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## Rule 10b-5 at the Intersection of Greenwash and Green Investment: The Problem of Economic Loss

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# RULE 10B-5 AT THE INTERSECTION OF GREENWASH AND GREEN INVESTMENT: THE PROBLEM OF ECONOMIC LOSS

CADESBY B. COOPER\*

**Abstract:** Despite the recent growth of socially responsible investment (“SRI”), there is little evidence supporting its central claim: that it can affect a company’s cost of capital, thus inducing good behavior. Accordingly, this Note questions whether there are legal ramifications for a company that misrepresents its environmental and social practices, when such practices in fact do not affect the expected future cash flows of the company, the company’s cost of capital, and in turn, the price of the company’s stock. SEC Rule 10b-5 provides a private right of action for securities fraud, but requires that an investor sustain an economic loss as a result of a company’s material misrepresentation. If SRI cannot affect a company’s cost of capital, and ultimately its stock price, then Rule 10b-5 is unavailable—the economic loss element of the claim cannot be satisfied. The human motivations for SRI are complex, however, and financial professionals continue to make investment decisions based on companies’ social and environmental representations, which the companies continue to make, perhaps, to gain reputational benefit in the eyes of consumers. For these reasons, this Note argues that there should be a legal remedy for “green misrepresentations” that do not cause a drop in share price. It goes on to suggest that preventative measures be implemented because, regardless of the economic harm to the investor, there is a direct moral harm in being misled into supporting environmental practices counter to one’s beliefs, and an opportunity cost in foregoing investments that produce real-world benefits for the environment and society.

## INTRODUCTION

Socially responsible investment (“SRI”) practices have grown tremendously over the past two decades.<sup>1</sup> The latest statistics show that assets engaged in SRI represent over eleven percent of the \$33 trillion of assets under management in the U.S. financial market.<sup>2</sup> SRI includes the practice of invest-

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\* Senior Articles Editor, BOSTON COLLEGE ENVIRONMENTAL AFFAIRS LAW REVIEW, 2014–2015.

<sup>1</sup> THE FORUM FOR SUSTAINABLE & RESPONSIBLE INV., REPORT ON SUSTAINABLE AND RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES 11–12 (2012), available at [http://www.ussif.org/files/publications/12\\_trends\\_exec\\_summary.pdf](http://www.ussif.org/files/publications/12_trends_exec_summary.pdf), archived at <http://perma.cc/Q9KC-9LA6> (“From 1995 to 2012, the SRI universe increased by 486[%] while the broader universe of [managed assets] increased by 376[%].”).

<sup>2</sup> *Id.* at 11.

ing based on religious, labor, or human rights grounds.<sup>3</sup> It also includes *green investing*, which usually refers to the practice of excluding companies from, or including companies into, an investment portfolio based on the impact that their business strategies have on the environment.<sup>4</sup> Ultimately, green investors want to make a profit while addressing pressing environmental issues such as climate change.<sup>5</sup>

The heightened social and environmental awareness of consumers and investors, however, has caused companies to misrepresent their practices as green, when in fact, they do not produce real-world benefit to the environment.<sup>6</sup> Termed “greenwash,” these communications disclose false or misleading claims about environmental performance.<sup>7</sup> Companies have an incentive to greenwash to improve returns on investments and to gain positive goodwill in the form of reputation because it is cheaper and easier to misrepresent the extent or existence of a green practice than it is to establish an effective one, especially when managers do not feel that they will be held accountable in the short run.<sup>8</sup> Often, companies need only communicate their green practices to generate positive goodwill or adopt hollow green processes for inclusion among green investing portfolios.<sup>9</sup> Evidence also suggests that green norms within an industry can pressure laggards to greenwash their practices to avoid the competitive disadvantage of a poor environmental reputation while saving the costs that their competitors spend for green results.<sup>10</sup>

Unlike the consumer context, in which the Federal Trade Commission (FTC) has made some effort to curb the proliferation of greenwashed advertisements,<sup>11</sup> similar regulatory action has been nonexistent within securities

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<sup>3</sup> HUNG-GAY FUNG ET AL., SOCIALLY RESPONSIBLE INVESTMENT IN A GLOBAL ENVIRONMENT 5 (2010).

<sup>4</sup> *See id.*

<sup>5</sup> *See id.* at 6, 15.

<sup>6</sup> *See* Magali A. Delmas & Vanessa Cuerel Burbano, *The Drivers of Greenwashing*, 54 CAL. MGMT. REV., no. 1, Fall 2011, at 64, 64.

<sup>7</sup> *See id.* at 65.

<sup>8</sup> *See* BENJAMIN J. RICHARDSON, SOCIALLY RESPONSIBLE INVESTMENT LAW: REGULATING THE UNSEEN POLLUTERS 11 (2008); Delmas & Burbano, *supra* note 6, at 73; Caroline Flammer, *Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors*, 56 ACAD. MGMT. J. 758, 760 (2013) (noting that CEOs have cited “brand, trust, and reputation . . . as one of the main factors driving them to take action on sustainability issues”).

<sup>9</sup> *See* Magali A. Delmas et al., *Triangulating Environmental Performance: What Do Corporate Social Responsibility Ratings Really Capture?*, 27 ACAD. MGMT. PERSP. 255, 263 (2013).

<sup>10</sup> *See* Delmas & Burbano, *supra* note 6, at 72; Flammer, *supra* note 8, at 759.

<sup>11</sup> The Federal Trade Commission Act and the Lanham Act govern consumer protection and false advertising claims, but do not effectively regulate greenwashing claims. *See* Nick Feinstein, Note, *Learning From Past Mistakes: Future Regulation to Prevent Greenwashing*, 40 B.C. ENVTL. AFF. L. REV. 229, 239–40, 241–42 (2013). Neither statute provides for citizen standing, leaving the FTC as the sole policing agent. *See id.* at 252. The FTC has demonstrated considerable inaction over such claims. *See id.* at 245 (noting that the FTC brought zero claims against alleged greenwashing companies between 2000 and 2009). The FTC’s main contribution in the area has been the publication of

fraud law.<sup>12</sup> The Securities and Exchange Commission (SEC) neither requires disclosure of all environmental information that might be considered socially or ethically important, nor regulates the myriad ratings systems in place that quantify the environmental performance of companies for green investors.<sup>13</sup> Companies that voluntarily disclose social or ethical misinformation, however, can incur liability under the catchall anti-fraud provisions of SEC Rule 10b-5, or the “Rule.”<sup>14</sup>

The U.S. Supreme Court has created a private right of action under the Rule that might be available to some victims of green misrepresentation, but both the Court and Congress have significantly narrowed its scope in recent decades.<sup>15</sup> Moreover, the Rule requires that a plaintiff suffer an economic loss and limits the amount of recovery to the drop in share price attributable to the defendant’s representational misconduct.<sup>16</sup> Thus, whether brought by the SEC or a private plaintiff, Rule 10b-5 is inherently ill suited for application in the SRI market, where largely intangible and non-economic values drive investment decisions and where the social and environmental costs of misrepresentations do not necessarily translate into immediate market losses.<sup>17</sup>

Some commenters have noted the possible application of a private Rule 10b-5 action to green misrepresentations without exploring the unique difficulties presented by its focus on economic loss.<sup>18</sup> Not all green misrepresentations create equal harms, and although some manifest an economic harm, others do not.<sup>19</sup> Central to SRI and green investing is the use of investor screens that sort

“Green Guides” that advance a standard, albeit in the form of a guideline lacking the force of law. *Id.* at 242–43. Furthermore, the statutes “lack the specificity and detail to adequately police environmental claims.” *Id.* at 252–53.

<sup>12</sup> See Elizabeth Ann Glass Geltman, *Disclosure of Contingent Environmental Liabilities by Public Companies Under the Federal Securities Laws*, 16 HARV. ENVTL. L. REV. 129, 169–70 (1992); Benjamin J. Richardson & Wes Cragg, *Being Virtuous and Prosperous: SRI’s Conflicting Goals*, 92 J. BUS. ETHICS (SUPPLEMENT 1) 21, 30 (2010).

<sup>13</sup> Geltman, *supra* note 12, at 169–70 (“[T]he SEC retracted its 1973 rules requiring disclosure of all environmental information that might be considered socially or ethically important regardless of its traditional materiality, because the resulting excessive level of disclosure obscured truly ‘material’ information.”).

<sup>14</sup> See *id.* at 169.

<sup>15</sup> See *infra* note 107 and accompanying text.

<sup>16</sup> See, e.g., Erica P. John Fund, Inc. v. Halliburton, Co., 131 S. Ct. 2179, 2186 (2011).

<sup>17</sup> See FUNG ET AL, *supra* note 3, at 46; Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 369–70 (2007).

<sup>18</sup> See Rachel Cherington, *Securities Laws and Corporate Social Responsibility: Toward an Expanded Use of Rule 10b-5*, 25 U. PA. J. INT’L ECON. L. 1439, 1452–53 (2004) (focusing on the issue of materiality); Miriam A. Cherry & Judd F. Sneirson, *Chevron, Greenwashing, and the Myth of “Green Oil Companies,”* 3 WASH. & LEE J. ENERGY, CLIMATE & ENV’T 133, 146–48 (2012) (focusing on the issue of materiality).

<sup>19</sup> See Richardson & Cragg, *supra* note 12, at 32. For example, human rights abuses and environmental abuses might be legal in some countries, particularly those with emerging economies. *Id.* If these practices were originally misrepresented to investors then they would not incur legal costs to the

investment targets according to their environmental track records.<sup>20</sup> Proponents of SRI contend that foregoing investment in, or divesting from, a company causes a drop in its market value.<sup>21</sup> If this were true, then green investors would always be able to bring a Rule 10b-5 action—assuming its other elements were met—because the divestment by green investors following a corrected misrepresentation would create a market loss even if the misrepresentation itself did not involve information that changed the company’s expected future cash flows.<sup>22</sup> Finance theory, however, casts this assumption in a dubious light,<sup>23</sup> and in turn, calls into doubt the availability of private Rule 10b-5 remedies in many circumstances.<sup>24</sup> Regardless of economic loss, however, green investors who fall prey to misrepresentations of a purely social or green character suffer losses of another kind.<sup>25</sup> First, they suffer from having been duped into supporting practices antithetical to their moral code.<sup>26</sup> Second, they suffer an opportunity cost on their investment; although they might get their money back after learning of a green misrepresentation—by selling their stock—they have lost opportunities during the investment period to invest in companies that actually utilize true green practices.<sup>27</sup>

This Note analyzes the extent to which the Rule’s private right of action is available to victims of greenwash.<sup>28</sup> Part I summarizes the concept of SRI and the investment methodology of green investors.<sup>29</sup> Part II introduces the Securities and Exchange Act and Supreme Court precedent on the Rule.<sup>30</sup> Part III analyzes the elements of the Rule to demonstrate the extent to which it is available to victims of green misrepresentation and concludes that the claim will generally be unavailable when the misrepresentation does not involve information bearing on the future expected cash flows of the company.<sup>31</sup> Part IV suggests an administrative alternative to the Rule that aims to prevent green

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company when they came to light. *See id.* If no other costs were incurred, then the market value of the company’s stock would not be affected because it simply reflects the expected future cash flows of the business. *See* RICHARDSON, *supra* note 8, at 166–67.

<sup>20</sup> *See* FUNG ET AL., *supra* note 3, at 8 (noting that “social screening, which accounts for about 72[%] of the money in SRI mutual funds, is the most prevalent form of SRI . . .”).

