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# THE DUTY TO DISCLOSE FORWARD-LOOKING INFORMATION: A LOOK AT THE FUTURE OF MD&A

SUZANNE J. ROMAJS

## INTRODUCTION

Congress enacted the Securities Act of 1933<sup>1</sup> and the Securities Exchange Act of 1934<sup>2</sup> to provide for full and fair disclosure to investors.<sup>3</sup> As the primary administrator of the federal securities statutes, the Securities and Exchange Commission ("SEC") was delegated the responsibility of assuring that information important to investors' decisions is available.<sup>4</sup> In some respects, however, the SEC's policies have hindered Congress' goal of full disclosure. For instance, with respect to forward-looking information,<sup>5</sup> the SEC's traditional policy was to prohibit its disclosure.<sup>6</sup> Gradually, though, the SEC's disclosure philosophy underwent a semi-revolution. Today the SEC encourages,<sup>7</sup> and in some areas requires,<sup>8</sup> the disclosure of forward-looking information. Full and fair dis-

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1. 15 U.S.C. §§ 77a-77aa (1988 & Supp. II 1990) [hereinafter 1933 Act].

2. 15 U.S.C. §§ 78a-78ll (1988 & Supp. II 1990) [hereinafter 1934 Act].

3. See Securities Exchange Bill of 1934, H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934) ("Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value."); see also *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977) (describing the "fundamental purpose" of the 1934 Act as implementing a "philosophy of full disclosure").

4. For example, in § 13(a) of the 1934 Act, the SEC is authorized to prescribe such rules and regulations as are necessary for the protection of investors and to ensure fair dealing in the securities markets. See 15 U.S.C. § 78m(a) (1988). Under the authority of this section, the SEC has promulgated rules requiring corporations to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K. See 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13 (1992).

5. This type of information is included under the more common label of "soft information," which generally includes opinions, predictions, analyses, and other subjective evaluations. See House Comm. on Interstate & Foreign Commerce, 95th Cong., 1st Sess., Report of the Advisory Comm. on Corporate Disclosure To The Securities and Exchange Commission 347, abstracted in [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,357, at 88,667 (Nov. 3, 1977) [hereinafter Advisory Committee Report]; Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. Pa. L. Rev. 254, 255 (1972). Since "soft information" can be both prospective and non-prospective, this Note uses the label "forward-looking information" to denote the category of soft information that is prospective only.

6. See *infra* notes 23-26 and accompanying text (describing SEC's traditional policy).

7. See 17 C.F.R. § 229.10(b) (1992) ("Commission policy on projections. The Commission encourages the use . . . of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format.").

8. See 17 C.F.R. § 229.303(a)(3)(ii) (1992) (mandating that corporations discuss in the management discussion and analysis section of SEC filings "any known trends or uncertainties that . . . [the corporation] reasonably expects will have a material favorable or unfavorable impact on . . . revenues or income from continuing operations"); see also Items 8 and 9 of Sched. 13E-3, 17 C.F.R. § 240.13e-100 (1992) (compelling disclosure of certain predictions and other soft information in going private transactions).

closure, however, appears to remain an unachieved ideal.

One required disclosure provision that recently has become a focal point in the disclosure area is Item 303 of Regulation S-K.<sup>9</sup> Item 303 creates an affirmative duty to disclose forward-looking information in the Management's Discussion and Analysis ("MD&A") section of periodic reports, proxy statements, and prospectuses.<sup>10</sup> Despite this disclosure requirement, however, investors are still generally deprived of such forward-looking information. This is partly because prior to its decision in *In re Caterpillar, Inc.*,<sup>11</sup> the SEC did not strictly enforce compliance with Item 303.<sup>12</sup> Moreover, the courts, consistent with their usual approach to the nondisclosure of forward-looking information,<sup>13</sup> generally were

