth Circuit in *White v. Abrams* in 1974, a handful of courts set out what they called a "flexible duty" to disclose. The duty was applied as a function of the specific transactional context and is aimed at determining both the duty to disclose and scienter. Courts used a multifactor test and examined the following: (1) the informational asymmetry between the parties and their relationship; (2) their relative access to information; (3) who initiated the transaction; (4) the benefit to the defendant from withholding the information; and (5) the defendant's awareness of reliance by the counterparty. The multifactor analysis was an amalgam of the various common law sources of the duty to disclose. At bottom, it amounted to asking the question of whether the circumstances were such that the counterparty expected that certain information, if possessed by the other side, would be disclosed. Versions of the Ninth Circuit's flexible duty test were picked up in the Sixth, Eighth, and Eleventh Circuits. But its import has always been unclear in the light of *Chiarella's* insistence on the need to find a fiduciary-type duty. In other words, the question has been: Does

119. 495 F.2d 724, 730-36 (9th Cir. 1974); see also Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681-83 (N.D. Ind. 1966) (applying an approach similar to the flexible duty approach in looking to see whether there was a special relationship that could justify finding a duty to disclose). For additional background on the flexible duty and the first decade of cases that applied it, see Fishman, supra note 11, at 275-278 (1987) (describing the flexible duty to disclose in the context of the Court's decisions in cases such as *Chiarella* and *Dirks*).

120. Zweig v. Hearst Corp., 594 F.2d 1261, 1268 (9th Cir. 1979); Spectrum Fin. Cos. v. Marconsult Inc., 608 F.2d 377, 381-82 (9th Cir. 1979).

121. For a recent discussion of these factors and their importance at common law, see Melvin A. Eisenberg, *Disclosure in Contract*, 91 CAL. L. REV. 1645, 1648 (2004).


123. See Fishman, supra note 119, at 275-78 (explaining the narrow view of the sources of the duty in the post-*Chiarella* period, that viewed fiduciary duties as the only source of duties to disclose and the broader view that included the flexible duty as a possible source). For examples of post-*Chiarella* cases applying both *Chiarella* and the flexible duty, see City of Harrisburg v. Bradford Trust Co., 621 F. Supp. 463, 473-74 (M.D. Pa. 1985); Ahern v. Gausson, 611 F. Supp. 1465, 1488 (D. Or. 1985); Marrero v. Banco di Roma (Chicago), 487 F. Supp. 568, 574 (E.D. La. 1980). In a number of these cases, even though the court cites to the flexible duty, it is not clear that a flexible duty violation is enough to produce a violation for purposes of Section 10(b) in the absence of a *Chiarella*-type fiduciary duty violation. But see Bradford Trust Co., 621 F. Supp. 463 (suggesting that the two sources of duties can exist independently). But, if there is the need for a *Chiarella*-type fiduciary duty to be violated, it is not clear at all what work the court's citation to the flexible duty is doing. For recent examples of this confusion, see Ziemba v.
the flexible duty operate as an independent source of the duty to disclose or is it only applicable as a means to determine whether a fiduciary-type relationship exists? Interestingly enough, at least as a formal doctrinal matter, the source of that disappearance was not Chiarella (or, more specifically, an interpretation of Chiarella that said that the only source of the duty to disclose was the presence of a fiduciary-type relationship). Indeed, the flexible duty survived for at least ten years after Chiarella was decided.

The source of the disappearance (or at least, the diminishment) of the flexible duty was a 1991 decision out of the Ninth Circuit itself, Titan v. Hollinger Corp., where the court interpreted the Supreme Court to have rejected the flexible duty on the grounds that it was based on a negligence standard. But if one looks at the language in Hollinger, and the Supreme Court opinion that it cites, Ernst & Ernst v. Hochfelder, it is evident that the Court was talking only about the scienter requirement, not the duty to disclose. The Supreme Court, in Hochfelder, did say that a section 10(b) suit required the plaintiff to demonstrate that the defendant had scienter. But it said nothing about the duty to disclose. Yet Hollinger began the process of rejecting the flexible duty as a test for scienter. At least one circuit court has forcefully called attention to this puzzle regarding the disappearance of the flexible duty, but few others have picked up on it.