<sup>21</sup> RICHARDSON, *supra* note 8, at 165.

<sup>22</sup> *See id.* at 165–67.

<sup>23</sup> *See id.* at 165 (explaining that finance theory does not support the proposition that SRI can induce a company to behave in a certain way because it cannot affect its cost of capital or its stock price).

<sup>24</sup> *See id.*; *supra* note 19 and accompanying text.

<sup>25</sup> *See* FUNG ET AL., *supra* note 3, at 3; RICHARDSON, *supra* note 8, at 12–13, 20–21.

<sup>26</sup> *See* FUNG ET AL., *supra* note 3, at 3; RICHARDSON, *supra* note 8, at 12–13, 20–21.

<sup>27</sup> *See* Delmas & Burbano, *supra* note 6, at 73; Delmas et al., *supra* note 9, at 263.

<sup>28</sup> *See infra* notes 166–294 and accompanying text.

<sup>29</sup> *See infra* notes 33–89 and accompanying text.

<sup>30</sup> *See infra* notes 90–164 and accompanying text.

<sup>31</sup> *See infra* notes 166–261 and accompanying text.

misrepresentations by considering the intangible interests at stake and removing the incentives for companies to greenwash.<sup>32</sup>

## I. SOCIALLY RESPONSIBLE INVESTMENT

SRI encompasses a broad array of “investments and investment strategies that . . . attempt to create positive social change, minimize environmental damage, and incorporate religious or ethical beliefs.”<sup>33</sup> SRI is based on the premise that private investment imposes costs on the public that should be internalized by the investor.<sup>34</sup> Ultimately, socially responsible investors (“SRI investors”) hope to prosper financially while building a better world.<sup>35</sup> This investment strategy has become one of the fastest growing segments of the financial market as more of today’s investors consider how their investment decisions impact their community and the environment they share with others within the modern global system.<sup>36</sup>

### A. The Forms of SRI

Once filtered by conventional financial metrics, SRI investors typically construct their portfolios by assessing companies according to additional environmental and social criteria.<sup>37</sup> Investors might use one or more of several distinct but related selection strategies.<sup>38</sup> Among the most common forms are shareholder engagement and activism and the use of investment screens<sup>39</sup> based on social or environmental performance.<sup>40</sup> The first strategy involves

<sup>32</sup> See *infra* notes 262–294 and accompanying text.

<sup>33</sup> FUNG ET AL., *supra* note 3, at 1; RICHARDSON, *supra* note 8, at 84.

<sup>34</sup> See Richardson & Cragg, *supra* note 12, at 22.

<sup>35</sup> See FUNG ET AL., *supra* note 3, at 6.

<sup>36</sup> *Id.* at 1–2; see THE FORUM FOR SUSTAINABLE & RESPONSIBLE INV., *supra* note 1, at 11–12 (providing statistics of SRI growth in relation to overall market growth of professionally managed assets). SRI’s roots reach back to the nineteenth century when Christian investors began screening their investments for activities they considered sinful. Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681, 684 (2002). The year 1928 marked the first public offering of a screened investment fund—the Pioneer Fund in Boston—by an ecclesiastical group. *Id.* Similarly, students during the Vietnam era pressured universities to divest their portfolios of defense industry stocks. *Id.* The 1970s saw the creation of two major mutual funds: Pax World Fund and Third Century Fund. *Id.* at 685. These funds respectively screened out arms producers and compiled a portfolio of companies that supported their communities and the environment. *Id.* The most prominent example of SRI employment occurred in the 1980s with the widespread screening and divestment by U.S. investors of South African companies that supported Apartheid. *Id.*

<sup>37</sup> FUNG ET AL., *supra* note 3, at 27; RICHARDSON, *supra* note 8, at 90.

<sup>38</sup> FUNG ET AL., *supra* note 3, at 27.

<sup>39</sup> See *infra* notes 45–49 and accompanying text (explaining that investment screens are applied to SRI portfolios by adding or removing companies based on positive and negative criteria).

<sup>40</sup> See FUNG ET AL., *supra* note 3, at 27–28; RICHARDSON, *supra* note 8, at 95–98; see also Robert A.G. Monks, *Introduction* to PETER CAMEJO, *THE SRI ADVANTAGE: WHY SOCIALLY RESPONSIBLE*

shareholders who engage their company's managers through active dialogue to promote beneficial environmental and social practices.<sup>41</sup> Shareholder activists, on the other hand, seek the same results as engagers, but employ more direct tactics.<sup>42</sup> They might attempt to circumvent complacent managers by submitting resolutions and voting at annual meetings.<sup>43</sup> Even if the shareholder resolutions are not adopted, they can result in negotiated settlements with the company that ultimately improve its social accountability.<sup>44</sup>

SRI portfolios can be screened according to negative and positive criteria.<sup>45</sup> Negative screening excludes particular investment opportunities in target acquisitions that perform poorly according to social and environmental standards.<sup>46</sup> A negative screen, for example, might exclude oil, tobacco, or weapons manufacturers from a SRI portfolio.<sup>47</sup> Positive screening, on the other hand, actively seeks companies that perform highly according to social or environmental standards.<sup>48</sup> A positive screen can be more difficult to apply than a negative screen because some social criteria are not quantifiable, which can make the ultimate investment decision depend heavily on the investor's values and judgment when considering multiple investment opportunities.<sup>49</sup>

### B. Green Investment Screen Metrics

Fund managers and individual investors use green screens—whether positive or negative—to choose investments based on environmental criteria.<sup>50</sup> These criteria attempt to quantify or otherwise reflect the environmental practices of companies and can be divided into several categories, including eco-efficiency, environmental impact, and environmental management.<sup>51</sup> Eco-efficiency refers to the ratio of a good or service's value, to the amount of natural resources, waste, and pollution that are used or created during its produc-

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INVESTING HAS OUTPERFORMED FINANCIALLY, at xvi–xviii (2002) (arguing that passive screening practices may be ineffective and that active shareholder involvement is a “critical element for an effective SRI”).

<sup>41</sup> FUNG ET AL., *supra* note 3, at 30; RICHARDSON, *supra* note 8, at 95.

<sup>42</sup> FUNG ET AL., *supra* note 3, at 30; RICHARDSON, *supra* note 8, at 96.

<sup>43</sup> FUNG ET AL., *supra* note 3, at 30; RICHARDSON, *supra* note 8, at 96.

<sup>44</sup> FUNG ET AL., *supra* note 3, at 30–31. Resolutions need not be adopted to be effective. *Id.* (providing example that “shareholders withdrew a climate proposal at Ford Motor Company after the company presented its plans to reduce greenhouse gas emissions by thirty percent in new vehicles by the year 2020”); *see also* RICHARDSON, *supra* note 8, at 96 (explaining why resolutions need not be adopted to be effective).

<sup>45</sup> FUNG ET AL., *supra* note 3, at 28; RICHARDSON, *supra* note 8, at 90.

<sup>46</sup> FUNG ET AL., *supra* note 3, at 28; RICHARDSON, *supra* note 8, at 90.

<sup>47</sup> FUNG ET AL., *supra* note 3, at 28; RICHARDSON, *supra* note 8, at 90.

<sup>48</sup> FUNG ET AL., *supra* note 3, at 28; RICHARDSON, *supra* note 8, at 90.

<sup>49</sup> FUNG ET AL., *supra* note 3, at 28.

<sup>50</sup> *See id.* at 31–32; RICHARDSON, *supra* note 8, at 94.

<sup>51</sup> FUNG ET AL., *supra* note 3, at 32–33.

tion.<sup>52</sup> It may include the measure of minimum energy use, minimum waste disposal in landfills, or minimum greenhouse gas emissions.<sup>53</sup> Environmental impacts measure the real-world effects of a company's operations.<sup>54</sup> Such impacts include measurements of water, soil, air, and groundwater pollution, loss of biodiversity, and impacts on natural resources such as forests and fisheries.<sup>55</sup> Criteria within the environmental management category include a company's professed and practiced commitments to the environment and its managerial practices.<sup>56</sup> These include policy statements from corporate officers about their stand on environmental issues and the institution of environmentally friendly systems throughout the entire lifecycle of the company's products or services.<sup>57</sup>

With the rise in SRI's popularity, a number of specialized organizations have created performance indices that rate companies according to environmental criteria.<sup>58</sup> These indices can be useful to SRI investors because they condense a company's environmental performance into comparable numbers.<sup>59</sup> Neither rating companies nor fund managers, however, have accepted any one methodology to create these metrics, and the SEC has not offered any guidance in this area.<sup>60</sup> Thus, although performance metrics and indices might help investors decide which companies are actually producing green outcomes, the disparity between current ratings methodologies, the lack of transparency and accountability in portfolio selection, and the lack of regulatory guidance dampen their effectiveness.<sup>61</sup>

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<sup>52</sup> *Id.* at 33.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 33–34.

<sup>57</sup> *Id.* at 34.

<sup>58</sup> Delmas et al., *supra* note 9, at 255–58; *see also* RICHARDSON, *supra* note 8, at 90 (noting that some market index companies, such as KLD Research and Analytics, claim to construct their indices according to environmental and social criteria and only then evaluate financial performance “retroactively,” whereas others construct their indices considering environmental and financial performance contemporaneously). Other examples of market indices include the Domini Social Equity Fund, *see Domini Social Equity Fund*, DOMINI SOC. INVS, <https://www.domini.com/domini-funds/domini-social-equity-fund> (last visited Feb. 11, 2015) *archived at* <https://perma.cc/2UJB-T368>, and the Calvert Social Index, *see The Calvert Social Index*, CALVERT INVS., <http://www.calvert.com/sri-index.html> (last visited Feb. 11, 2015), *available at* <http://perma.cc/E4RP-KEZ8>.

<sup>59</sup> *See* FUNG ET AL., *supra* note 3, at 36; RICHARDSON, *supra* note 8, at 94 (noting that indices can “form a template” for individual and fund investors).

<sup>60</sup> *See* FUNG ET AL., *supra* note 3, at 40; RICHARDSON, *supra* note 8, at 147; Delmas et al., *supra* note 9, at 256. The SEC explicitly notes on its website that it does not regulate market indices. *Market Indices*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/indices.htm> (last visited Feb. 9, 2015), *archived at* <http://perma.cc/3JYY-Z2WR>.

<sup>61</sup> *See* FUNG ET AL., *supra* note 3, at 39–40; RICHARDSON, *supra* note 8, at 147; Delmas et al., *supra* note 9, at 256.



Although green investors can use or formulate environmental metrics, they must ultimately base them on the voluntary or required disclosures of companies.<sup>62</sup> Environmentally responsible investors thus face at least three challenges: (1) making a decision when there is not enough data on point; (2) ascribing value based on available data to environmental risks that are inherently difficult to measure and value; and (3) unknowingly relying on green-washed data.<sup>63</sup>

### C. Incentives to Invest in SRI

The green screen metrics reflect green investors' dual aims of supporting environmentally positive practices within business operations and also reaping a return.<sup>64</sup> Green investors, like other SRI investors, base their investment decisions partly on their ethical beliefs or values.<sup>65</sup> They can be divided into at least two general groups.<sup>66</sup> First, there are those who feel that the psychic comfort of behaving ethically compensates for the possible greater risk and less return that might be associated with their SRI portfolio.<sup>67</sup> Second, there are those who do not believe that there must be a direct trade-off between high financial returns and social responsibility.<sup>68</sup> These investors believe that the long-term risk-adjusted returns are greater for SRI portfolios than for conventional portfolios because social responsibility translates into more sustainable business practices, which in turn, yield higher returns in the long run and generally signal that a company is well managed.<sup>69</sup>

These classifications show that SRI screening is still investment because it involves a present payment for a future return.<sup>70</sup> But, to some extent, both groups of SRI investors want to do good to feel good, in addition to getting a return on their investment.<sup>71</sup> The second group of investors, however—who equate sustainability with profitability—share incentives that coincide with traditional investors.<sup>72</sup> Yet, to be considered true SRI adherents, even these

<sup>62</sup> See Delmas et al., *supra* note 9, at 263.