9. Regulation S-K was adopted in 1977 as part of the SEC's effort to integrate the separate disclosure systems that evolved under the 1933 and 1934 Acts. See Adoption of Disclosure Regulation and Amendments of Disclosure Forms and Rules, Securities Act Release No. 5983, [1937-1982 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,258, at 62,663 (codified at 17 C.F.R. Pt. 229). As such, the Regulation sets forth substantive disclosure requirements for periodic reports, 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13 (1992); proxy statements, 17 C.F.R. §§ 240.14a-3, 240.14a-101, item 13 (1992); and prospectuses, 15 U.S.C. § 77(j) (1990), 17 C.F.R. §§ 230.420-230.432 (1992). Item 303 is a sub-section of Regulation S-K that sets forth the substantive disclosure requirements for "[m]anagement's discussion and analysis of financial condition and results of operation" contained in periodic reports, proxy statements, and prospectuses. 17 C.F.R. § 229.303 (1992). For further discussion of Item 303's requirements, see *infra* notes 10, 65-119, and accompanying text.

10. Corporations are required to discuss and analyze in the Management's Discussion and Analysis ("MD&A") section of SEC filings any known trends, events, or uncertainties which are reasonably certain to impact future liquidity, capital resources, and results of operation. Item 303 of Regulation S-K calls for the following, in relevant part:

*Liquidity:* [management must] [i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the [corporation's] liquidity increasing or decreasing in any material way.

*Capital Resources:* [management must] [d]escribe any known material trends, favorable or unfavorable, in the [corporation's] capital resources.

*Results of Operations:* [management must] [d]escribe any known trends or uncertainties that have had or that the [corporation] reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

17 C.F.R. § 229.303(a)(1)-(3) (1992); see *SEC Enforcement Chief Warns Companies, CPAs On Management Discussion, Analysis*, 16 Sec. Reg. & L. Rep. (BNA) 95 (Jan. 13, 1984) (asserting that there is an affirmative duty to disclose forward-looking information in the MD&A). For further discussion on the MD&A, see *infra* at notes 65-119 and accompanying text. Examples of the type of information covered by this provision are discussed *infra* at text accompanying notes 207-37.

11. Exchange Act Release No. 30,532, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,830 (Mar. 31, 1992) [hereinafter *Caterpillar*] (first SEC enforcement action predicated entirely upon inadequate MD&A disclosures); see also *infra* notes 96-119 and accompanying text (discussing *Caterpillar*).

12. See Harvey L. Pitt et al., *MD&A Through the Eyes of Management: A Closer Look at the SEC's Caterpillar Decision*, in 24th Annual Instit. on Sec. Reg. 481, 485 (PLI Corp. L. & Practice Course Handbook Series No. B-792, 1992) (describing inadequate compliance by corporations).

13. For a discussion of courts' general unwillingness to impose Rule 10b-5 liability for the nondisclosure of forward-looking information, see *infra* notes 124-47 and accompa-

unwilling to enforce Item 303 through Rule 10b-5,<sup>14</sup> which is the general antifraud provision of the 1934 Act.

The failure of both the SEC and the courts to enforce Item 303 hurts investors and thus impedes an important objective of the securities laws. Noncompliance with Item 303 denies investors access to the information that is most valuable to their investment decision.<sup>15</sup> Moreover, noncompliance also theoretically results in a less efficient market.<sup>16</sup> Thus, given Congress' intent and the importance of the type of information required by Item 303, the SEC and the courts should make every effort to enforce compliance with that provision, including imposing Rule 10b-5 liability for failure to disclose when there was an affirmative duty to do so under Item 303 of Regulation S-K.

Focusing on the MD&A, this Note highlights the separate but parallel approaches taken by the SEC and the courts regarding the disclosure of forward-looking information. Part I lays out the history of the SEC's

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nying text. The forward-looking information involved in the cases cited was not within the mandatory disclosure requirement of Item 303. Such information was therefore an optional disclosure under 17 C.F.R. § 229.10(b) (1992). However, as discussed throughout this Note, courts appear not to have approached nondisclosure of mandatory forward-looking information any differently than optional forward-looking information.

