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Why Not Tell the Truth?

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Earlier this year, when I was asked to give a talk on business ethics for MBA students at another university, the first thought that came to mind as a topic was, "Why not tell the truth?" This in turn triggered the image of an ad run by Volvo in the early 1990s. The ad showed a monster truck driving over the top of a row of cars, crushing the roofs of all except the Volvo. But the Volvo's roof was reinforced with lumber and steel that the viewers couldn't see, whereas the other cars' roof support pillars were severed or weakened.

What made this advertisement all the more memorable was an article in the Wall Street Journal which focused upon it and quoted a University of Michigan business school professor, who opined, "I don't find these commercials morally repugnant, or have any legal concerns about them." In essence, the professor viewed the ads as merely a metaphor for the idea that a Volvo was a very safe car.

In discussing this subject, one person suggested that, if Christ could speak in parables, why can't businessmen speak in metaphors. At first blush, this might appear to be a valid point. However, on examination, the analogy fails. Christ spoke in parables in order to make us think to discover the truth. The Volvo ad is not designed to lead us to the truth but rather to create a visceral impression that a Volvo is the safest car. The Volvo story is not a parable, but rather a blatantly deceptive attempt to influence buying habits.

The sad reality is that truth is the victim in so many aspects of our society. By representing that Saddam Hussein possessed weapons of mass destruction and was an "immediate threat" to the United States, the American public was lead to support a preemptive war in Iraq. It now appears improbable that Saddam actually did possess such weapons. Depending upon political persuasion, one may believe that the weapons claim was a lie or merely an erroneous conclusion. However, the evidence now seems to indicate that the intelligence community's assessment that Saddam "may have" was translated into public communications as "does have." Is this semantics or deception?

Such issues undercut public trust in the government. This trust is further eroded when a key administration official such as Secretary of Defense Donald Rumsfeld reconstructs the terms that were used to describe the "immediate threat" presented by Saddam Hussein, as he did recently on national television. In light of what has been learned in the past several months, some of the deception that arises in the political arena could be considered humorous, if only the results were less tragic.

Returning to the world of business and then to the interface of politics and business, business leaders extol our stock market system as an efficient market. Lawyers and economists, particularly the "law and economic" types, tell us that stock prices "impound" all the information that is publicly disclosed. The Supreme Court has accepted the "fraud on the market" theory, which holds that the price of a company's stock is determined by the available information regarding the company and its business, as supporting a rebuttable presumption of reliance.

In view of the foregoing, one would expect that Congress and the federal courts would be vigilant in ensuring that the information by a company's management is truthful and forthcoming. But it does not always play out that way.

In 1995, Congress passed the Private Litigation Securities Reform Act ("PLRSA"). It provided, in part, that when a plaintiff alleges that management has made a misstatement, the complaint "shall specify each statement alleged to be misleading, the reason or reasons why the statement is misleading, and, if an allegation ... is made on information and belief, the complaint shall state with particularity all facts on which the belief is..."
formed. It also provided that if the scienter or mental state of mind of the defendant is an element of the cause of action, the complaint shall "state with particularity facts giving rise to a strong inference" that the defendant acted with scienter.

On their face, the above provisions do not seem that extraordinary—except that the PLSRA further requires that pleading with particularity be done without the benefit of discovery. On top of that, some courts have exalted "particularity" to place an absurd pleading burden on the Plaintiff.

Let's take a look at one decision, *Silicon Graphics Inc. Securities Litigation*, handed down by the supposedly "liberal" Ninth Circuit. Plaintiff alleged that six of the company's top officers made a series of misleading statements to inflate the value of the company's stock, while they engaged in massive insider trading. The majority set forth some of plaintiff's allegations:

September 19, 1995: McCracken told Morgan Stanley that there were "no supply constraints" on the Indigo2.

September 21, 1995: McCracken announced at an industry conference that Indigo2 sales growth "was accelerating."

September 22, 1995: McCracken told Morgan Stanley that "there is no problem with [Indigo2], nor is there an engineering halt."

September 26, 1995: SGI announced "volume shipments" of the Indigo2 workstation.

The reality was this:

Soon thereafter, SGI began to publicly confirm the negative rumors about its performance. On January 2, 1996, the company announced its disappointing second quarter results and acknowledged that revenue growth for the year would be much lower than expected. The next day, SGI's stock fell to $211/8.

On January 17, 1996, SGI's officers admitted to securities analysts that SGI had been unable to fill Indigo2 orders because of a shortage of ASIC chips and other primary components. They also acknowledged that OEM, North American, and European sales had all been down.

According to the court, the complaint lacked "particularity." The majority acknowledged that:

Brody alleges that SGI's internal reports (footnote omitted) alerted the officers to serious production and sales problems. According to Brody, the Flash reports, Financial Statements/Packages and Stop Ship reports announced that: (1) SGI was not shipping the Indigo2 workstation in volume; (2) North American and European sales remained slow; and (3) SGI would not meet its revenue and growth targets for FY96. Brody contends that the reports notified the officers that SGI was suffering "weak North American sales due to continuing problems with its North American direct sales force" and "a very poor Oct., with revenues, net income and earnings per share well below forecasted and budgeted levels."

However:

It is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim. In this case, Brody's complaint does not include adequate corroborating details. She does not mention, for instance, the sources of her information with respect to the reports, how she learned of the reports, who drafted them, or which officers received them. Nor does she include an adequate description of their contents which we believe—if they did exist—would include countless specifics regarding ASIC chip shortages, volume shortages, negative financial projections, and so on. We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability.