<sup>63</sup> See FUNG ET AL., *supra* note 3, at 16.

<sup>64</sup> *Id.* at 44.

<sup>65</sup> RICHARDSON, *supra* note 8, at 12–13; see FUNG ET AL., *supra* note 3, at 3.

<sup>66</sup> FUNG ET AL., *supra* note 3, at 3 (dividing SRI investors into three categories based on their investment philosophies); RICHARDSON, *supra* note 8, at 12–13 (dividing SRI investors as “business case” or “ethical case” according to their investment philosophies).

<sup>67</sup> See FUNG ET AL., *supra* note 3, at 3; RICHARDSON, *supra* note 8, at 12–13, 20–21.

<sup>68</sup> FUNG ET AL., *supra* note 3, at 3; RICHARDSON, *supra* note 8, at 12–13.

<sup>69</sup> FUNG ET AL., *supra* note 3, at 3; see RICHARDSON, *supra* note 8, at 13.

<sup>70</sup> See Knoll, *supra* note 36, at 689.

<sup>71</sup> See FUNG ET AL., *supra* note 3, at 3, 46.

<sup>72</sup> See *id.* at 3.

sustainable investors must also rely on non-financial criteria to some extent and must consider these factors independently from their financial impact.<sup>73</sup>

The reason that both groups believe that social screening can be consistently profitable is because it supposedly filters out short-sighted companies that try to cut costs in the short-term, which creates greater long-term risk.<sup>74</sup> For example, short-term upfront costs such as regulatory compliance might not produce immediate value to a company, but such costs can save the company money down the road.<sup>75</sup> Similarly, environmental site studies and site preparation, which might go beyond regulatory compliance requirements, can be expensive in the short-term but could yield the benefit of uncovering and mitigating unique site risks that would otherwise incur tort or statutory liability later on.<sup>76</sup>

Yet even when SRI is not based on environmental risks that directly impact a company's bottom line, SRI investors believe that social screening can create good in the world because it influences the behavior of companies.<sup>77</sup> This assumes that a screened investment or divestment will affect a company's stock price, which will, in turn, affect its cost of capital.<sup>78</sup> As a low cost of capital is beneficial to a company, SRI investors believe that they wield the power to reward and punish.<sup>79</sup> Although this might be true in some circumstances, both conventional finance theory and real world case studies indicate that such power would be an exception, rather than the rule.<sup>80</sup>

#### D. The Incentives for Company Compliance with SRI Goals

SRI practices can provide companies with a competitive advantage through risk avoidance, the potential for sustainable profit, and reputational gain.<sup>81</sup> Companies that incorporate environmental factors in their strategic objectives might be able to differentiate themselves from their industry peers.<sup>82</sup> This reputational benefit can improve their relationship with governmental agencies and the public.<sup>83</sup> Indeed, between fifty and seventy percent of the

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<sup>73</sup> Knoll, *supra* note 36, at 691. For a study on the factors that drive SRI decisions, see Geoffrey Williams, *Some Determinants of the Socially Responsible Investment Decision: A Cross-Country Study*, 8 J. BEHAV. FIN. 43, 54 (2007) (suggesting that consumers' characteristics and their general attitude towards the social policies of a company impact their investment decision, whereas financial and demographic factors do not).

<sup>74</sup> See FUNG ET AL., *supra* note 3, at 74.

<sup>75</sup> See *id.*

<sup>76</sup> See *id.*

<sup>77</sup> RICHARDSON, *supra* note 8, at 165–66.

<sup>78</sup> *Id.*; see *infra* note 206 and accompanying text (defining cost of capital).

<sup>79</sup> RICHARDSON, *supra* note 8, at 165.

<sup>80</sup> *Id.* at 166, 170; see Knoll, *supra* note 36, at 710.

<sup>81</sup> See FUNG ET AL., *supra* note 3, at 76; Richardson & Cragg, *supra* note 12, at 28.

<sup>82</sup> See FUNG ET AL., *supra* note 3, at 76.

<sup>83</sup> *Id.* at 75.

business value of many large public companies is attributable to their brand name and goodwill.<sup>84</sup> Reputational risk, therefore, heavily influences companies' efforts to make a commitment to green practice.<sup>85</sup>

This alleged commitment to green practices, however, need not translate into actual positive outcomes for the environment to garner investor approval of it, and thus reputational benefit.<sup>86</sup> To keep up with industry leaders, some organizations might misrepresent their practices for fear of falling behind rivals who have already implemented actual green practices.<sup>87</sup> In sum, both environmentally responsible investors and greenwashing companies seek intangibles from each other in the form of the psychic comfort from doing good and reputational benefits, respectively.<sup>88</sup> The intangible nature of these incentives are difficult to value in terms of financial harm and gain, which is a precondition to any remedial measure that seeks to optimally compensate investors while deterring misconduct.<sup>89</sup>

## II. REGULATION OF ENVIRONMENTAL MISREPRESENTATION

### A. *The Securities and Exchange Act of 1934 and Rule 10b-5*

Congress passed the Securities and Exchange Act of 1934 (the "Exchange Act" or the "Act") to protect investors against fraud and manipulation of stock prices.<sup>90</sup> The legislative underpinning of the Act was to inject honesty into the market through continuing disclosure requirements.<sup>91</sup> Section 10(b) of the Act promotes the integrity of these disclosures by prohibiting "(1) the 'use or employ[ment] . . . of any . . . deceptive device,' (2) 'in connection with the purchase or sale of any security,' and (3) 'in contravention of Securities and Exchange Commission rules and regulations.'"<sup>92</sup>

In 1942, the Securities and Exchange Commission (SEC) promulgated Rule 10b-5 (the "Rule") under the authority granted to it by Congress through Section 10(b) of the Exchange Act.<sup>93</sup> The Rule provides:

<sup>84</sup> Richardson & Cragg, *supra* note 12, at 28.

<sup>85</sup> *Id.* at 28–29.

<sup>86</sup> See Delmas & Burbano, *supra* note 6, at 72.

<sup>87</sup> *Id.*

<sup>88</sup> See FUNG ET AL., *supra* note 3, at 46; Richardson & Cragg, *supra* note 12, at 28–29.

<sup>89</sup> See Dane A. Holbrook, *Measuring and Limiting Recovery Under Rule 10b-5: Optimizing Loss Causation and Damages in Securities Fraud Litigation*, 39 TEX. J. BUS. L. 215, 237–39 (2003); *infra* notes 168–261 and accompanying text.

<sup>90</sup> Geltman, *supra* note 12, at 129–30; see Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended in 15 U.S.C. §§ 78a–78pp (2012)).

<sup>91</sup> Geltman, *supra* note 12, at 129; see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

<sup>92</sup> *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 340 (2005) (quoting 15 U.S.C. § 78j(b)).

<sup>93</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>94</sup>

Section 10(b) of the Act does not expressly provide a civil remedy for its violation and the legislative history does not suggest that Congress considered the creation of a private action at the time of its passage.<sup>95</sup> There is also no indication that the SEC considered the question of a private action when it adopted the Rule.<sup>96</sup> Instead, courts have found an implied private right of action under the Act and the Rule based on common law tort actions for deceit and misrepresentation, and have subsequently shaped the right of action, over the decades, into what it is today.<sup>97</sup>

Although recognizing that the private action under the Rule is an “indispensable tool” with which to fight securities fraud, Congress eventually passed the Private Securities Litigation Reform Act of 1995 (“PSLRA”) to stop significant abuses of the Rule as a class-action device in securities litigation.<sup>98</sup> The PSLRA modifies the private Rule 10b-5 action with several substantive and procedural requirements and limits how it can be brought in federal court, in the class action context.<sup>99</sup> Further, it caps recoverable damages and attorney’s fees, provides a “safe harbor” defense for forward-looking statements, and imposes heightened pleading requirements for certain elements of the Rule.<sup>100</sup>

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<sup>94</sup> 17 C.F.R. § 240.10b-5 (2012).

<sup>95</sup> *Blue Chip Stamps*, 421 U.S. at 729.

<sup>96</sup> *Id.* at 730.

<sup>97</sup> *See id.* at 730–31; Burch, *supra* note 17, at 363.

<sup>98</sup> H.R. REP. 104-369 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730; *see* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81 (2006) (“According to the [House Conference] Report, nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and ‘manipulation by class action lawyers of the clients whom they purportedly represent’ had become rampant in recent years.”).

<sup>99</sup> Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1319 (2008).

<sup>100</sup> 15 U.S.C. §§ 78u-4, 78u-5 (2012); *see* Merrill Lynch, Pierce, Fenner & Smith Inc., 547 U.S. at 81 (noting that the PSLRA also imposes restrictions on the selection of, and compensation awarded to,

Accordingly, to bring suit, a citizen plaintiff must allege: (1) a material misrepresentation or omission; (2) scienter (i.e., a wrongful state of mind); (3) a connection with a purchase or sale of a security; (4) reliance, often referred to in cases involving public securities markets—fraud-on-the-market cases—as transaction causation; (5) economic loss;<sup>101</sup> and (6) loss causation (i.e., a causal connection between the material misrepresentation and the loss).<sup>102</sup>

Justice Rehnquist once described the private right of action under the Rule as a “judicial oak that has grown from little more than a legislative acorn.”<sup>103</sup> It has also been characterized as an adaptive organism that reflects the economic ideology of the time.<sup>104</sup> The Rule’s imprecise language has permitted judges to apply it through the decades even as market composition and investor behavior have changed.<sup>105</sup> For example, courts permitted the liberal use of the Rule during the middle of the twentieth century when the general concern in securities regulation was “essentially consumer protection to be accomplished through full disclosure . . . .”<sup>106</sup> In recent decades, however, judges have curtailed the private use of the Rule as the financial market has shifted in composition to large institutional investors and fund managers who have been increasingly threatened by an abuse in class action and derivative litigation.<sup>107</sup>

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lead plaintiffs in class actions, mandates imposition of sanctions for frivolous litigation, and authorizes a stay of discovery pending resolution of a motion to dismiss). In response to the PSLRA’s restrictions, private plaintiffs began bringing class-action securities suits in state courts under various state law fraud theories that paralleled the Rule. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 547 U.S. at 82. Congress countered by passing the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) to keep certain private securities class action lawsuits alleging fraud in federal court and, thus, subject to the PSLRA. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. 78bb(f)(1) (2012)); see *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 547 U.S. at 82–83.

<sup>101</sup> See *infra* notes 150–156 and accompanying text (addressing economic loss as being intertwined with loss causation).

<sup>102</sup> *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

<sup>103</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

<sup>104</sup> Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 FORDHAM L. REV. S7, S7 (1993).

<sup>105</sup> *Id.* at S7, S11–S13.

<sup>106</sup> *Id.* at S11.