14. 17 C.F.R. § 240.10b-5 (1992) ("It shall be unlawful for any person . . . (b) . . . 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 . . ."). Although the general rule is that there is no duty to disclose all material information, Rule 10b-5 is often used as the source of an implied duty of disclosure. See Dennis J. Block et al., *Affirmative Duty To Disclose Material Information Concerning Issuer's Financial Condition and Business Plans*, 40 Bus. Law. 1243, 1249-50 (1985) [hereinafter Block et al., *Affirmative Duty*] (discussing general rule that there is no duty to disclose material information when the corporation is not trading in its own stock, but listing numerous exceptions to the general rule). Despite the exceptions to the general rule, in the forward-looking information context, many courts have declined to find such a duty and, therefore, have declined to impose Rule 10b-5 liability for the nondisclosure of forward-looking information.

15. Since investment decisions are inherently forward-looking, the importance of such information cannot be understated. Investors choose securities by balancing expected return against the degree of risk involved. See John S. Poole, *Management Forecasts: Do They Have A Future In Corporate Takeovers?*, 42 Sw. L.J. 765, 792 (1988) [hereinafter Poole, *Management Forecasts*]. Moreover, although forward-looking information was initially thought to be unreliable, see *infra* notes 23-26 and accompanying text, that view has changed. The known trends and uncertainties required by Item 303 are less speculative and therefore more trustworthy than other forward-looking information. For instance, projections, which are not required by Item 303, do not involve present knowledge but involve hypothesizing and anticipating future events. Reliability therefore should not be a major issue with the type of forward-looking information required by Item 303.

16. Empirical research has demonstrated that securities prices reflect publicly available information. Thus, increasing the amount of information generally available, especially information about the future prospects of the corporation, should increase the efficiency of the securities markets. See John S. Poole, *Improving the Reliability of Management Forecasts*, 14 J. Corp. L. 547, 550 (1989) [hereinafter *Improving the Reliability*]. For a fuller discussion of the efficient markets theory, see Joseph DeSimone, Note, *Should Fraud on the Market Theory Extend to the Context of Newly Issued Securities?*, 61 Fordham L. Rev. S151 (1993).

approach to forward-looking information, highlighting its current stance as to required and voluntary disclosures. Part II discusses the courts' approaches to the duty to disclose forward-looking information under Rule 10b-5, noting the influence of the SEC's position on this issue. Part III suggests that, in assessing the duty to disclose the forward-looking information required by Item 303 of Regulation S-K, courts should adopt the test set forth by the SEC in its 1989 Interpretive Release.<sup>17</sup> This Part also suggests, as urged by the SEC, that once forward-looking information is disclosed in the MD&A, courts should apply the safe harbor protection of Rules 175 and 3b-6<sup>18</sup> to prevent corporations from being punished for complying with SEC requirements.

### I. THE SEC'S APPROACH TO DISCLOSURE OF FORWARD-LOOKING INFORMATION

The SEC's approach to the disclosure of forward-looking information is constantly evolving. Its disclosure philosophy has moved from an absolute prohibition on the disclosure of forward-looking information, to its current position that most forward-looking information, such as projections, may be voluntarily disclosed.<sup>19</sup> Further, in Item 303 of Regulation S-K,<sup>20</sup> the SEC has progressed beyond its policy of voluntary disclosure. In Item 303, the SEC mandates that corporations disclose in the MD&A section of SEC filings any "known trends, demands, commitments, events or uncertainties" that will have a material impact on future liquidity, capital resources, and results of operations.<sup>21</sup>

The importance of the SEC's changing position on the issue cannot be understated for, as the rule-making body in the area of securities regulation, the SEC is considered the authority. Virtually every circuit addressing the disclosure of forward-looking information has devoted some discussion to the SEC's position.<sup>22</sup> An analysis of the SEC's evolving

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17. See Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosure, Exchange Act Release No. 26,831, 6 Fed. Sec. L. Rep. (CCH) ¶¶ 72,436 and 73,193, at 62,843-44 (May 18, 1989) [hereinafter 1989 Interpretive Release]. For a full discussion of this test, see *infra* text accompanying notes 80-86.

18. See Safe Harbor Rule For Projections, Exchange Act Release No. 15,944, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979) [hereinafter 1979 Safe Harbor] (codified at 17 C.F.R. §§ 230.175, 240.3b-6 (1992)). The safe harbor provisions, discussed *infra* notes 50-63 and accompanying text, shield from liability any forward-looking information made in good faith and with a reasonable basis.