That one case—Arthur Young & Co. v. Reves—is worth considering. Reves involved an Arkansas cooperative that issued notes to a large number of investors. When the investment turned south, the disgruntled investors sued the accountants, among others. On remand from the Supreme Court, which determined that the instruments at issue were securities, the Eighth Circuit faced
the question of whether the accountants had had a duty to disclose to investors a fuller picture regarding the cooperative's fortunes. The court applied the flexible duty and found that the duty had indeed been violated. Among the factors that appeared to be important to the court were the facts that the investors were farmers in Arkansas, the prominent accountants had made multiple appearances at the cooperative's meeting, and the accountants were fully aware of the cooperative's problems, but said nothing to warn the investors. There was no preexisting fiduciary-type duty between the accountants and the investors, but the court found that the overall picture suggested that the accountants' silence had been misleading. In other words, the transactional context was such that the farmers expected that the accountants would inform them if there were problems with their investment in the cooperative's notes.

And indeed, if one looks beyond the insider trading and issuer contexts, we find evidence that courts have embraced the transaction-based duty in other contexts. When broker-dealers transact with customers, for example, there is assumed to be an implicit representation that the securities in question are appropriate for the customer. Also, in the secondary liability context covering lawyers, accountants, and other secondary participants, one often sees reference to some kind of flexible duty.

132. Id. at 1329-32.
133. Id.
134. The court does say that the context was such that the investors reposed "trust and confidence" in the accountants. Id. at 1331 (citing Chiarella v. United States, 445 U.S. 222, 232 (1980)). This reference to "trust and confidence" was likely an attempt to suggest that the court was staying consistent with the duty parameters set forth by Chiarella. But to look at the facts is to realize that there was no pre-existing relationship between the investors and accountants that would suggest that the former had reposed "trust and confidence" in the latter in a fiduciary sense. Instead, it simply is that the circumstances suggested that silence on the part of the accountants was likely to be misleading. And we see that at least some later cases, for example Reves, stand for the proposition that a duty to disclose can be created either by finding a fiduciary-type duty, as in Chiarella, or by finding the flexible duty factors violated. 937 F.2d at 1329-31; Camp v. Dema, 948 F.2d 455, 460 (8th Cir. 1991).
136. Cynthia A. Bedrick, Defining the Duty: Attorneys' Obligations Under Rule 10b-5, 74 IND. L. J. 1297, 1306-1312, 1318-1320 (1999) (describing thirteen different approaches that courts have taken to the duty question in the lawyer obligation context – many of which reject the narrow fiduciary duty approach); see also Robert J. Haft, Liability of Attorneys and Accountants for Securities Transactions, in OPINIONS IN SEC TRANSACTIONS, at 777, 783 (PLI Corp. Law &
Cascade International Inc., the Eleventh Circuit, while rejecting the fraud claims against the lawyers and accountants who had helped prepare the problematic offering documents, suggested that a duty to disclose could arise if the plaintiffs were able to demonstrate that the investors had relied on the expertise of these secondary actors. This reasoning was very much in line with Reves. That said, it must be noted that these references to the flexible duty have greatly diminished in the period after the Court’s decision eliminating aiding and abetting liability to primary violators under Section 10(b) in Central Bank in 1994. The larger question, though, is why, if transaction or context-based duties have been considered appropriate in these other contexts, have they not survived in Section 10(b) jurisprudence regarding issuer obligations? As noted, using such a duty would certainly help courts avoid much of the confusion that they now face when they have to twist and turn, borrowing from state fiduciary principles to create or fail to create duties in contexts such as that of a public offering or a repurchase.