<sup>107</sup> *Id.* at S12–13; see, e.g., *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) (narrowly interpreting the element of “making” a misrepresentation); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007) (interpreting “strong inference” of scienter within the meaning of the PSLRA); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 86 (2006) (holding the SLUSA preempts state law class action lawsuits brought by purchasers and sellers of securities); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) (holding that a private plaintiff may not maintain an aiding and abetting suit under the Rule).

In relation to green investing, the Rule complements the SEC's mandatory contingent environmental disclosure requirements, found in Regulation S-K.<sup>108</sup> The Rule serves as a broad catchall anti-fraud provision that fills the gaps between the periodic and continuous mandatory disclosure requirements of the Exchange Act by creating liability for certain material misrepresentations or omissions.<sup>109</sup>

### 1. Material Misrepresentation or Omission of Fact

A misrepresentation or omission of fact must be material in nature.<sup>110</sup> The U.S. Supreme Court has repeatedly eschewed a bright-line materiality test, recognizing that “any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding . . . must necessarily be [over or under inclusive].”<sup>111</sup> It has instead chosen a delicate case-by-case assessment: the materiality requirement is satisfied when “there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>112</sup> The Court chose this threshold—and not a lower one—because it does not want managers to bombard investors with trivial information in an attempt to obfuscate informed decision-making.<sup>113</sup>

In *Matrixx Initiatives, Inc. v. Siracusano*, the plaintiff alleged that a defendant's failure to disclose medical reports that showed a possible causal link between one of its cold medications and adverse health effects in those who took the medication was a material omission.<sup>114</sup> The Court declined to find the omission immaterial simply because the scientific reports at issue did not support causation with statistically significant data.<sup>115</sup> It held that the failure to reveal the reports was a material omission because they demonstrated a plausible causal link between the medication and the malady in light of all of the

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<sup>108</sup> Perry E. Wallace, *Disclosure of Environmental Liabilities Under the Securities Laws: The Potential of Securities-Market-Based Incentives for Pollution Control*, 50 WASH. & LEE L. REV. 1093, 1105, 1115 (1993) (noting that the SEC has promulgated a series of environmental provisions, contained in Regulation S-K, which require disclosure of actual or potential environmental liabilities and obligations); see Item 303, 17 C.F.R. § 229.303 (2014).

<sup>109</sup> Wallace, *supra* note 108, at 1115.

<sup>110</sup> *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011).

<sup>111</sup> *Id.* at 1318–19.

<sup>112</sup> *Id.* at 1318 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1975)).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.* at 1314.

<sup>115</sup> *Id.* at 1319.

facts, and thus the potential for liability, which would have altered the total mix of information relevant to a reasonable investor.<sup>116</sup>

In *In re Ford Motor Co. Securities Litigation*, the plaintiff alleged that the defendant's professed commitment to quality, safety, and corporate citizenship was a material misrepresentation in light of its sale of defective products.<sup>117</sup> For example, the company claimed that it sold products of superior quality and that it wanted to be the leader in corporate social responsibility.<sup>118</sup> The U.S. Court of Appeals for the Sixth Circuit found these statements to be "mere corporate puffery or hyperbole that a reasonable investor would not view as significantly changing" the total mix of information available.<sup>119</sup> Such "rosy affirmations" from corporate managers, it reasoned, are "numbingly familiar to the marketplace—loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor" would consider them material, even if they were misleading.<sup>120</sup>

## 2. Connection with a Purchase or Sale of a Security

The Supreme Court has deemed the language of the Exchange Act to evince a Congressional scheme that limits the plaintiff class in a Rule 10b-5 action to "actual purchasers and sellers."<sup>121</sup> These include those who have entered a contract to purchase or sell a security or otherwise obtained contractual rights or duties, such as in a put, call, or option.<sup>122</sup> Recognizing that Congressional intent is not easily ascertained in the Act, and observing that judicial craftsmanship largely fashioned the Rule from its inception, the Court based its decision to limit the plaintiff class primarily on the prudential concern that a broader class would invite abuse through vexatious litigation.<sup>123</sup>

At least three classes of plaintiffs therefore cannot bring claims under the Rule because they lack the necessary contractual relationship: (1) potential purchasers of shares who allege that a material misrepresentation or omission caused them to forego a purchase; (2) shareholders who allege that they decid-

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<sup>116</sup> *Id.* at 1322 (finding that other facts in the reports, such as documented cases of illness by medical professionals and a medical presentation that reported documented illness following the administration of the drug, demonstrated a plausible causal link in the absence of statistically significant data).

<sup>117</sup> 381 F.3d 563, 570 (6th Cir. 2004).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.* at 570–71.

<sup>121</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731, 733 (1975).

<sup>122</sup> *Id.* at 750–51; *see Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 589–90, 594–95 (2001) (holding that oral purchases or sales do not fall outside of the Act because they are contracts to which the Act itself deems applicable).

<sup>123</sup> *Blue Chip Stamps*, 421 U.S. at 737.

ed not to sell their shares because of an “unduly rosy representation or a failure to disclose unfavorable material,” and (3) “shareholders, creditors, and perhaps others related to [the issuing corporation] who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5.”<sup>124</sup>

### 3. Scierter

The Supreme Court has interpreted the language of the Exchange Act to reflect a Congressional intent to only proscribe liability for intentional actions.<sup>125</sup> Although the Court has thus foreclosed liability based on negligence, it has not expressly decided whether some level of recklessness can meet the scierter standard.<sup>126</sup> As of 2007, each federal Court of Appeals that has considered the issue has held that allegations of recklessness *are* sufficient to satisfy the scierter requirement.<sup>127</sup>

The PSLRA imposes a heightened pleading requirement for allegations of scierter in private securities fraud litigation.<sup>128</sup> It requires that a plaintiff “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>129</sup>

The Court has interpreted the PSLRA’s “strong inference” standard to be an inherently “comparative inquiry.”<sup>130</sup> The inference of scierter must be persuasive in light of other explanations.<sup>131</sup> A complaint will survive only if “a reasonable person would deem the inference of scierter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”<sup>132</sup> The Court makes this determination by looking to the allegations as

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<sup>124</sup> *Id.* at 737–38. The second and third groups, however, can often circumvent the “actual purchaser or seller” limitation by bringing a derivative action on behalf of the company itself if it is a purchaser or seller of the securities. *Id.*

<sup>125</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 214 (1976) (inferring intent from the words found in Section 10(b): manipulative; device; and contrivance).

<sup>126</sup> *Id.* at 214 n.12. The legal definition of scierter is:

1. A degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act’s having been done knowingly, esp. as a ground for civil damages or criminal punishment. 2. A mental state consisting in an intent to deceive, manipulate, or defraud. In this sense, the term is used most often in the context of securities fraud.

BLACK’S LAW DICTIONARY 1824 (10th ed. 2014).

<sup>127</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 n.3 (2007) (noting, however, that the circuits differ on the degree of recklessness required).

<sup>128</sup> 15 U.S.C. § 78u-4(b)(1) (2012); *Tellabs Inc.*, 551 U.S. at 321.

<sup>129</sup> 15 U.S.C. § 78u-4(b)(1), (2).

<sup>130</sup> *Tellabs Inc.*, 551 U.S. at 323.

<sup>131</sup> *Id.* at 324 (“The inference that the defendant acted with scierter need not be irrefutable, i.e., of the ‘smoking-gun’ genre, or even the most plausible of competing inferences.”).

<sup>132</sup> *Id.*



a whole and treating “the absence of a motive allegation, though relevant, [as] not dispositive.”<sup>133</sup>

The PSLRA additionally created a safe harbor for forward-looking statements made by corporate officers, directors, and employees while working on the issuer’s behalf.<sup>134</sup> It applies to, among other things, future management plans and objectives.<sup>135</sup> The provision generally relieves a corporation of liability for such a statement if at least one of several conditions is met, including when the statement is both “forward-looking” and qualified with “meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those [stated].”<sup>136</sup>

In *Matrixx Initiatives, Inc.*, the defendant argued that the plaintiff failed to allege facts sufficient for the Court to find that it had acted with scienter.<sup>137</sup> The inference that it had acted recklessly or knowingly, the defendant argued, was equally or less compelling than the inference that it had simply deemed the implicating reports to be too few in number to indicate anything meaningful to its shareholders.<sup>138</sup> The Court was not persuaded, finding that the complaint stated that the defendant was sufficiently concerned about the connection between its medication and its customers’ illness that it had hired a consultant to review the medication, asked an expert scientist to participate in animal studies, and convened a panel of physicians and scientists.<sup>139</sup> The Court noted that the defendant issued a press release suggesting the studies had confirmed that its product did not cause illness when, in fact, it had not conducted any relevant studies, and the scientific evidence at that time was inconclusive, a factor which it deemed to be “most significant.”<sup>140</sup> The Court found these allegations as a whole gave rise to a cogent and compelling inference that the defendant elected to not disclose the reports of adverse events, and did so not because it “believed they were meaningless but because it understood their likely effect on the market.”<sup>141</sup>

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<sup>133</sup> *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1324 (2011).

<sup>134</sup> 15 U.S.C. § 78u-5(a) (2012); see also Ann Morales Olazábal, *Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What’s Safe and What’s Not?*, 105 DICK. L. REV. 1, 4, 7 (2000) (explaining the applicability of the safe harbor provision and noting that underwriters and outside reviewers, such as accounting firms, are also protected by the provision).

<sup>135</sup> 15 U.S.C. § 78u-5(i)(1); Olazábal, *supra* note 134, at 4.

<sup>136</sup> 15 U.S.C. § 78u-5(c)(1); Olazábal, *supra* note 134, at 6.

<sup>137</sup> 131 S. Ct. at 1323.

<sup>138</sup> *Id.* at 1324.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at 1324–25.

#### 4. Reliance

Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's purchase.<sup>142</sup> Traditionally, a plaintiff proves reliance by showing awareness of a specific misrepresentation and that he or she engaged in the relevant transaction—e.g., purchasing common stock—as a result.<sup>143</sup>

Modern securities fraud, however, is much more complex than early fraud cases because it involves a vast impersonal market in which millions of shares are exchanged each day.<sup>144</sup> Whereas the reliance inquiry in a face-to-face transaction on a closed-market focuses on the subjective pricing of the relevant information by the potential buyer, “the presence of an [open] market . . . transmits information to the investor in the processed form of a market price.”<sup>145</sup> This processed price theoretically “acts as the agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.”<sup>146</sup> Accordingly, a purchaser of stock on an open market relies on any material misrepresentation that a seller has made.<sup>147</sup>

The Supreme Court has thus created a rebuttable presumption of reliance in cases of securities fraud perpetrated on the open-market in order to unencumber potential plaintiffs of the “unrealistic evidentiary burden” of having to show a “speculative state of facts,” such as how he or she would have acted if the omitted material information had been disclosed or if the misrepresentation had not been made.<sup>148</sup> To invoke the presumption, a plaintiff must demonstrate that: (1) the alleged misrepresentation was made to the public; (2) “the stock traded in an efficient market;” and (3) “the relevant transaction took place between the time the misrepresentation was made and the time the truth was revealed.”<sup>149</sup>

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<sup>142</sup> *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179, 2184–85 (2011).

<sup>143</sup> *Id.* at 2185.

<sup>144</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 243–44 (1988).

<sup>145</sup> *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (D. Tex. 1980); *see also Basic Inc.*, 485 U.S. at 244 (quoting *In re LTV Sec. Lit.*, 88 F.R.D. at 143).

<sup>146</sup> *In re LTV Sec. Litig.*, 88 F.R.D. at 143; *see also Basic Inc.*, 485 U.S. at 244 (quoting *In re LTV Sec. Lit.*, 88 F.R.D. at 143).