19. See 17 C.F.R. § 229.10(b) (1992) (encouraging but not requiring the disclosure of forward-looking information in the form of projections).

20. See 17 C.F.R. § 229.303 (1992).

21. See 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,842 n.7.

22. See, e.g., Walker v. Action Indus., Inc., 802 F.2d 703, 709 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987); Starkman v. Marathon Oil Co., 772 F.2d 231, 239-40 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986); Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978, 985-88 (3d Cir. 1984); Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221 (9th Cir. 1980); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1292-94 (2d Cir. 1973).

disclosure philosophy is therefore necessary to understand the courts' positions on the issue.

### A. *Traditional Policy of Exclusion*

Traditionally, the SEC prohibited the use of forward-looking information in disclosure documents.<sup>23</sup> The reason for this prohibition primarily was to protect unsophisticated investors.<sup>24</sup> That investors placed a high value on information contained in SEC filings raised the concern that the inclusion of forward-looking information in SEC filings "would clothe such information with an unduly high aura of credibility."<sup>25</sup> Essentially, the SEC determined that the risk of overly-optimistic management predictions outweighed the benefit derived by investors.<sup>26</sup>

### B. *The Move to Permissive Inclusion*

#### 1. The SEC's Evolving Position

In 1969 the SEC reexamined its traditional disclosure policy<sup>27</sup> after recognizing, among other things, the growing criticism of the status quo in disclosure,<sup>28</sup> as well as the technological advances enabling investors to obtain information from SEC filings.<sup>29</sup> It determined that a better balance between the needs of unsophisticated investors and the demands

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23. See Statement by the Commission on Disclosure of Projections of Future Economic Performance, Exchange Act Release No. 9984, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,666 (Feb. 2, 1973) [hereinafter 1973 Disclosure Announcement] (acknowledging that "[i]t has been the Commission's long standing policy generally not to permit projections to be included in . . . reports filed with the Commission"). The SEC's prohibition on the use of forward-looking information also applied to proxy statements. For an example of the SEC's traditional policy as applied to proxy statement disclosures, see 17 C.F.R. § 240.14a-9 note (1956); see also Adoption of Amendments to Proxy Rules, Exchange Act Release No. 5276, [1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,380 (Jan. 17, 1956) (discussing note to Rule 14a-9 using "predictions as to specific future market values, earnings [and] dividends" as examples of what would be misleading in proxy statements). *But see infra* note 42. As applied to disclosures in prospectuses, see Guidelines for the Release of Information by Issuers Whose Securities Are in Registration, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578 (Aug. 16, 1971) (information disclosed in prospectuses "should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value").

24. See Disclosure To Investors—A Reappraisal of Administrative Policies Under the '33 and '34 Acts, [1963-1972 Special Studies Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,601, at 65,242 (May 9, 1969) [hereinafter Wheat Report] ("[P]rojections in filed documents might become traps for the unsophisticated who would be prone to attach more significance to such projections than they deserve.").

25. Schneider, *supra* note 5, at 258 (noting the effect that formal review of SEC filings appears to have on investor reliance).

26. See *id.* at 268; 1973 Disclosure Announcement, *supra* note 23, at 82,667.

27. See Wheat Report, *supra* note 24, at 65,241.

28. See *id.*

29. See *id.*

of knowledgeable investors was warranted.<sup>30</sup> However, it declined to propose any changes in its traditional policies at that time.<sup>31</sup>

On the basis of information obtained through public hearings which it conducted in 1972,<sup>32</sup> the SEC came to acknowledge the importance of forward-looking information to the investing public.<sup>33</sup> In 1973, the SEC took its first step toward integrating forward-looking information into the disclosure system by repealing its traditional prohibition of forward-looking information in SEC filings.<sup>34</sup> It had determined that allowing such information in SEC filings "would assist in the protection of investors and would be in the public interest."<sup>35</sup> The SEC's announcement, however, expressly provided that the disclosure of forward-looking information was only voluntary, not mandatory.<sup>36</sup>