The reluctance of courts to embrace the flexible duty doctrine, we suspect, has been out of a fear that doing so might create additional obligations for companies to disclose proprietary information. But, as Reves itself illustrates, the flexible duty applies only as a function of specific transactional context. That is, one must consider whether the company, law firm, or accountants involved have created a reasonable expectation of disclosure. Absent the defendant’s creation of this expectation, there is no duty. In other words, this is properly a tort analysis, not property analysis.

III. CLEARING UP THE CONFUSION

We hope we have demonstrated the confusion in the law. Our goal now is to sort out some of the doctrinal conflicts that we have surveyed and to see if we can simplify the analysis. The following guidelines should help.
A. Insider Trading is a Special Subject Under Rule 10b-5, and the Holdings and Dicta from Insider Trading Cases Should Not Be Imported to Non-insider Trading Cases

In many ways, much of the confusion in the case law on the duty to disclose comes from Chiarella’s dicta that duty is central and arises only when there is a pre-existing fiduciary relationship between the parties. Read in context, this dictum was addressed to the unique problem of working out an appropriate solution to the insider trading problem in a world where informational imbalances abound and markets reward prompt information discovery. The fiduciary principle was chosen not because it was the only norm available but because the Court thought it captured the desired line of demarcation: those with a fiduciary duty of loyalty ought not put their interests before those of the shareholders to whom they owe that duty. The Court believed any broader or fuzzier line—such as one based simply on fairness—would be overbroad and chill too much acceptable trading behavior in the markets.139

Such a reading suggests that the holding and dicta in Chiarella are unlikely to be helpful in solving different 10b-5 problems, such as the issuer’s duty to disclose. The many courts that have assumed otherwise have sown the seeds of confusion. Other 10b-5 issues involve a very different mix of interests, and as a result there is no reason to assume that the “fiduciary breach” or “wrongdoer” line of demarcation is the right one.

We would say the same about the misappropriation theory. As we have seen, the underlying “duty to disclose” principle articulated in O’Hagan has immense potential breadth, capturing the full range of concealed fiduciary misconduct touching on the purchase or sale of securities.140 Again, however, it needs to be read in context. Clearly, the Court was trying to articulate a line similar to that drawn in Chiarella, between trading that is disloyal (and hence simply should not be allowed) and that which forms part of the acceptable operations of the markets. The idea is that instilling investor confidence in the integrity of the markets requires discouraging “bad” trading, and the

139. See Pritchard, Agency Law, supra note 53, at 932-34 (discussing the Court’s decision in Chiarella); Langevoort, supra note 45, at 19-20.
140. See supra Part II.B.
theft of information is plainly bad. The broad duty to disclose one's own misappropriation to the source of the information was merely a tool needed to capture that idea. Importing that tool too easily to other disclosure issues under Rule 10b-5 again risks taking it severely out of context.

To underscore all of this, consider the effects of the rules in the insider trading area. As insider trading law developed, courts first looked to see whether there was a fiduciary-type duty that was violated in such cases. If under the classical theory, involving a company insider doing the trading, the duty violation is vis-à-vis the company's shareholders. Here, the duty to disclose is the insider's obligation either to disclose the information to the public or to abstain from trading. Disclosure to the public in this context, though, is a meaningless requirement since effective disclosure would mean that there would be no value in doing the trading in question. The rule, in effect, says that insiders with a material informational advantage over shareholders are prohibited from trading—what we have long known to be the practical effect of the abstain or disclose rule. It operates as an injunction against certain kinds of trading by the company insiders. Unlike the approach of a tort-type analysis, there is no attempt in the insider trading cases to discern whether the counterparty to the trade was actually misled. The focus is on the person doing the trading and the improper nature of their conduct. Indeed, the counterparty in a market transaction likely had no idea that she was trading against a company insider and just as easily could have executed that same transaction with some non-insider at the same price.