<sup>147</sup> *Basic Inc.*, 485 U.S. at 244.

<sup>148</sup> *Id.* at 245. The Court gives examples of showings that would rebut this presumption, such as a demonstration that the “market makers” were privy to the truthful information, if, despite the fraudulent attempt to manipulate market price, news of the truthful information entered the market and dissipated the effects of the misstatements or a demonstration that the plaintiffs divested their shares for reasons other than the belief that a misrepresentation had occurred. *Id.* at 248–49. The Court later referred to the concept underlying the rebuttable presumption as the well-known “fraud-on-the-market” theory. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 170–71 (2008). For the legal background and an overview of the fraud-on-the-market theory, see Jeffrey L. Oldham, Comment, *Taking “Efficient Markets” Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 1006–15 (2003).

<sup>149</sup> *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179, 2185 (2011).

## 5. Loss Causation and Economic Loss

Loss causation is the second segment of causation that connects the initial misrepresentation and inflated price at which the security was purchased to the actual economic loss sustained by the plaintiff.<sup>150</sup> A plaintiff must show that the misrepresentation resulted in subsequent economic loss in the form of a decreased share price.<sup>151</sup> This requirement prevents securities laws from essentially requiring issuers to insure investors against declines in the value of their investments that are unrelated to the alleged fraud.<sup>152</sup>

An inflated purchase price alone is not sufficient to cause an economic loss.<sup>153</sup> For instance, an investor who purchases a security with an inflated price based on a material misrepresentation might sell before the misrepresentation comes to light, before a drop in share price occurs, and thus, before an economic loss is incurred.<sup>154</sup> Additionally, an economic loss might be the result of other intervening causes, such as world events, new economic circumstances, changes in investor expectations, or new industry or company-specific conditions that cause a drop in share price.<sup>155</sup> A plaintiff would not be able to prove loss causation to the extent that any one of these factors has caused his or her economic loss.<sup>156</sup>

### *B. Damages Under Rule 10b-5*

As in common law fraud, damages are an element of a private Rule 10b-5 action.<sup>157</sup> The Exchange Act limits recovery in any private action to “actual” damages.<sup>158</sup> Actual damages do not include punitive or other extra-compensatory damages and are usually measured by the plaintiff’s out-of-pocket loss.<sup>159</sup> Additionally, the PSLRA limits damages in private actions to the difference between the security’s purchase price and the security’s mean

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<sup>150</sup> See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343–44 (2005).

<sup>151</sup> *Id.*

<sup>152</sup> Holbrook, *supra* note 89, at 223.

<sup>153</sup> *Erica P. John Fund, Inc.*, 131 S. Ct. at 2186.

<sup>154</sup> *See id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.12(1)(A) (2015), available at Westlaw 4 Law Sec. Reg. § 12.12(1)(A).

<sup>158</sup> 15 U.S.C. § 78bb(a)(1) (2012); *Blue Chip Stamps*, 421 U.S. at 734.

<sup>159</sup> Holbrook, *supra* note 89, at 226. The Court has also expressly recognized a measure of damages based on the defendant’s gain for fraud perpetrated on a closed market. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972). This measure is generally based on contract law and thus requires that privity exist between the plaintiff and defendant; privity is absent in most open-market fraud cases because the company that makes the representation does not sell the stock to the plaintiff. Burch, *supra* note 17, at 365, 368. The defendant’s gain measure also affords a more concrete valuation for closed-market damages because there is no market-value benchmark that can be used by the court to determine out of pocket loss. *See id.* at 364–65.

trading price during the ninety-day period preceding the date on which the misrepresentation was revealed to the market.<sup>160</sup> This provision thus caps the plaintiff's total possible recovery.<sup>161</sup>

The out-of-pocket damage rule focuses only on what the plaintiff has lost, making no allowance for what the plaintiff might have gained had the misrepresented information been true or had the defendant performed as promised.<sup>162</sup> It equals the difference between the price at which the plaintiff bought or sold the securities and the price at which the plaintiff would have bought or sold those securities in the absence of the defendant's misrepresentation.<sup>163</sup> This loss calculus fixes the measure of the loss on the date of the purchase or sale itself and, per the requirements of the loss causation element, excludes any loss that is attributable to any market decline unrelated to the misrepresentation.<sup>164</sup> Accordingly, the "most common method of estimating per-share damages" is to use an "event study" to "isolate the effects of the withheld [or misrepresented] information" on the post-disclosure stock price from factors "unrelated to the litigation."<sup>165</sup>

### III. APPLICATION OF RULE 10B-5 TO GREENWASH

The elements of economic loss and loss causation pose obstacles to green investors who want to pursue a Rule 10b-5 (the "Rule") claim for certain green misrepresentations.<sup>166</sup> Certain other elements of the Rule, however, pose additional obstacles that are unique to greenwash.<sup>167</sup> These are identified to suggest that there are other potential limits on the Rule's availability in the socially responsible investment ("SRI") context, even if the plaintiff suffers an economic loss.<sup>168</sup>

#### *A. Material Misrepresentation or Omission of Fact*

The social or green character of a misrepresentation is not alone determinative of its materiality.<sup>169</sup> The U.S. Supreme Court has explicitly rejected such categorical rules.<sup>170</sup> In *Matrixx Initiatives, Inc. v. Siracusano*, the Court noted

<sup>160</sup> 15 U.S.C. § 78u-4e (2012); Holbrook, *supra* note 89, at 228 n.95.

<sup>161</sup> Holbrook, *supra* note 89, at 228 n.95.

<sup>162</sup> *Id.* at 228.

<sup>163</sup> *See id.*

<sup>164</sup> *Id.* at 229.

<sup>165</sup> *Id.* at 234 (quoting Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1491 (1996)).

<sup>166</sup> *See supra* notes 150–156, *infra* notes 204–252 and accompanying text.

<sup>167</sup> *See supra* note 18 and accompanying text (discussing materiality).

<sup>168</sup> *See infra* note 169–261 and accompanying text.

<sup>169</sup> *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318–19 (2011).

<sup>170</sup> *Id.*

that the defendant's argument rested on the flawed premise that statistically significant scientific data was the *only* reliable evidence of causation between a drug and an illness.<sup>171</sup> It went on to demonstrate that there were other facts that indicated that there was indeed a plausible causal link that a reasonable investor would consider relevant.<sup>172</sup> This focus on causation shows what the Court considered most important to its materiality inquiry—that which the causal link led to: significant liability, subsequent costs, and ultimately, a good economic reason for investors to have divested their money had the information been disclosed.<sup>173</sup> Thus, the Court implicitly drew the line of materiality at the point where the information contained indicia that could bear on the economic value of the company.<sup>174</sup>

The U.S. Court of Appeals for the Sixth Circuit focused on the vagueness of the company's statements in *In re Ford Motor Co. Securities Litigation*.<sup>175</sup> Noting that the statements were “not capable of objective verification” and “so lacking in specificity” that they could not be important, the court demonstrated an implicit line of reasoning that is similar to that of the Court in *Matrixx Initiatives, Inc.*<sup>176</sup> Such imprecise information is immaterial to a reasonable investor because it is not specific enough to relate the economic value of the company.<sup>177</sup>

Taken together, *Matrixx Initiatives, Inc.*, and *In re Ford Motor Co. Securities Litigation* have at least one implication for green investors: the material omission of a particular report with specific information and non-material misleading statements of a generalized nature show that materiality depends, to some degree, on the specificity of the information at issue and that misleading information alone is not sufficient.<sup>178</sup> Therefore, the typical misleading green slogans and affirmations that companies make about their reputations and practices will probably not meet the materiality requirement.<sup>179</sup> These might include, for example, British Petroleum's television and print advertisements professing that it is a “global leader” in clean energy production and Walmart's public relation announcement proclaiming that it is an environmental leader.<sup>180</sup>

<sup>171</sup> *Id.* at 1319.

<sup>172</sup> *Id.* at 1323 (noting that if information provided to Matrixx by medical experts revealed a plausible causal relationship between its product and illness, consumers would have probably not used the product as a result and the resulting drop in sales would have been relevant to a reasonable investor).

<sup>173</sup> *See id.*

<sup>174</sup> *See id.*

<sup>175</sup> *See Matrixx Initiatives, Inc.*, 381 F.3d 563, 570–71 (6th Cir. 2004).

<sup>176</sup> *See* 131 S. Ct. at 1323; *In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 571 (6th Cir. 2004).

<sup>177</sup> *See In re Ford Motor Co. Sec. Litig.*, 381 F.3d at 571.

<sup>178</sup> *See Matrixx Initiatives, Inc.*, 131 S. Ct. at 1323; *In re Ford Motor Co. Sec. Litig.*, 381 F.3d at 571.

<sup>179</sup> *See In re Ford Motor Co. Sec. Litig.*, 381 F.3d at 570.

<sup>180</sup> *See Nilima Choudhury, Walmart Accused of 'Greenwashing' Over Clean Energy Claims*, RESPONDING TO CLIMATE CHANGE (Nov. 18, 2013, 9:19 AM), <http://www.rtcc.org/2013/11/18/>

That the misrepresentation must contain information that is specific enough to implicate a potential change in the company's economic value seems implicit in the Court's holdings.<sup>181</sup> Yet the Court has stated that the policy of the test is to filter out trivial information.<sup>182</sup> Thus, the test's purpose does not seem to contemplate such a narrow reading; only through the Court's application of the materiality test does the focus on information revealing potential economic costs appear.<sup>183</sup> Therefore, this focus might simply be incidental to determining materiality in the vast majority of securities fraud cases, which inherently involve economic information at their core.<sup>184</sup>

Furthermore, statistics show that SRI market participants have invested a significant amount of assets in screened accounts, and these investors base their investment decisions on non-economic factors.<sup>185</sup> It seems untenable to exclude all such market participants from the "reasonable investor" designation because the sheer value of SRI investments evinces that it is a reasonable investment strategy.<sup>186</sup> Additionally, focusing too closely on the economic costs normally associated with typical misrepresentations might overlook the possibility that even purely ethical misrepresentations can have long-term economic costs that might not manifest in an immediate reduction in stock price.<sup>187</sup> Thus, a strong argument can be made that a reasonable investor would consider information that reveals potential reduction in the value of the company, whether economic or social, as significantly changing the total mix of information made available.<sup>188</sup>

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walmart-accused-of-greenwashing-over-clean-energy-claims/, archived at <http://perma.cc/CAX3-59FQ>; James Ridgeway, *BP's Slick Greenwashing*, MOTHER JONES (May 4, 2010, 7:30 AM), <http://www.motherjones.com/mojo/2010/05/bp-coated-sludge-after-years-greenwashing>, archived at <http://perma.cc/8GRA-NS98>.

<sup>181</sup> See, e.g., *Matrixx Initiatives, Inc.*, 131 S. Ct. at 1323; *In re Ford Motor Co. Sec. Litig.*, 381 F.3d at 571.

<sup>182</sup> See *Matrixx Initiatives, Inc.*, 131 S. Ct. at 1318.

<sup>183</sup> *Id.* at 1323; see *In re Ford Motor Co. Sec. Litig.*, 381 F.3d at 571.

<sup>184</sup> See RICHARDSON, *supra* note 8, at 21 ("[Although] the market [might] value ethical conduct when embodied in regulation or social pressures expressed through the lens of reputational risk, ethics has not traditionally been integral to investment decisions.").