The SEC then drafted proposals for implementing its new policy. These proposals, published in 1975,<sup>37</sup> received a great deal of public criticism.<sup>38</sup> For instance, the proposals did not define any standard of materiality applicable to the disclosure of forward-looking information, thus making it difficult for corporations to determine when a disclosure might

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30. *See id.*

31. *See id.* at 65,242. Several persons who participated in the Disclosure Study Group which prepared the Wheat Report indicated their feelings that the Group missed an opportunity by not "easing up" on the disclosure of projections. *See The New Era in SEC Disclosure: The Wheat Report*, at 160, 162 (transcript from Securities Law Committee of the Federal Bar Association) (Sept. 5, 1969).

32. *See* Public Hearings on Estimates, Forecasts or Projections of Economic Performance, Exchange Act Release No. 9844, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,075, at 82,323 (Nov. 1, 1972). At the time of these proceedings, corporations were prohibited from including such information in SEC documents, but not from disclosing this information through other media. *See id.* (acknowledging that forecasts are "in circulation"); *see also* 1973 Disclosure Announcement, *supra* note 23, at 82,667 (noting that "projections are currently widespread in the securities markets"). According to then-SEC Chairman William J. Casey, the 1972 hearings were held to allow the SEC to decide whether it should take the lead in establishing standards for the disclosure of forward-looking information for purposes of fostering corporate responsibility, increasing the reliability of such disclosures, and increasing investor confidence. *See id.* at 82,323. For a summary of comments received during the 1972 hearings, *see Arthur Andersen and FEI Counter Other SEC Witnesses, Call Projections Misleading, Not Helpful*, Sec. Reg. & L. Rep. (BNA) No. 180, at A5-6 (Dec. 6, 1972); *SEC Hears How British Certify Earnings Forecasts; Accountants Play 'Valuable Role'*, Sec. Reg. & L. Rep. (BNA) No. 179, at A7-10 (Nov. 29, 1972); *SEC Witnesses Urge Some Form of Projections in Financial Reports*, Sec. Reg. & L. Rep. (BNA) No. 178, at A6-9 (Nov. 22, 1972).

33. *See* 1973 Disclosure Announcement, *supra* note 23, at 82,666-67.

34. *See id.* at 82,667.

35. *Id.*

36. *See id.*

37. *See* Proposed Rules on Earnings Projections, Securities Act Release No. 5581, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,167 (Apr. 28, 1975) [hereinafter 1975 Proposed Rules].

38. Approximately 420 comment letters—generally critical—were received on these proposals. For a summary of the comments, *see Commission Reviews Comments on its Projections Proposal: Changes Expected*, Sec. Reg. & L. Rep. (BNA) No. 320, at D1-4 (Sept. 24, 1975) [hereinafter *Commission Reviews Comments*].

be required.<sup>39</sup> Furthermore, the proposals set forth very stringent requirements for safe harbor protection<sup>40</sup> causing concern that the liability exposure of corporations would be significantly increased if corporations chose to make forward-looking disclosures.<sup>41</sup> Yielding to the public criticism, the SEC withdrew its proposals in 1976.<sup>42</sup> The SEC reemphasized, however, its support for voluntary disclosure of projections in public filings.<sup>43</sup> It proposed very general guidelines for voluntary forward-looking disclosures, indicating that such disclosures must be in good faith, have a reasonable basis, and be accompanied by information sufficient to permit informed investment decisions.<sup>44</sup>

While the 1976 proposed guidelines awaited final approval, the SEC appointed an Advisory Committee to review its disclosure policies, including its policy on forward-looking information.<sup>45</sup> The primary function of the Advisory Committee was to study the current disclosure system and collect the opinions of interested persons on the issue of forward-looking disclosures.<sup>46</sup> At the conclusion of its study, the Advisory Committee supported the SEC's move toward encouraging voluntary disclosure of forward-looking information, but stopped short of endorsing a policy of mandatory disclosure.<sup>47</sup> In addition, the Advisory Committee declined to suggest a definition of materiality that would aid in assessing the duty to disclose such information.<sup>48</sup> In accordance with the Advi-