So, too, with the misappropriation theory. The obligation of the insider is to disclose that she is planning to trade. But the rule is not actually meant to produce disclosure to the source or protect the source's property rights in the information. After all, no employee or agent is really going to disclose to her boss that she is planning to steal from her before she does the stealing. The rule, while articulated as a disclosure obligation, again amounts to a prohibition on trading. In other words, the right to trade on the information is allocated

141. See, e.g., Elliott J. Weiss, United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading, 23 J. CORP. L. 395, 431-35 (1998). This is not to say that the Court's approach was analytically coherent, but simply effective in pursuing its chosen aim of promoting investor confidence. We acknowledge that the cumulative effect of the case law may be far removed from intellectual coherence. Saikrishna Parkash, Our Dysfunctional Insider Trading Regime, 99 COLUM. L. REV. 1491, 1532-47 (1999); Donna M. Nagy, Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion, 59 OHIO ST. L.J. 1223, 1264-80 (1998).

142. LOSS & SELIGMAN, supra note 62, at 784-85.
exclusively to the source and the employee of the source is excluded from using the information. That rationale, though perfectly serviceable in its own context, simply does not work when applied to questions such as an issuer's affirmative disclosure duty.

B. The Issuer's Duty to Disclose Rests Best on Tort-type Reasoning

As just suggested, one of the biggest mistakes courts have made is to treat the insider trading rules and rhetoric as if they provided a useful framework on a very different kind of question, the issuer's duty to disclose. The issuer's duty poses a distinct and complicated set of interests. Disclosure is costly, in a way borne directly by investors, both in terms of the time and effort it takes to gather and produce and in the threat of premature release of proprietary information that operates to the disadvantage of the firm. On the other hand, the benefits of disclosure are hard to dispute.\textsuperscript{143} As Ed Kitch and other scholars in this area have shown, striking the right balance is difficult.\textsuperscript{144}

A number of implications follow. First, courts should be reluctant to set policy in issuer disclosure cases—that is a job the securities laws assign to the SEC, and the SEC's choices should presumptively define the proper "property-thinking" norms. In other words, where the SEC has addressed a subject by setting affirmative disclosure rules, the presumption should be that the antifraud rules require nothing else. Thus, the scope of disclosure in a public offering should be what the instructions of the relevant form require. So, too, in the proxy area.\textsuperscript{145} Though surely tempting, it would be wrong to draw from Chiarella's fiduciary principle any duty to disclose more than the rules require.\textsuperscript{146} This is not to say, however, that the duty to


\textsuperscript{144} Edmund W. Kitch, \textit{The Theory and Practice of Securities Disclosure}, 61 BROOK. L. REV. 763 (1995); Paul G. Mahoney, \textit{Mandatory Disclosure as a Solution to Agency Problems}, 62 U. CHI. L. REV. 1047, 1047, 1111-1112 (1995). This is a common ground for doubting that even the SEC can do a good job, see, e.g., Stephen Choi & A. C. Pritchard, \textit{Behavioral Economics and the SEC}, 56 STAN. L. REV. 1, 5 (2003) (arguing that behavioral and cognitive biases affect the SEC's ability to effectively regulate financial markets). Regardless of whether one agrees, the idea that courts can do a better job under the rubric of fraud is highly doubtful.

\textsuperscript{145} One of us has suggested a stronger usefulness to the fiduciary obligation in the proxy context, see Langevoort, supra note 45, at 466. On reflection, it is probably best to leave this as part of management's duty not to mislead. Descriptively, however, it is clear that many courts have operated as if there were a fiduciary duty to disclose in proxy solicitations.

\textsuperscript{146} As noted earlier, one recent case, \textit{State of New Jersey v. Sprint Corp.}, 314 F. Supp. 2d 1119, 1139 (D. Kan. 2004), came to this conclusion. The court in that case did not flag the fact
disclose as applied by courts need necessarily be restrictive—recall that the SEC mandates in all filings the disclosure of additional material information necessary to make the responses to the line-item requirements not misleading.\textsuperscript{147} But that "half-truth" notion is the boundary line. Cases like \textit{Shaw} that look for a duty to disclose something beyond that explicitly required should limit the inquiry to those disclosures that satisfy our "tort-thinking" test: that is those whose omissions would likely mislead reasonable investors, given the informational context the SEC has created for disclosure in public offerings.