<sup>185</sup> See THE FORUM FOR SUSTAINABLE & RESPONSIBLE INV., *supra* note 1, at 11.

<sup>186</sup> See generally FUNG ET AL., *supra* note 3, at 8–10 (providing statistics related to SRI growth for various nations' economies).

<sup>187</sup> PETER CAMEJO, *THE SRI ADVANTAGE: WHY SOCIALLY RESPONSIBLE INVESTING HAS OUTPERFORMED FINANCIALLY* 51 (2002). SRI focuses on the long-term and encourages policies that strengthen the economy's potential. *Id.* Camejo explains by way of example that although clear-cutting thousand-year-old redwoods might be profitable in the short-term, the practice could undermine the economy over the long-term and eventually be reflected in the financial performance of the company. *Id.*

<sup>188</sup> See *Matrixx Initiatives, Inc.*, 131 S. Ct. at 1323; CAMEJO, *supra* note 187, at 51.

### B. Connection with a Purchase or Sale of a Security

Green investors differ from traditional investors in the way they base their purchasing decisions, but not in the manner in which they purchase their securities.<sup>189</sup> They merely screen potential investments according to environmental metrics or criteria before making an ordinary purchase.<sup>190</sup> Green investors, therefore, will typically meet the actual purchaser requirement of the Rule because they hold contractual rights to their investments.<sup>191</sup>

### C. *Scienter*

Generally, green investors want to avoid companies that adopt hollow environmental practices—such as making exaggerated claims or intentions—that do not create environmentally positive results.<sup>192</sup> Such claims, despite their misleading nature, might often fall under the Private Securities Litigation Reform Act’s (the “PSLRA”) safe harbor provision.<sup>193</sup> For example, Walmart recently stated that it intends to produce seven billion kilowatt hours of renewable energy annually by 2020 in order to decrease its energy consumption by twenty percent over that time.<sup>194</sup> This claim might not incur liability under the Rule even if it was recklessly made and never materializes.<sup>195</sup> Walmart would have only needed to sufficiently couch the statements in cautionary language to have them qualify under the PSLRA’s safe harbor provision.<sup>196</sup>

Beyond the safe harbor provision, the PSLRA and case law requires that a plaintiff plead facts that, on the whole, give rise to a strong inference that the defendant acted recklessly or knowingly.<sup>197</sup> As the Court demonstrated in *Matrixx Initiatives, Inc.*, the inference that the defendant acted with intent must be at least as compelling as any opposing inference.<sup>198</sup> In that case, the Court found that this standard was met because the defendant had hired a consultant to review the safety of its product, solicited the advice of experts, and then, importantly, issued a press release that suggested its studies had confirmed the safety of its product when this was not actually the case.<sup>199</sup> It thus appears

<sup>189</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 750–51 (1975).

<sup>190</sup> See FUNG ET AL., *supra* note 3, at 27 (explaining that the use of positive screens simply entails the purchase of a security based on how well its underlying assets meet certain social criteria).

<sup>191</sup> See *Blue Chip Stamps*, 421 U.S. at 750–51; FUNG ET AL., *supra* note 3, at 27.

<sup>192</sup> See *Delmas & Burbano*, *supra* note 6, at 263.

<sup>193</sup> 15 U.S.C. § 78u-5(a) (2012).

<sup>194</sup> Choudhury, *supra* note 180.

<sup>195</sup> 15 U.S.C. § 78u-5(c)(1), (i)(1).

<sup>196</sup> *Id.* The safe harbor applies when “a forward-looking statement . . . is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.” *Id.* § 78u-5(c)(1)(A)(i).

<sup>197</sup> See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007).

<sup>198</sup> 131 S. Ct. at 1324.

<sup>199</sup> *Id.*

green investors will need to plead facts that demonstrate that the defendant had reason to know that its environmental claims were not true and that, taken together, sufficiently support the inference that the defendant subsequently stood by its misrepresentations to protect its interests.<sup>200</sup>

#### D. Reliance

Green investors who bring suit over a misrepresentation that creates an artificial market price will be able to rely on the rebuttable presumption of reliance by showing that the misrepresentation became known to the public, the transaction occurred in an open-market, and the relevant purchase took place between the time the misrepresentation was made and the time the truth was revealed.<sup>201</sup>

Apart from the rebuttable presumption, green investors may prove reliance the traditional way: by pointing to specific facts that demonstrate a misrepresentation was made and that it formed a basis for their investment decision.<sup>202</sup> Misrepresentations of a purely ethical or green nature might often come in the form of an overt statement that can be identified by a values-based investor, especially when made by a defendant company to gain a reputational benefit.<sup>203</sup>

#### E. Loss Causation and Economic Loss

Companies view investment as the means to acquire new physical resources, such as facilities and equipment, and new human resources, such as skills and training.<sup>204</sup> These resources are otherwise known as capital, which companies use “to produce goods and services.”<sup>205</sup> The company’s cost of capital is the amount that it has to pay to make itself attractive to investors—paid in the form of the investor’s return.<sup>206</sup> A low cost of capital allows a company to undertake additional profitable projects.<sup>207</sup> Furthermore, cost of capital is

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<sup>200</sup> See *id.* at 1324–25.

<sup>201</sup> See *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179, 2185 (2011).

<sup>202</sup> *Id.*

<sup>203</sup> See *id.*; FUNG ET AL., *supra* note 3, at 31–34 (describing the kinds of information that a green investor might rely upon when making a purchasing decision).

<sup>204</sup> See ROBERT E. HALL & MARC LIEBERMAN, *MICROECONOMICS: PRINCIPLES AND APPLICATIONS* 406 (4th ed. 2006); Knoll, *supra* note 36, at 703.

<sup>205</sup> See HALL & LIEBERMAN, *supra* note 204, at 406.

<sup>206</sup> Knoll, *supra* note 36, at 703.

<sup>207</sup> RICHARDSON, *supra* note 8, at 166; Knoll, *supra* note 36, at 703.



generally assumed to have an inverse relationship with stock price.<sup>208</sup> A higher stock price confers additional benefits upon a company.<sup>209</sup>

By choosing not to invest in certain unethical companies, green investors aim to lower the demand for the company's stock, which lowers the market price of its shares and raises its cost of capital.<sup>210</sup> Investors hope to influence corporate behavior by rewarding ethical companies with capital and punishing unethical companies with the loss of capital.<sup>211</sup> A green investor is similarly motivated to divest from a company that misrepresents a green practice.<sup>212</sup> Thus, the premise of SRI suggests that the economic loss element of a Rule 10b-5 action will always be satisfied following a misrepresentation because the green investor's divestment will reduce the market price of the stock even if the corrected information does not reduce the expected future earnings of the company.<sup>213</sup>

This presumption, however, runs counter to the basic principles of finance.<sup>214</sup> The demand for a stock is generally represented by a downward sloping curve along each unit of quantity demanded for a particular price.<sup>215</sup> A share of stock's value to any particular owner "is equal to the total present value of its future after-tax profits."<sup>216</sup> The equilibrium price of a stock is its actual value at any given time and is determined almost instantaneously by the market of buyers and sellers, each of whom drive the price to that point according to their unique profit forecasts.<sup>217</sup> It can be found at the point where the demand curve intersects with the vertical supply curve.<sup>218</sup> Therefore, when the market finds out that a company previously misrepresented information, and that information, once revealed, bears negatively on the expected earnings of the company, the demand curve shifts leftward and the equilibrium price falls.<sup>219</sup>

<sup>208</sup> Knoll, *supra* note 36, at 703 n.137 (noting that this assumption requires that the market be at least weak-form efficient).

<sup>209</sup> Knoll, *supra* note 36, at 703 (noting that a higher stock price is desirable to a company for several other reasons, including an increase in the value of the investor's total investment in the company and an increase in the value of its employees' stock options).

<sup>210</sup> *Id.* at 704.

<sup>211</sup> *Id.*; see also RICHARDSON, *supra* note 8, at 165, 166 ("[I]n this perspective, the ability of SRI to change corporate behavior is not by moral suasion as much as by affecting the bottom line.").

<sup>212</sup> See Knoll, *supra* note 36, at 703.

<sup>213</sup> See RICHARDSON, *supra* note 8, at 166–67.

<sup>214</sup> *Id.* at 166.

<sup>215</sup> HALL & LIEBERMAN, *supra* note 204, at 428.

<sup>216</sup> *Id.*

<sup>217</sup> *Id.* at 428–29.

<sup>218</sup> *Id.* (noting that the supply curve is vertical because the number of outstanding shares is fixed).

<sup>219</sup> See *id.* at 429–30.

The same is not true for a sale of stock in the absence of new information (i.e., when the corrected information does not reduce expected earnings).<sup>220</sup> Under conventional finance theory, the sole act of divestiture or trade of any quantity of a company's shares does not affect its price.<sup>221</sup> This is because all relevant information is already available and known to the market and there exists many perfect substitutes in the form of other outstanding common stock shares in the same company.<sup>222</sup> The theory thus holds that at any given time, the stock price accounts for all information available.<sup>223</sup> For example, suppose a car enthusiast wants to sell and liquidate his or her stock in a company to buy a new car; this desire to sell is unique and is in no way motivated by, nor does it implicate, the potential earnings of the company.<sup>224</sup> Moreover, this sale is not like the sale of a one-of-a-kind painting.<sup>225</sup> The price of such an item would be set by the unique interests of the purchaser and seller because there would be no available substitutes, whereas the price of the car enthusiast's share of stock would be set by the vast market of buyers and sellers who would value it and every other share of the company's stock the same way: according to the company's expected future cash flows.<sup>226</sup>

The downward sloping and horizontal demand curve models offer two conclusions, respectively.<sup>227</sup> First, if a misrepresentation contains new, unexpected information that both offends the green investor's ethics and bears on the company's potential earnings, then the demand for the company's stock will decrease because *all* investors would consider the extra risk in subsequent purchases and sales.<sup>228</sup> The decrease in demand causes a new, lower equilibrium price that implies an economic loss and therefore should make a Rule 10b-5 action available.<sup>229</sup> Second, if a misrepresentation only contains information that offends the green investor's ethics, and does not affect the expected future cash flows of the company, then neither it nor the subsequent divestment will

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<sup>220</sup> See RICHARDSON, *supra* note 8, at 166–67; see also Knoll, *supra* note 36, at 706–07 (explaining the effect of SRI screening on the price of a company's stock along a horizontal demand curve).

<sup>221</sup> RICHARDSON, *supra* note 8, at 166; see Knoll, *supra* note 36, at 706–07.

<sup>222</sup> RICHARDSON, *supra* note 8, at 166–67.

<sup>223</sup> *Id.*

<sup>224</sup> See *id.* at 166–67 n.361.

<sup>225</sup> See HALL & LIEBERMAN, *supra* note 204, at 102–03 (explaining how the availability of substitution affects the elasticity of demand); RICHARDSON, *supra* note 8, at 166–67 n.361; *Definition of 'Inelastic'*, INVESTOPEDIA, [www.investopedia.com/terms/e/inelastic.asp](http://www.investopedia.com/terms/e/inelastic.asp) (last visited Feb. 9, 2015), archived at <http://perma.cc/5B3P-APW9>.

<sup>226</sup> See RICHARDSON, *supra* note 8, at 166–67 n.361; Pietra Rivoli, *Making a Difference or Making a Statement? Finance Research and Socially Responsible Investment*, 13 BUS. ETHICS Q. 271, 276 (2003).

<sup>227</sup> See Knoll, *supra* note 36, at 705–06.

