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When Is a Cautionary Statement Not Meaningful?

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According to the SEC, forward-looking statements included within the MD&A section of an issuer's periodic reports filed under the Exchange Act are within the scope of the PSLRA's safe harbor for forward-looking statements. If, however, an issuer is aware that a "possible risk" is actually occurring, a warning related to that risk is not a meaningful cautionary statement that would be afforded protection by the PSLRA's safe harbor.

Background

Seeking to reduce frivolous securities litigation, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), which created, among other things, a statutory safe harbor for certain forward-looking statements made by issuers subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934. Under the PSLRA, if a forward-looking statement is immaterial or accompanied by meaningful cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statement, or if a plaintiff cannot prove that the forward-looking statement was made with actual knowledge that the forward-looking statement was false or misleading, there is no liability for the forward-looking statement in a private action for securities fraud.

The judicially created "bespeaks caution" doctrine provides that cautionary language meeting certain standards can render forward-looking statements inactionable under federal securities antifraud laws if the forward-looking statements are later found to be incorrect. The bespeaks caution doctrine is a widely accepted defense to claims under the federal securities antifraud laws and provides issuers with parallel protection for forward-looking statements.

Pending Second Circuit Case

In a case currently pending in, and under consideration by, the U.S. Court of Appeals for the Second Circuit (Second Circuit) (No. 02-5533, 2004 WL 632750 (S.D.N.Y. Mar. 31, 2004), *appeal docketed*, No. 08-5442 (2d Cir. Nov. 7, 2008)), a publicly-traded financial services company announced the recognition of a loss in the second quarter of 2001 due largely to write-downs of investments in high-yield debt held by a subsidiary. The company's investors subsequently filed a complaint in the U.S. District Court for the

Southern District of New York (Southern District) alleging that the company and certain of its individual officers knowingly issued false and misleading statements leading up to the announcement, specifically a statement in the Management's Discussion and Analysis (MD&A) section of the company's first quarter 2001 Form 10-Q to the effect that total losses on high-yield debt investments were expected to be substantially lower in the remainder of 2001 than in the first quarter. The Southern District dismissed the complaint, and the plaintiffs appealed to the Second Circuit. The Second Circuit invited the U.S. Securities and Exchange Commission (SEC) to address the proper application of the PSLRA to this forward-looking statement and the related cautionary statement, and the SEC accordingly submitted an *amicus curiae* brief.

The SEC's Analysis

MD&A is Not Part of Financial Statements Prepared in Accordance with GAAP

The PSLRA excludes from its safe harbor those forward-looking statements that are included in financial statements prepared in accordance with GAAP. In the Second Circuit case, the forward-looking statement at issue was made in the MD&A section of the defendant's Form 10-Q. Therefore, according to the SEC, the challenged forward-looking statement is not excluded from the PSLRA's safe harbor because MD&A is separate and distinct from the financial statements contained in an issuer's Form 10-Q. The same conclusion should also apply in respect of MD&A in an issuer's Form 10-K.

The Form 10-Q Adequately Identified the Forward-Looking Statement, but the Related Cautionary Language Was Not "Meaningful" to be Protected by the PSLRA's Safe Harbor

The PSLRA requires that, to be protected, a statement must be identified as a forward-looking statement. There is no bright-line test to determine whether a forward-looking statement is sufficiently identified. Generally, an issuer does not need to include all forward-looking statements in a separate section or label each forward-looking statement. Cues like "we expect" or "we believe"—coupled with an explanatory note of the issuer's intention to designate a statement as forward-looking—are generally sufficient. In the Second Circuit case, according to the SEC, the defendant satisfied the PSLRA's safe harbor by identifying forward-looking statements in its Form 10-Q with an explanatory note at the end of the report indicating that certain forward-looking words were used to identify forward-looking statements.

According to the SEC, however, warning of a potential event or condition that an issuer is aware is occurring would be misleading, in which case the PSLRA's safe harbor is not available. In the Second Circuit case, according to the SEC, the defendant's statement regarding potential portfolio losses due to potential deterioration in the high-yield sector was not "meaningful" under the bespeaks caution doctrine and the PSLRA's safe harbor because, according to plaintiffs' allegations and accepting them as true, at the time that the defendant was warning of potential deterioration in the high-yield sector, the defendant was aware that such deterioration was actually occurring.

A Forward-Looking Statement Made with Actual Knowledge That it is False and No Reasonable Basis is Misleading

The PSLRA states that a person is not liable with respect to a forward-looking statement if the plaintiff fails to prove that the statement was made with actual knowledge that the statement was false or misleading. According to the SEC, a forward-looking statement is made with actual knowledge that it is misleading if the speaker makes the forward-looking statement with no reasonable basis or no basis at all. In the Second Circuit case, according to the SEC, the defendant's forward-looking statement that losses were expected to be substantially lower is a statement of prediction or expectation, which contains at least three implicit factual assertions, namely that (1) the statement is genuinely believed, (2) there is a reasonable

basis for that belief and (3) the speaker is not subjectively aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. Courts have long held that a forward-looking statement made in a case in which any of these implicit representations is false, as alleged by the plaintiffs in the Second Circuit case, is actionable under federal securities antifraud laws. Therefore, a speaker has actual knowledge that a forward-looking statement is misleading if the speaker actually knows that one or more of these implicit factual representations is not true.

Key Takeaways

On the surface, the SEC's analysis stands for a simple proposition and, indeed, admonition to issuers: Forward-looking statements surrounded by contextually meaningless cautionary statements do not get a "free pass" from the disclosure liability standards of the federal securities laws. Embedded within this simple proposition, however, are a few important reminders of which every issuer should be mindful in the context of preparing its public disclosure:

- As calendar-year issuers emerge from preparing their Form 10-Ks, including the rigor and thoroughness involved in crafting cautionary statements for forward-looking statements and risk factors, it is tempting to view the resulting disclosure as relevant and meaningful until the process commences for next year. It is critical, however, for an issuer to regularly review its cautionary statement and risk factor disclosure to ensure that it continues to be current, relevant and meaningful to the issuer's business. This review should occur not only when preparing the issuer's Form 10-Qs, but also in ordinary-course communications with the market that typically contain forward-looking statements, such as press releases. Issuers should be cognizant of changing business, market and other conditions that necessitate new or different cautionary statements or risk factors.

- Boilerplate cautionary statements or risk factors that could cause actual results to differ materially from projected results are not meaningful for purposes of avoiding disclosure liability. The SEC indicated that cautionary statements must be specific, substantive and tailored with the objective of conveying factors that could realistically cause results to differ materially from the projections in the forward-looking statements. An issuer will sometimes assign drafting responsibility for its periodic reports to different areas within its organization (*e.g.*, MD&A is often initially prepared by the external reporting and accounting personnel while cautionary statements and risk factors are often initially drafted by internal legal personnel). This is an efficient division of responsibility, but it is critical that, at some point in the process, the issuer integrates the various portions of the disclosure to be internally consistent, especially MD&A and other risk-oriented disclosure. The final disclosure product will, therefore, be more likely to reflect the issuer's business and the risks it faces—and less susceptible to retrospective scrutiny.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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