

Second Circuit Provides Guidance as to When a Cautionary Statement Is Not Meaningful

by Jeffrey J. Delaney and Anthony D. Foti

According to the Second Circuit, vague cautionary language related to a forward-looking statement does not warrant protection under the PSLRA's safe harbor, but plaintiffs nonetheless face a heavy burden in establishing a defendant's actual knowledge that a forward-looking statement was misleading.

In a prior [Advisory](#), we discussed an *amicus curiae* brief submitted by the U.S. Securities and Exchange Commission (SEC) in a case then pending before the U.S. Court of Appeals for the Second Circuit (Second Circuit), in which the sole issue before the court was whether a particular forward-looking statement was protected by the safe harbor of the Private Securities Litigation Reform Act of 1995 (PSLRA). Last week, the Second Circuit issued its opinion in this case, which provides some insight for public companies that wish to avail themselves of the PSLRA's safe harbor and, in certain respects, validates the SEC's analysis as to when a cautionary statement is not meaningful enough to merit protection under the PSLRA's safe harbor. No. 08-5442, 2010 WL 1960019 (2d Cir. May 18, 2010).

The Second Circuit held that, while the forward-looking statement in the defendant's first quarter 2001 Form 10-Q (specifically, that total losses on high-yield debt investments were expected to be substantially lower in the remainder of 2001 than in the first quarter) was not accompanied by meaningful cautionary language, the plaintiffs did not show that the forward-looking statement was made with actual knowledge that it was misleading.

Forward-Looking Statement Was Not Accompanied by Meaningful Cautionary Language

The Second Circuit held that the defendant's cautionary language regarding possible portfolio losses due to potential deterioration in the high-yield sector was not meaningful because the cautionary language was vague, verged on boilerplate and did not convey any substantive information. The cautionary language, which essentially warned that "if our portfolio deteriorates, then there will be losses in our portfolio," did not warn of the exact risk that caused the projection to miss the mark. According to the Second Circuit, the same cautionary language that appeared in the defendant's Form 10-Q was also included by the defendant in numerous reports dating from periods before and after the defendant reported the loss. The repetition of the defendant's cautionary language over time—despite how conditions changed vis-à-vis its portfolio—belied any contention that the cautionary language was tailored to the specific future projection.

Forward-Looking Statement Was Not Made with Actual Knowledge That It Was Misleading

The Second Circuit considered whether a reasonable person would, based on the facts alleged by the plaintiffs, deem an inference cogent and at least as compelling as any opposing inference that the defendant (1) did not genuinely believe the forward-looking statement, (2) actually knew that it had no reasonable basis for making the forward-looking statement or (3) was aware of undisclosed facts tending to seriously undermine the accuracy of the forward-looking statement. According to the Second Circuit, its “job is not to scrutinize each allegation in isolation but to assess all of the allegations holistically.”

The Second Circuit held that the facts supported a conclusion that the defendant was presented with the highly likely risk that its high-yield portfolio would deteriorate and an inference that the defendant did not know the extent of the likely deterioration. According to the Second Circuit, however, the circumstantial evidence supporting an inference of non-fraudulent intent, with the defendant engaging in a good-faith process to inform itself and the public of the risks, was more compelling. While the Second Circuit found the inference of fraudulent intent plausible—and considered it to be a close case—when the Second Circuit examined the record as a whole, it concluded that the inference of fraudulent intent was not at least as compelling as any opposing inference one could draw from the facts alleged. As a result, in light of the heightened pleading standards of the PSLRA, the Second Circuit affirmed the district court’s dismissal of the plaintiffs’ claim under Section 10(b) of the Securities Exchange Act of 1934.

Key Takeaways

This case is instructive for public companies in the following ways:

- First, as we noted in our prior [Advisory](#), 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. Meaningful cautionary language must be specifically tailored to the statement at issue. Boilerplate disclosure can be turned against a registrant because of its inherent lack of specificity. The Second Circuit’s holding confirmed the importance of registrants regularly reviewing the cautionary statements and risk factor disclosure contained in their public filings to ensure that the disclosure continues to be current and meaningful, especially as business and market conditions change over time.
- Second, although, in this particular case, the Second Circuit found that the plaintiffs did not meet the heavy burden of proving actual knowledge that the particular forward-looking statement at issue was misleading, registrants would be remiss in taking great comfort in this holding. The Second Circuit considered this case to be a close call, so executive officers should remain vigilant and thoughtful when evaluating whether they have a reasonable basis for a particular forward-looking statement, especially in situations in which the executive officers have incomplete information.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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