<sup>228</sup> See HALL & LIEBERMAN, *supra* note 204, at 429–30; RICHARDSON, *supra* note 8, at 166–67; Knoll, *supra* note 36, at 704–06.

<sup>229</sup> See Knoll, *supra* note 36, at 705.

decrease the demand of the stock.<sup>230</sup> The ethical leanings of green investors are, practically speaking, the equivalent to the car enthusiast's desire to sell and liquidate his or her stock in a company to buy a new car—it is an individualized and specific choice, which neither reflects nor implicates the potential earnings of the company.<sup>231</sup> That some buyers will exit the market does not shift the demand curve because the rest of the market does not view the new information to be relevant.<sup>232</sup> The market as a whole values the stock at the same price as before the misrepresentation.<sup>233</sup> The only effect of the divestment is that green investors own less of the company and traditional investors own more.<sup>234</sup> The company still “raises the same amount of capital, its asset prices are unchanged[,] and its cost of capital is the same.”<sup>235</sup> Moreover, a remedy under the Rule is not available because the green investor does not incur an economic loss.<sup>236</sup>

The existence of a horizontal demand curve for divestment, however, is based on models of perfect market efficiency that might not hold true under all circumstances.<sup>237</sup> Empirical evidence suggests that a downward sloping demand curve could exist when the sale of a stock takes place, even in the absence of new information.<sup>238</sup> A sale might affect demand when investors believe that the stock has few substitutes, such as stock in specialized boutique companies or when a sale takes place in a small and restricted market.<sup>239</sup> Large block sales of stock by socially responsible investors (“SRI investors”) might also lower demand by causing other investors to assume that new earnings information has been released.<sup>240</sup> At least one study has shown that a drop in price might result from a boycott by ethical investors, albeit a very small one.<sup>241</sup> As econometric analysis can isolate a discrete drop in share price fol-

<sup>230</sup> See RICHARDSON, *supra* note 8, at 166–67; Knoll, *supra* note 36, at 706.

<sup>231</sup> See RICHARDSON, *supra* note 8, at 167; Knoll, *supra* note 36, at 706; see also HALL & LIEBERMAN, *supra* note 204, at 429–30 (explaining factors that bear on expected earnings).

<sup>232</sup> See RICHARDSON, *supra* note 8, at 167; Knoll, *supra* note 36, at 706.

<sup>233</sup> See RICHARDSON, *supra* note 8, at 167; Knoll, *supra* note 36, at 706.

<sup>234</sup> Knoll, *supra* note 36, at 706.

<sup>235</sup> *Id.*

<sup>236</sup> See RICHARDSON, *supra* note 8, at 167; Knoll, *supra* note 36, at 706.

<sup>237</sup> Rivoli, *supra* note 226, at 277 (noting that the horizontal demand curve model rests on several perfect market assumptions, including “costless transactions, full information and zero information costs, homogeneous expectations, and available perfect substitutes”).

<sup>238</sup> Knoll, *supra* note 36, at 707–10 (summarizing the relevant empirical literature); Rivoli, *supra* note 226, at 284–85 (predicting four scenarios based on empirical literature in which SRI screening will influence companies' behavior).

<sup>239</sup> See RICHARDSON, *supra* note 8, at 168–70; Rivoli, *supra* note 226, at 284–85.

<sup>240</sup> See Knoll, *supra* note 36, at 707; Rivoli, *supra* note 226, at 282 (noting that research shows that the drop in share price following large block sales is often quickly reversed).

<sup>241</sup> RICHARDSON, *supra* note 8, at 170 (noting that seventy-five percent of investors in the entire market “would have to boycott a stock in order for the targeted company's cost of equity to increase by even [one-percent]”).

lowing a misrepresentation, even a relatively small drop that is sustained within the PSLRA's ninety-day market-loss window should be enough for a green investor to allege an economic loss.<sup>242</sup>

Although these empirical studies of stock sales are cause for questioning the extent to which the perfect market assumptions of finance theory hold true in the real world, they have nonetheless failed to account for the effects of SRI divestment on stock prices in several prominent case studies.<sup>243</sup> The companies that supported Apartheid and continued to do business in South Africa following divestment by SRI investors did not suffer adverse stock price movements.<sup>244</sup> Additionally, the significant divestment from tobacco companies by large investors did not impact their stock prices and the exclusion from SRI funds did not cause a decrease in the value of other objectionable stocks, such as alcohol and weapons manufacturers.<sup>245</sup>

Thus, apart from the possible circumstances when market imperfections might exist, the sum of evidence indicates that it is highly unlikely that a green investor would succeed in bringing a Rule 10b-5 action.<sup>246</sup> Green investors will not be able to allege economic loss when the corrected information reveals an unethical, but otherwise legal, practice that does not bear on the company's earnings because divestment alone generally does not reduce demand or the stock's equilibrium price.<sup>247</sup>

Beyond the potential economic loss to the green investor, there might be multiple parties who suffer to some extent from a purely ethical green misrepresentation.<sup>248</sup> The green investors themselves might suffer psychic injury from having been duped into supporting practices that are antithetical to their values.<sup>249</sup> Furthermore, natural resources existing in public trust might be indirectly damaged by the misappropriation of the green investor's financial support and protection, assuming they would have otherwise put their money to some effective use.<sup>250</sup> On an even more abstract level, such misrepresentations could undermine the legitimacy of the SRI movement, which, if it continues to grow and becomes the mainstream approach, could potentially be very effec-

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<sup>242</sup> See Holbrook, *supra* note 89, at 233–34 (noting that courts use econometrics to isolate extra-fraud causes of stock price movement and measure appropriate damages).

<sup>243</sup> See RICHARDSON, *supra* note 8, at 167–68, 170–71; Knoll, *supra* note 36, at 710.

<sup>244</sup> RICHARDSON, *supra* note 8, at 167–68; Knoll, *supra* note 36, at 710.

<sup>245</sup> RICHARDSON, *supra* note 8, at 168.

<sup>246</sup> See *id.* at 166–68, 170–71; Knoll, *supra* note 36, at 710; Rivoli, *supra* note 226, at 284–85.

<sup>247</sup> See RICHARDSON, *supra* note 8, at 166–68, 170–71; Knoll, *supra* note 36, at 710; Rivoli, *supra* note 226, at 284–85.

<sup>248</sup> See CAMEJO, *supra* note 187, at 51; Delmas & Burbano, *supra* note 6, at 84; Richardson & Cragg, *supra* note 12, at 32.

<sup>249</sup> See FUNG ET AL., *supra* note 3, at 3, 44–46 (describing the SRI investor's "feel good" interest).

<sup>250</sup> See CAMEJO, *supra* note 187, at 51; Delmas et al., *supra* note 9, at 263 (recognizing that green communications do not always produce green results); Richardson & Cragg, *supra* note 12, at 32.

tive at influencing company behavior and thus producing real-world environmental benefits.<sup>251</sup> The Rule is a securities fraud device, however, and its focus is on market value; to the extent that these harms do not cause a decline in an investment's market value, they will not incur liability under the Rule.<sup>252</sup>

### F. Damages

A green misrepresentation that causes a drop in share price will permit a green investor plaintiff to identify and isolate an economic loss, demonstrate loss causation, and recover the difference between the artificially inflated price and its inherent value on the date of purchase.<sup>253</sup>

Assuming typical open primary and secondary market conditions, the out-of-pocket loss rule,<sup>254</sup> however, is of questionable efficacy, both in terms of compensation to green investor victims and deterrence of misrepresenting companies.<sup>255</sup> A Rule 10b-5 action is typically brought by a class of current and former shareholders who purchased the stock during the relevant class period as a result of the company's representational misconduct.<sup>256</sup> If the class of plaintiffs wins a judgment or reaches a settlement, then the current shareholders of the defendant pay those costs.<sup>257</sup> Accordingly, securities class actions on the open market simply transfer money between current shareholders and former shareholders.<sup>258</sup> Therefore, even when the economic loss element is satisfied and the Rule permits green investors to bring suit and recover out-of-pocket damages, they might in fact recover nothing at all—instead finding that they are merely paying their lawyers to pay themselves.<sup>259</sup> If they are not current shareholders, then they will only recover from current, often innocent, shareholders.<sup>260</sup> Meanwhile, the corporate managers who made the misrepresentations might go largely unpunished and the lawyers who litigated the case will take up to thirty percent of the award.<sup>261</sup>

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<sup>251</sup> See Delmas & Burbano, *supra* note 6, at 84 (noting that greenwash can erode consumer and investor confidence in the SRI market); Delmas et al., *supra* note 9, at 263.

<sup>252</sup> See, e.g., *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179, 2186 (2011).

<sup>253</sup> See *id.*; Holbrook, *supra* note 89, at 228.

<sup>254</sup> See *supra* notes 157–165 and accompanying text.

<sup>255</sup> See Burch, *supra* note 17, at 374–76.

<sup>256</sup> *Id.* at 374.

<sup>257</sup> *Id.* These implications hold true for diversified investors as well. *Id.* at 374–75. Well-diversified investors will likely be shareholders within the class period or in the group indirectly funding the settlement or judgment in lawsuits across the spectrum of their investments. *Id.* Although they will “win” on some days and “lose” on others,” on balance, the investors will only succeed in transferring their wealth from one place to another, all while paying their attorneys to do so. *Id.*

<sup>258</sup> *Id.*

<sup>259</sup> See *id.*

<sup>260</sup> See *id.*

<sup>261</sup> See *id.* at 374–76.

#### IV. AN ADMINISTRATIVE ALTERNATIVE TO ADDRESS GREENWASH

Misrepresentations in the socially responsible investment (“SRI”) universe often cause unique harms that can be difficult to value according to an economic formula.<sup>262</sup> The purpose of the private right of action under Rule 10b-5 (the “Rule”) is to provide a remedy for securities fraud that has traditionally led to economic loss.<sup>263</sup> It is no wonder then that economic loss forms the crux of liability under the Rule and limits its effectiveness in the SRI context.<sup>264</sup> Preventative regulatory measures should still exist, however, because greenwashing can cause green investors to invest in and support practices they find unethical.<sup>265</sup> Further, such misrepresentations cause green investors to incur an opportunity cost in the form of a missed opportunity to invest in companies that support true green practices over the investment period.<sup>266</sup> The optimal remedy for green misrepresentations would focus on the deterrence of wrongdoers because this indirectly protects the unique intangible values of green investors.<sup>267</sup> Ultimately, green investors want the assurance that their investment will yield the social benefit professed by the company rather than the assurance that their money will be returned to them if it is not.<sup>268</sup>

##### *A. The SEC Should Develop a Uniform Environmental Performance Ratings System*

The first step in creating such a remedy is that the Securities and Exchange Commission (SEC) should adopt standards for environmental ratings organizations like KLD Research and Analytics, Domini Social Investments, and Calvert Investments,<sup>269</sup> which guide their methodologies to focus on information that reflects real-world environmental results and not merely green communications or processes.<sup>270</sup> Like mutual fund screens, a number of companies have developed green indices that use one of fifty or more unique ratings methodologies.<sup>271</sup> These funds and indices’ ratings methodologies must inevitably prioritize some criteria over others—for example, giving more weight to practices that address climate change than to practices that address

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<sup>262</sup> See Richardson & Cragg, *supra* note 12, at 29.

<sup>263</sup> See Erica P. John Fund, Inc. v. Halliburton, Co., 131 S. Ct. 2179, 2186 (2011).

<sup>264</sup> See *id.*; Richardson & Cragg, *supra* note 12, at 29, 32.