What about the duties to update or correct? One plausible response might be Judge Easterbrook's opinion in \textit{Gallagher v. Abbott Labs.}\textsuperscript{148} Easterbrook viewed the plaintiffs as making, effectively, a duty-to-update claim. Turning to the Seventh Circuit's unwillingness to recognize such a duty, he explained that the creation of a duty-to-update was the province of the SEC and not the courts. Presumably, the story here is that Congress delegated the authority for rulemaking in the disclosure department to the SEC because of its special expertise. Courts do not have this expertise and, therefore, rationally may not want to engage in this potentially dangerous task.

We disagree, though his point about deference and institutional competence is well taken. To us, deference is appropriate when the underlying question is policy-based "property" thinking, driven by the desire to achieve the right balance of fairness or efficiency. However, when a form of issuer disclosure actually has the potential to mislead investors, courts have long-standing institutional competence to police the area. And to us, the duty to update — properly understood — has this character. There are some disclosures that reasonably do lead investors to rely on the statements beyond the date on which the statement was made: that is, those that establish some new policy or speak in terms of a plan or commitment in a way that invites continued reliance. But most issuer disclosures only speak to the moment, and these should not be subject to the duty to update. The relatively small handful of cases where courts have imposed liability

\textsuperscript{147} See supra Part II.A.

\textsuperscript{148} 269 F.3d 806 (7th Cir. 2001).
for failure to update seems to respect this distinction, though not with the clarity we might like in explaining it.\footnote{149}

As to the duty to correct, we face a harder problem. One way of looking at the duty to correct is that it is conceptually indistinct from the duty to update, so that both should be applied narrowly using the "continuing representation" idea. We suspect, however, that the judicial impulse to force correction more aggressively than updating is based on something akin to a tort-like duty to rescue. That is, when an issuer has caused investors to rely to their detriment on a prior statement that was false, though not fraudulent, when made, the issuer has a duty to avoid any future harm to those investors who may still be relying, without worrying significantly whether those investors still may be relying justifiably or not. This would be based in part on fairness, part on efficiency. That might suggest that we are in the "property" area, but courts probably can be excused for being assertive in this context. Deference and restraint are normally necessary because of the difficulty of balancing the issuer's interests regarding such issues like the costs of information production or the need for confidentiality. Once the issuer has chosen to speak on an issue but has done so falsely, albeit innocently, then these competing interests largely fall away. In other words, there are very few policy-based reasons one can think of not to compel correction. Its endorsement by all courts that have considered the question is not surprising once we look carefully at the duty issue.

The question of issuer disclosure when an issuer repurchases its securities is even more complicated. On the assumption that issuer trading in the open markets is anonymous, tort-type thinking would not justify an affirmative disclosure obligation. It is clearly property-type thinking that governs this question, which may suggest a hands-off attitude. However, we believe that issuer trading is simply a species of insider trading generally, an area where the courts have assumed responsibility for setting the property-like rules governing the exploitation of informational advantages. Imposing a duty to disclose on issuers under Rule 10b-5, which most people currently assume to be the law, has ample justification when thought of as an insider trading problem because it responds to concerns (such as adverse selection in markets or the perception of unfairness) that are traditional in insider trading reasoning.

Again, however, there is no strong reason to assume that the opposite is also true—that a fiduciary duty attaches to issuer sales of

\footnote{149. Indeed, in \textit{Gallagher} itself, application of this approach would have led to the conclusion that there was no duty to update.}
securities that do not take the form of anonymous open market trades. The point in *Chiarella* that purchases and sales should be treated identically makes sense in the insider trading context given the special objectives at work there.\(^\text{150}\) An issuer negotiating a private placement of securities, or conducting a registered public offering, has no pre-existing trust relationship with potential investors that would justify any greater disclosure burden than those (if any) imposed by SEC rules.

