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How To Avoid Liability For Halo Statements

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U.S. Securities and Exchange Commission Chairman Jay Clayton recently reminded us that corporate culture and the "tone from the top" remain important to regulators, even in this enforcement-lite environment. Speaking about financial firm culture before the New York Fed, Clayton predicted pain for firms whose cultural compass diverges from the commission's. "[I]f the regulator is convinced a firm has a cultural problem and the firm continues to fight that conclusion, tension is likely to be high and progress — which involves fostering mutual regulator-firm respect and trust — will be slow and costly all around." "Culture," Clayton said, "is not optional."[1]

What might the private securities litigation bar take away from the chairman's remarks?

Companies last burnished their ethics codes to tout their reputations for probity in the wake of Enron, WorldCom and Sarbanes-Oxley. And just as night follows day, the plaintiffs bar tried to turn these so-called "halo statements" against companies to establish securities fraud liability under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. The mixed success of those efforts teaches important lessons for the potential next wave of corporate-culture-driven securities litigation. In this article, we review recent halo statement cases to illustrate those lessons and highlight steps companies should (and should not) take when controversy arises.

Background

Courts have interpreted Section 10(b) and Rule 10b-5 to provide a private cause of action for money damages for an investor who suffers a loss buying or selling securities in reliance on an untrue statement or omission of a material fact. A fact is material if there is substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell shares of the stock.[2] An omission of material fact is actionable only if a defendant has a duty to disclose it. Neither Section 10(b) nor Rule 10b-5 imposes a duty to disclose all material, nonpublic information. But when a party chooses to speak, it must speak accurately and completely.[3]

Halo statements about a company's "reputation, integrity, and compliance with ethical norms" typically are considered immaterial because they are "too general to cause a reasonable investor to rely on them."[4] Indeed, in a variety of contexts — bribery, insider trading, fraudulent expense reporting, sexual harassment — courts have dismissed lawsuits when plaintiffs attempted to show that a company's halo statements were false in light of the alleged misconduct.

Hewlett Packard, for example, successfully moved to dismiss a securities fraud action based on its former CEO's alleged unethical and improper personal conduct.[5] The plaintiff alleged that HP

"made material misrepresentations when [it] adopted its Standards of Business Conduct without disclosing that [its CEO] was violating the [standards]."[6] But the court disagreed. It held that "a code of ethics is inherently aspirational" and, therefore, "it simply cannot be that every time a violation of that code occurs, a company is liable under federal law for having chosen to adopt the code at all."[7]

The court in In re Braskem SA Securities Litigation[8] reached a similar result. Braskem centered on an undisclosed bribery scheme. The plaintiffs alleged that the defendants' failure to disclose the scheme rendered misleading the statements in the company's code of conduct about its trustworthy culture, commitment to integrity and rejection of bribery. The defendants moved to dismiss those claims on the ground that the statements were immaterial puffery. The court granted the motion. Distinguishing the statements from those that survived dismissal in other cases, the court held, "[there] is an important difference between a company's announcing rules forbidding bribery and its factually representing that no officer has engaged in such forbidden conduct. The [operative complaint] does not allege any historical representation by [the company] to the effect that its officers had uniformly abided by these rules."[9]

Fallen Angels

Halo statements are not themselves problematic, as Braskem and HP demonstrate.The problems occur when deeds do not match the words, such as when a company touts its code of conduct defensively, to reassure markets that wrongdoing did not occur, or offensively, to attribute its success to its reputation for transparency and integrity.

In re Petrobras Securities Litigation,[10] which centered on a bribery and kickback scheme, is an example of using halo statements defensively. The plaintiff alleged that statements about transparency and integrity and rejecting bribery were made or published when the defendants knew about ongoing misconduct. Moving to dismiss, the defendants argued that no reasonable investor would credit aspirational statements about conducting business with transparency and integrity and rejecting bribery. The court disagreed. Halo statements generally are inactionable puffery, the court acknowledged. But when a company makes statements "repeatedly in an effort to reassure the investing public about the Company's integrity, a reasonable investor could rely on [the statements] as reflective of the true state of affairs at the Company."[11]

Wielding halo statements defensively is not the only way in which a company might cross the line. Halo statements that attribute corporate success to a compliant culture might also be actionable. In Richman v. Goldman Sachs Group Inc.,[12] for example, the shareholder-plaintiffs alleged that undisclosed conflicts of interest in certain mortgage transactions rendered the investment bank's halo statements materially misleading. Specifically, the investment bank had disclosed to investors that it was long those transactions without disclosing that it also had substantial short positions; and it also failed to disclose to investors in one synthetic transaction that a hedge fund that had shorted the transaction also helped picked the transaction's reference credits. SEC actions and other revelations related to the transactions allegedly caused the bank's share price to drop, prompting the shareholder lawsuit.

The shareholders claimed that the investment bank's silence rendered materially misleading its halo statements about avoiding conflicts of interest, as well as its claims that (1) placing its clients' interests first was the "basic reason for our success," (2) its reputation was "one of our most important assets," and (3) "[i]ntegrity and honesty are at the heart of our business."[13] The defendants moved to dismiss and argued that the halo statements were inactionable puffery.

The court sided with the shareholders because the halo statements did not jibe with the half-true transaction disclosures. "Goldman must not be allowed to pass off its repeated assertions that it complies with the letter

and spirit of the law, values its reputation, and is able to address 'potential' conflicts of interest as mere puffery or statements of opinion. Assuming the truth of plaintiffs' allegations, they involve misrepresentations of existing facts."[14] The court also rejected the defendants' claim that the halo statements were immaterial. "[T]he Court cannot say that Goldman's statements that it complies with the letter and spirit of the law and that its success depends on such compliance, its ability to address 'potential' conflict of interests, and valuing its reputation, would be so obviously unimportant to a reasonable investor."[15]

Practical Guidance

Petrobras, Richman and similar cases should not send companies scurrying to excise halo statements. Rather, they should remind us that when it comes to securities fraud, context is key and statements are to be evaluated "in the light of the circumstances under which they were made" to determine whether they are materially misleading.[16] Consequently, companies should consider the following:

Halo statements should be couched in aspirational terms and not as guarantees. The risk profile of, "We forbid bribery" is less than, "We don't bribe" or "We have an effective anti-bribery policy."[17]

Companies should periodically evaluate their halo statements to confirm they are consistent with the facts on the ground. "We will not tolerate harassment" is aspirational, unless the company is aware of, and has not appropriately handled, harassment. In this regard, halo statements that ascribe a company's fortunes to its reputation or commitment to ethical conduct should be carefully considered.

Finally, when responding to alleged malfeasance, companies should refrain from referencing their halo statements to assure the markets that the allegations are untrue, at least until they confirm that the facts support doing so.

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