<sup>265</sup> See FUNG ET AL., *supra* note 3, at 3; RICHARDSON, *supra* note 8, at 12–13, 20–21.

<sup>266</sup> See Delmas & Burbano, *supra* note 6, at 73; Delmas et al., *supra* note 9, at 263.

<sup>267</sup> See Holbrook, *supra* note 89, at 237–39; Richardson & Cragg, *supra* note 12, at 29, 31.

<sup>268</sup> See FUNG ET AL., *supra* note 3, at 3, 44–46, 48; Richardson & Cragg, *supra* note 12, at 29, 31.

<sup>269</sup> See *supra* note 58 and accompany text.

<sup>270</sup> See Delmas et al., *supra* note 9, at 255–56, 263; see also RICHARDSON, *supra* note 8, at 90 (noting the shortcomings of current screening and index methodologies).

<sup>271</sup> Delmas et al., *supra* note 9, at 255; see also RICHARDSON, *supra* note 8, at 90 (describing several ratings organizations and their index methodologies).

rainforest loss or water usage.<sup>272</sup> The lack of uniformity and transparency among these rating methodologies reduce their reliability and effectiveness.<sup>273</sup> Moreover, studies have shown that many of these methodologies assign high ratings to greenwash and often yield SRI portfolios that are practically indistinguishable from conventional ones.<sup>274</sup>

Although it might be useful and even necessary for funds and indices to use a variety of methodologies, one prominent scholar has argued that it would nevertheless be more effective if such methodologies focused on fewer criteria that yielded actual environmental results.<sup>275</sup> A more uniform system in this sense would give notice to corporate managers about which of their company's practices will be shown to green investors in the form of ratings and would thereby allow them to make a better cost-benefit analysis of which green practices are worth adopting.<sup>276</sup> It would also increase the legitimacy of the green investment movement by making it more likely that green investments actually protect the environment.<sup>277</sup>

### *B. Green Investor Guides and Civil Fines*

The second step is that the SEC should adopt guidelines for corporate managers similar to the Guides for the Use of Environmental Marketing Claims that the Federal Trade Commission (FTC) has issued to advertisers.<sup>278</sup> Such guides would give notice to corporate managers of which communications the SEC deems greenwash.<sup>279</sup> The SEC should also supplement them with warnings for first-time or non-material violations and civil fines for repeat or egregious violations.<sup>280</sup>

The economic analysis of tort law posits that the optimization of deterrence can be achieved by giving an incentive to potential wrongdoers—in the

<sup>272</sup> Delmas et al., *supra* note 9, at 256; *see also* RICHARDSON, *supra* note 8, at 90 (citing other problems that might arise in the screening methodologies of a given index).

<sup>273</sup> Delmas et al., *supra* note 9, at 255–56; Richardson & Cragg, *supra* note 12, at 28.

<sup>274</sup> Delmas et al., *supra* note 9, at 256, 263; Richardson & Cragg, *supra* note 12, at 28 (noting that almost any company can pass muster under the typical SRI selection methodology).

<sup>275</sup> Delmas et al., *supra* note 9, at 263; *see* Delmas & Burbano, *supra* note 6, at 80 (making a similar argument in relation to eco-labels within the marketing context).

<sup>276</sup> *See* Burch, *supra* note 17, at 382–83; Delmas et al., *supra* note 9, at 263; Holbrook, *supra* note 89, at 237–38.

<sup>277</sup> *See* Delmas & Burbano, *supra* note 6, at 80, 84; Delmas et al., *supra* note 9, at 263.

<sup>278</sup> *See* 17 C.F.R. 260(b) (2012). *See generally* Feinstein, *supra* note 11, at 242–49 (giving an overview of the FTC's green guides). The FTC uses the Green Guides to notify marketers of which environmental claims violate the Federal Trade Commission Act. Feinstein, *supra* note 11, at 230.

<sup>279</sup> *See* Burch, *supra* note 17, at 382–83 (explaining the need to give corporate managers notice of what constitutes wrongful behavior).

<sup>280</sup> 15 U.S.C. § 78u (2012) (setting forth the SEC's authority to issue civil fines); *see* Burch, *supra* note 17, at 382–83 (discussing the role of a penalty in achieving deterrence); Feinstein, *supra* note 11, at 244–45 (noting that the FTC used the Green Guides as a basis for bringing enforcement actions against marketers).

form of avoiding a penalty—to “take the appropriate amount of care” and thus internalize the costs of their actions.<sup>281</sup> Accordingly, predictable and accurate damages are necessary conditions: potential wrongdoers will internalize the costs of their actions only if they consider it the cheapest option.<sup>282</sup> The optimization of deterrence generally focuses on making the wrongdoer internalize the harm dealt to the victim because setting a penalty according to the wrongdoer’s gain can impose unwanted costs on society through over deterrence.<sup>283</sup> When the victim’s loss cannot be measured accurately, however, setting a penalty according to the measure of the wrongdoer’s gain is appropriate.<sup>284</sup>

In the case of purely ethical green misrepresentations, the calculation of an optimal monetary penalty might prove impossible because both the investor’s loss and the company’s gain might be too intangible and speculative to measure.<sup>285</sup> But unlike the losses, which need to be accurately measured in order to be compensated and internalized by the company, the company’s gain need not be accurately measured to be taken away.<sup>286</sup>

The real driver of a purely green misrepresentation is the intangible reputation and goodwill benefits of being perceived a green company.<sup>287</sup> To take

<sup>281</sup> Holbrook, *supra* note 89, at 237; see Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 GEO. L.J. 421, 421 (1998).

Generally, complete deterrence is accomplished by eliminating the prospect of gain on the part of the offender. The alternative . . . is . . . optimal deterrence, . . . which implies deterring offensive conduct only up to the point at which society begins to lose more from deterrence efforts than from the offenses it deters.

Hylton, *supra*, at 421.

<sup>282</sup> Holbrook, *supra* note 89, at 237.

<sup>283</sup> Hylton, *supra* note 281, at 424. For example: if X causes a harm of \$100, and expects a penalty of \$50, then X would not spend more than \$50 to avoid causing the harm. *Id.* Hylton notes that a penalty “that is larger than the harm divided by the probability of liability [of being caught] would result in overdeterrence costs because potential offenders would invest too much, from society’s viewpoint, in efforts to avoid causing harm.” *Id.*

<sup>284</sup> *Id.* at 432. The victim’s loss measure is generally considered the superior penalty calculus because it cannot result in over deterrence costs to society regardless of whether gains or losses are greater. *Id.* at 424, 430. When the defendant’s gain is less than the costs imposed on the victim, however, then it cannot result in over deterrence costs either, and arguably proves the appropriate measure when additional factors are at play. See *id.* at 430–33. Among these factors is when there are information costs, that is, it is known that gains are less than social losses but the gains are easier to measure. *Id.* at 432–33.

<sup>285</sup> See FUNG ET AL., *supra* note 3, at 3, 44–46 (noting the intangible nature of green investor’s interest); RICHARDSON, *supra* note 8, at 166–68 (noting that investment can lower cost of capital for small specialized companies); Burch, *supra* note 17, at 369 (noting that part of the company’s gain is intangible).

<sup>286</sup> See Burch, *supra* note 17, at 369 (discussing the intangible benefits of a misrepresentation).

<sup>287</sup> See Flammer, *supra* note 8, at 760 (explaining a survey that “[seventy-two percent] of the CEOs cited ‘brand, trust, and reputation’ . . . as one of the main factors driving them to take action on sustainability issues”); Richardson & Cragg, *supra* note 12, at 28 (noting that reputation constitutes between fifty and seventy percent of many large companies’ value); see also FUNG ET AL., *supra* note



away those benefits, the SEC need only mandate that environmental performance rating organizations designate its civil fines as a significant discounting factor within their ratings calculus.<sup>288</sup> The civil fine, even if for a nominal value, could thus have the practical effect of banishing the violating company, for a time, from the SRI universe, thereby stripping it of its intangible reputational benefit and barring it from misappropriating the funds of future green investors.<sup>289</sup> In this way, the green investment guides, civil fines, and uniform standard of environmental performance ratings could prove an effective system of specific and general deterrence without the need to monetize the social values that are at the heart of SRI.<sup>290</sup>

The system could offer a cut-and-dried standard that allows corporate managers to predict the risks of greenwashing while providing them with an incentive to internalize their costs.<sup>291</sup> Although there is a potential downside to a strictly administrative enforcement mechanism—such as the risk of inadequate deterrence from constraints on the SEC’s budget, bureaucratic inefficiency, and regulatory capture—such risks should be considered in light of the potential for net cost reduction.<sup>292</sup> For example, it would not impose the substantial costs of mandatory disclosure<sup>293</sup> and would circumvent many of the inherent flaws of a Rule 10b-5 action among private litigants, including the costs to companies from vexatious litigation, the costs to non-culpable investors from paying attorneys to transfer their wealth, and the inherent limitation on recovery that economic loss poses in many cases.<sup>294</sup>

## CONCLUSION

The SEC and private litigants have traditionally used Rule 10b-5 to combat a wide range of securities fraud. The availability of Rule 10b-5 to private

3, at 75 (explaining that companies gain a competitive advantage through the reputational benefit of being perceived as environmentally responsible).

<sup>288</sup> See Delmas et al., *supra* note 9, at 255–56, 263.

<sup>289</sup> See FUNG ET AL., *supra* note 3, at 75; Delmas et al., *supra* note 9, at 255–56, 263.

<sup>290</sup> See Holbrook, *supra* note 89, at 237–39 (discussing optimal deterrence). Imposing both warnings and fines according to the SEC’s discretion would also allow for deterrence at the margin, which eschews a singular harsh penalty that would induce offenders to choose more harmful offenses. Hylton, *supra* note 281, at 426 (“For example, imposing the death penalty for purse-snatchers would provide little disincentive to the would-be purse snatcher to kill his victim, in order to take the purse with less effort.”).

<sup>291</sup> See Holbrook, *supra* note 89, at 237–39.

<sup>292</sup> See Rose, *supra* note 99, at 1340–41.

<sup>293</sup> See Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 242–46 (2006) (describing the costs associated with mandatory versus voluntary corporate governance disclosures).

<sup>294</sup> See *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (noting costs of vexatious litigation); Burch, *supra* note 17, at 374–75 (discussing transaction costs and wealth transference); see, e.g., *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179, 2186 (2011) (discussing the economic loss and loss causation requirements of Rule 10b-5).

litigants in the SRI context—and specifically the green investment context—however, is limited due to the economic focus of 10b-5 liability. Green investors might invest their money based on a company’s misrepresentation but will not be able to bring suit if their investment did not suffer an economic loss from a drop in share price. As a result, significant intangible costs can go uncompensated, including the green investor’s psychic harm for having been duped into complicity with an act he or she feels is unethical, the harm to the legitimacy of the green investment movement—including the loss of future green investments, the harm to actual green companies who missed out on the investment due to the wrongdoer’s misrepresentation, and the harm to the environment that results from less financial protection.

These harms can be redressed by a better system of deterrence of wrongdoers. Such a system could be implemented by the SEC to include a transparent and uniform environmental performance ratings standard that focuses on green outcomes rather than processes, green investor guides that instruct corporate managers on what is deemed greenwash, and civil fines that penalize wrongdoers and thereby incentivize their compliance with the guides by taking away their gains if they do not. Ultimately, this system would strengthen the green investment movement and help it better achieve actual positive environmental results for society and the planet.