From a standpoint of encouraging truthfulness by corporate executive, the *Silicon Graphics* decision is disturbing in several respects. First of all, how much specificity about inside corporate machinations is really possible without the benefit of discovery? If an informant is used to gain information, the Ninth Circuit would probably require that a plaintiff set forth the identity of the informant as part of the "particularity" requirement. If this were required, who would be a willing informant and run the risk of being black-balled in the industry? Fortunately, later decisions in other circuits have rejected the necessity to name the informant.

The Ninth Circuit also rejected the plaintiff's contention that the district court erroneously concluded that the officers' stock sales were not unusual or suspicious.
This Court has recognized that only "[i]nsider trading in suspicious amounts or at suspicious times is probative of bad faith and scienter." [Citation omitted.] Insider trading is suspicious when "dramatically out of line with prior trading practices at times calculated to maximize personal benefit from undisclosed inside information." [Citation omitted.] In this case, we conclude that the stock trading was not dramatically out of line with prior trading practices or otherwise suspicious enough to create a strong inference of the required deliberate recklessness.\textsuperscript{15}

<table>
<thead>
<tr>
<th>Manager's Name</th>
<th>Sold per court</th>
<th>Proceeds holding</th>
<th>Sales per holding</th>
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<tbody>
<tr>
<td>McCracken</td>
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The preceding table shows the sales of stock by the insiders that were not "unusual or suspicious:"

The Court opined that such sales were not suspicious for the following reasons:

All but two of the officers in this case sold a relatively small portion of their total holdings and traded in a manner consistent with prior practice. Collectively, the officers even including the two who sold the greatest percentage of their holdings-retained 90 percent of their available holdings. President McCracken sold just 2.6 percent of his holdings and options. Vice President Baskett sold 7.7 percent. Senior Vice Presidents Ramsay and Sekimoto sold 4.1 and 6.9 percent, respectively. Senior Vice President Kelly's and Burgess's sales appear somewhat suspicious-they sold 43.6 and 75.3 percent of their respective holdings.\textsuperscript{16}

Even with respect to the latter two sales, the Court determined that scienter could not be inferred because Kelly only sold 20,000 shares and Brody was prohibited from selling his stock, which he received when his former company was acquired by Silicon graphics, until the present quarter.\textsuperscript{17}

A truer picture of the motivation of the defendants is presented in the table below.\textsuperscript{18} The Court failed to acknowledge that the defendants sold their shares at about $37 per share after the misleading statements were made, and that the stock fell to $21 when the true facts were released by the company.\textsuperscript{19} Thus, the defendants saved millions of dollars as a result of their misleading statements.

The above graph also illustrates that, rather than the defendants only selling a small percentage of their stock, as the Court opined, they actually sold 17 percent to 95 percent of the stock they actually owned. The Court's figures were predicated on both stock owned and stock under option. The stock under option should be ignored because the executives were not at risk for these shares. However, with respect to their actual holdings, for which they had paid a price, they were at risk, and they avoided this risk by selling on inside information.

Not only the action of the executives but also that of the court could stand scrutiny. At a minimum, this is an example of structural bias in which the court and the executives think the same way, but it also suggests a more serious inference of improper court motives that serve to mislead the public while releasing the misleading executives from accountability.

The PSLRA contains another provision that it does not "impose upon any person a duty to update" forward-looking statements, such as earnings projections.\textsuperscript{20} One case, without relying on this PSLRA provision, held that there was no duty to update the following rationale:

[We do not think it can be said that an ordinary earnings projection contains an implicit representation on the part of the company that it will update the investing public with all material information.

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Finally, the federal securities laws, as they stand today, aim at encouraging companies to disclose their forecasts. A judicially created rule that triggers a duty of continuous disclosure of all material information every time a single specific earnings forecast is disclosed.
would likely result in a drastic reduction in the number of such projections made by companies. It is these specific earnings projections that are the most useful to investors in deciding whether to invest in a firm’s securities.\footnote{This is a classic case of circular reasoning. The court says that investors use company forecasts in determining whether to invest. However, the court does not want to impose a duty to update because that might discourage companies from issuing forecasts. But if there is a basis for updating, it means that the original forecast is wrong! If the company does not update, it means that investors are relying on erroneous forecasts. It is hard to see how this helps the efficiency of the market.}

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In the PSLRA and the court decisions discussed above is the presumption that corporate management would not mislead the investing public. Enron, WorldCom, and flock of other cases involving corporate corruption demonstrate that such a presumption is misplaced. Too often, both business and politics fail to hold transparency and truth as the prevailing ethic.

This problem needs to be addressed at both the macro and micro levels. Perhaps Sarbanes-Oxley will bring more integrity into the flow of corporate information. But the courts and Congress first need to examine the role they play in facilitating a "tone" that leads corporate officials to believe they will not be held accountable for their derelictions. And we all need to examine our own attitudes towards truth as an essential virtue in a democratic society.

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Moreover, assume that a forecast was originally made without an adequate basis so that investors were misled from the start. The PSLRA also provides that a plaintiff can bring suit only if he or she proves that the projection "was made with actual knowledge ... that the statement was false or misleading."\footnote{Once again, discovery is stayed if the defendant moves for summary judgment.}

Implicit in the PSLRA and the court decisions discussed above is the presumption that corporate management would not mislead the investing public. Enron, WorldCom, and a flock of other cases involving corporate corruption demonstrate that such a presumption is misplaced. Too often, both business and politics fail to hold transparency and truth as the prevailing ethic.

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