**C. SEC Line-items Do Create a Duty to Disclose**

One of the stranger results that some courts have reached is the one that line-item requirements do not create a 10b-5-based disclosure obligation.\(^\text{151}\) Indeed, almost every one of the arguments just made about the issuer disclosure question points in the opposite direction. We suggested that the difficult balancing associated with the questions of what issuer disclosure to compel and what nondisclosure to privilege is better done by the SEC than the courts. When the SEC has chosen to compel some disclosure via Regulation S-K or S-B or in the instructions to a required disclosure form, that work is done and the courts should accept the Commission's determination, not undercut it by eliminating an enforcement mechanism.

Another way of showing this is by reference to tort-type analysis. Consider first that it is well established that an affirmative misrepresentation in an SEC filing is actionable,\(^\text{152}\) reflecting the common-sense notion that reasonable investors actually rely on such disclosures. It follows to us that a deliberate omission has the same potential to mislead—the reader of the disclosure sees that the issuer is responding to the disclosure obligation and is entitled to assume that the response is not only accurate but complete as well. In other words, she actually can be misled by the omission.

\(^{150}\) As noted earlier, the point was raised in the *Chiarella* opinion that when an insider is selling, the purchaser has no pre-existing fiduciary relationship with the insider, so that the duty to disclose premised on such a relationship would not seem to follow. But Justice Powell simply stated that it would be a "sorry distinction" to raise. *Chiarella* v. U.S., 445 U.S. 222, 227 n.8 (citing Learned Hand's dictum in *Gratz* v. *Claughton*, 187 F.2d 46 (2d Cir. 1951)). Nothing better illustrates that issue specific nature of the Court's reasoning than this—it effectively relaxed its insistence on pre-existing duty simply to permit the law of insider trading to make sense.

\(^{151}\) See supra Part II.A.

\(^{152}\) Scores of cases have so held. For a seminal decision holding that Rule 10b-5 was available regarding false filings notwithstanding the presence of an express cause of action (albeit hard to satisfy from a plaintiff's perspective), see *Herman & McLean v. Huddleston*, 459 U.S. 375 (1983); *Ross v. A.H. Robins, Co. Inc.*, 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).
There are limits inherent in this approach. For example, if an issuer's response to a line-item were something along the lines of "we cannot provide the information requested" or a simple failure to file completely, this would operate as a breach of the line-item requirement but not be a fraud. The investor is on notice of the noncompliance and would not be misled. More subtly, the same would be true if the issuer's disclosure were obviously confusing. To illustrate, if a disclosure identified a self-dealing transaction but inappropriately omitted the amount of benefit, investors would be hard pressed to say that they were misled, because they would be aware that the issuer had not provided the required information.

In addition, to clear up what might be an additional source of confusion, plaintiffs do have to demonstrate more than the fact of the line-item omission. The omission simply satisfies the duty element. Materiality, scienter, reliance, and causation are additional elements, separate and distinct from the question of duty. But if plaintiffs are prepared to make those showings, the case should go forward.

D. In Cases Involving Neither Insider Trading Nor Issuer Disclosure Obligations, Courts Should Retain Flexibility in Finding Duties

By far, insider trading and issuer disclosure questions dominate the law relating to the affirmative duty to disclose. Our suggestion is that they represent two distinct fields of inquiry, with unique interests at stake, so that precedent and dicta developed within each should not automatically be applied to other kinds of duty questions. That means that the smaller category of cases addressing other kinds of dealings should be unencumbered by restraints such as those found in Chiarella's dicta, and courts should be sensitive to the different set of interests involved.

Two examples will make the point. Probably the next largest set of "duty" questions arises with respect to the disclosure obligations of broker-dealers when dealing with customers. The law has developed to a point where only a subset of such relationships are deemed fiduciary. If there is a fiduciary relationship, there is a complete duty to disclose—which the Supreme Court in Zandford extended to include nondisclosure of simple faithlessness. Though this principle may seem to be an extension of O'Hagan, where a

similar analysis was employed, it is really very different. Tort-type analysis can readily explain how a trusting client could in fact be deceived by such misconduct. Indeed, that is how the fiduciary duty to disclose initially developed.

In the nonfiduciary broker-customer relationship, that approach does not work. Yet we still see fairly broad duties to disclose risk-related information, often by reference to the fiction of the shingle theory. That is a property method at work, creating an expectation of fair dealing rather than necessarily protecting a pre-existing one. While that may seem inappropriate under our approach, consider the context. Congress long ago made broker-dealers a subject of extensive federal concern and made fraud the primary standard for policing their conduct outside the context of self-regulation. This signal gave courts reason to extend duties flexibly, which they have done. The same could be done in the mutual fund area, which recently has generated its own set of "duty" issues growing out of the late trading and market timing scandals.

By contrast, we can see why the same logic might not justify comparable expansiveness in settings such as corporate mismanagement—though the Sarbanes-Oxley Act suggests that in the last few years, the line of federal interest on matters of corporate governance may have shifted. Consider the Ken Lay example discussed earlier. One could take the Chiarella-O'Hagan fiduciary principle as giving rise to a broad duty to disclose all material facts, including one's own faithlessness. If that is tied to a securities purchase or sale, which could readily be found in the stock options granted by the presumably unsuspecting compensation committee of the board, nondisclosure of virtually anything smacking of corporate mismanagement could be a violation of Rule 10b-5. Thus far, courts have been reluctant to federalize corporate mismanagement, which would be an example of flexible duty analysis at the more restrictive end of the spectrum. To the extent that the federalism balance has shifted more recently, courts might be justified in expanding the notion of duty in the context to conform to the perceived increase in federal interest. For now, our point is that a flexible duty analysis captures what courts should do in this sphere fairly well.

That, in turn, suggests that the so-called death of "flexible duty" as a distinct form of reasoning (putting aside the state of mind element) may have been an overreaction to Chiarella and the

156. See supra Part II.B.
demotion of a construct that has a good deal of appeal. The small number of cases that have accepted the possibility of such analysis in the years after Chiarella—particularly the Eighth Circuit’s Reves decision—deserve more attention and respect than they have been given.

E. Concern About Litigation Abuse Should Not Play Any Role in Duty Questions

We suspect that courts that cut back on the duty involved in questions such as issuer liability in the aftermath of Chiarella may have felt comfortable in so doing not simply because the conclusion logically follows from the insider trading context (which it, in actuality, does not) but because narrowing duty seemed responsive to the growing feeling in the federal courts during the 1980s and 90s that nonmeritorious litigation was a growing problem. Broad, flexible duties seemed tailor-made for aggressive private litigants. The cutback most likely driven by this anti-plaintiff bias was the holding that SEC line-item requirements such as the MD&A do not create a duty for fraud purposes. This, as we have shown, sets logic and any reasonable notion of institutional primacy on its head.

The broader point we make here is one of judicial process. One can debate whether the judicial attitude toward excessive private litigation was justified during this time. Plainly, the courts were sensitive to the issue. But in 1995, Congress provided a comprehensive set of answers to the problem, particularly in the form of heightened pleading requirements and the safe harbor for forward-looking information. These steps may have been an overreaction, setting the bar too high, but that is not our point. Rather, the point is that now that Congress has addressed the question, for better or worse, courts should not draw blindly from pre-1995 case law that expressed discomfort with private litigation before the reforms Congress initiated. This may well be a serious problem because there was so much judicial innovation during that time period that can be traced to the discomfort. The point is that now, a case cannot go forward without a strong pre-discovery showing by the plaintiffs indicating that it is not a strike suit. Courts may not be perfect

157. See supra Part II.E.

arbiters here, but the bias surely favors defendants more than plaintiffs. Moreover, forward-looking disclosures get a deep safe harbor even when fraud seems likely.

Given those two "reforms," one might think about whether a court should hold that the kinds of forward-looking disclosures mandated by the MD&A give rise to a 10b-5 duty. Even if, prior to 1995, a judge might have thought that denying the duty would be a protective device, there is no reason to continue that logic in the aftermath of reform. While it is beyond the scope of this Article, we suspect that there are many doctrinal moves still applied today, even though the justification for the conservatism has been superseded now by what Congress did. In other words, there are legacies in the case law that operate perniciously today. We would venture the guess that many duty cases from this time period fall into that category.

IV. CONCLUSION

Our conclusion can be summarized by saying that the duty to disclose under Rule 10b-5 is not a problem with a single coherent answer but a set of problems that deserve different kinds of context-specific analysis. If this is correct, the law took a wrong turn when one subject area—insider trading—came to dominate thinking so much so that it appeared to be paradigmatic rather than unique. In many ways, our normative recommendations are simply a suggestion that courts return to commonsensical, case specific determinations—and cease using misfit rules and formulas.

In contrast to the law of insider trading, most duty questions are not designed to bar any activity but rather to encourage an appropriate level of candor in the capital markets. The largest categories of Section 10(b) claims involve attacks on statements. Here, courts ask the question of whether the statements were likely to mislead the reasonable investor. Starting from the basic premise that their job is to regulate speech, while keeping in mind that companies need to be able to speak to the public, they have created subcategories of speech that are intended to be less regulated, such as speech that looks to be puffery or speech that is accompanied by sufficient cautionary language. At the margins of the explicit speech cases are the partial speech cases. Here, what is alleged to be misleading is some combination of speech and context. Although not as comfortable

159. The belief that denying the duty was a protective device might explain the strange turn the law took.
with these cases as with the pure speech cases, we see that the courts attempt to locate these within the speech box and then apply a tort-type analysis to them.

Many of the struggles that the courts have had with the duties to update and correct and the half-truth rule are a function of (a) their uncertainty as to what analysis to apply to these partial speech cases, and (b) their attempt to squeeze these into the speech category and, therefore, a tort analysis. Once it is clear that a tort analysis should be applied in such speech plus circumstance cases, the courts then have to look to the combination of speech and circumstance and ask whether investors were misled. The analysis is much the same as though an affirmative statement were being attacked as misleading.

The difference is that in these cases it is often some inaction that is being attacked as misleading. For example, with the duties to correct and update, courts ask whether some prior statement is still "alive" and whether the failure to correct or update was misleading. And although courts have done little to explain how one might determine whether a prior statement is still alive, such an analysis would presumably look at factors such as the context in which the statement was made, the importance that the speaker gave to it, and the type of company at issue. This is tort-like thinking in that it indicates to companies primarily that while they may talk and act, they must be careful not to mislead.

Moreover, this liability is not necessarily a function of whether parties are in any sort of special relationship with those who were misled. The market is the analog to society in a formal tort action. Just as one has obligations to make sure that the path to one's home is cleared of ice and not so slippery that unwary trespassers or guests would fall, companies need to be careful in making statements, even if they are not aimed at investors, so that unwary market participants are not misled. For example, a company may be in the process of touting its new product to a group of customers, but that is not an excuse if investors happen to hear those statements and are misled. Such investors can sue as long as it would have been reasonable for them to have been misled. It is not a defense for the company to say that it did not aim its statements at the stock market but the product market.

The analytical tool that might well have been applied to all of the foregoing contexts is the "flexible duty," the label invoked in so many of the early duty to disclose cases. The duty is a function of factors such as the inequality in access to information between the parties and their initial expectations. The thrust of the duty is in telling the sophisticated sellers of securities that they have to be
careful when they transact with those less able to evaluate the transactions at issue. In other words, the flexible duty is a tool that one uses to apply a tort-type analysis to the question of whether nondisclosure under certain conditions can be misleading. That courts over the past two decades have demonstrated a reluctance to use this tool, even though it has been available to them and could have solved some of their more difficult analytical problems, is an unfortunate oversight.