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39. See 1975 Proposed Rules, *supra* note 37, at 85,302. Although the SEC's policy was to encourage but not require the disclosure of forward-looking information, the 1975 proposals were intended to integrate such information into the public disclosure system by requiring disclosure in SEC filings if material forward-looking information was non-publicly furnished to any person. *Id.*

40. See 1975 Proposed Rules, *supra* note 37, at 85,302-04 (listing requirements for safe harbor protection and placing burden on defendant of proving these requirements are met). In contrast, the safe harbor provisions, as later promulgated, shield from liability any forward-looking statements that meet the requirements of reasonableness and good faith. Moreover, they place the burden on plaintiff. See *infra* notes 50-63 and accompanying text.

41. See 1979 Safe Harbor, *supra* note 18, at 81,940 (noting commentators' feelings that the "[1975] proposed rules would in all likelihood increase the institution of frivolous, nuisance litigation . . . with a resulting cost and time burden to be borne by registrants").

42. See Adoption of Amendment to Rule 14a-9 and Withdrawal of Other Proposals, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461 (Apr. 23, 1976) [hereinafter 1976 Withdrawal]. In this statement, the SEC also amended the note to Rule 14a-9, deleting the reference to "earnings" projections as an example of misleading information in proxies. See *id.* at 86,201; see also 17 C.F.R. § 240.14a-9 note (1977).

43. See 1976 Withdrawal, *supra* note 42, at 86,202.

44. See *id.* at 86,203.

45. See Solicitation of Public Comments by Advisory Committee on Corporate Disclosure, Securities Act Release No. 5707, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,531, at 86,374 (May 18, 1976).

46. See *id.* at 86,374. A sampling of questions presented to interested parties included what the standard of materiality for disclosure should be and whether the SEC should require the disclosure of forward-looking information. See *id.* at 86,375.

47. See Advisory Committee Report, *supra* note 5, at 88,667.

48. See *id.* at 88,665-66.



sory Committee Report, the SEC subsequently issued a statement encouraging, but not requiring, disclosure of management projections both in filings with the SEC and in general.<sup>49</sup>

## 2. The SEC Safe Harbor Provisions

To enhance its policy of voluntary disclosure further, in 1979 the SEC adopted rules to provide "safe harbor" protection for certain types of forward-looking information filed with the SEC.<sup>50</sup> Under Rules 175 and 3b-6,<sup>51</sup> a qualifying forward-looking statement<sup>52</sup> will not be considered fraudulent "unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."<sup>53</sup> These rules place the burden on plaintiffs to show the absence of either good faith or a reasonable basis for the disclosure.<sup>54</sup>

The purpose of the safe harbor rules is to encourage the voluntary disclosure of forward-looking information by removing the deterrent of liability for making such disclosures.<sup>55</sup> With this purpose in mind, the SEC drafted the rules' definition of "forward-looking" information broadly. "Forward-looking" information is defined in the safe harbor rules as follows:

- (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
- (2) A statement of management's plans and objectives for future operations;
- (3) A statement of future economic performance contained in management's discussion and analysis . . . included pursuant to Item 303 of Regulation S-K ([17 C.F.R.] § 229.303); or
- (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in . . . (1), (2), or (3) of this section.<sup>56</sup>

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49. See Guides for Disclosure of Projections of Future Economic Performance, Exchange Act Release No. 15,305, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756, at 81,037 (Nov. 7, 1978) [hereinafter 1978 Disclosure Guides]. For further background, see Preliminary Response of the Commission to the Recommendations of the Advisory Committee on Corporate Disclosure, Exchange Act Release No. 14,471, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,505 (Feb. 15, 1978).

50. See 1979 Safe Harbor, *supra* note 18, at 81,938. The safe harbor provisions are still in effect today. See 17 C.F.R. §§ 230.175, 240.3b-6 (1992). For background, see Proposed Safe Harbor Rule for Projections, Exchange Act Release No. 15,306, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,757 (Nov. 7, 1978) [hereinafter 1978 Safe Harbor Proposal].

51. 17 C.F.R. §§ 230.175, 240.3b-6 (1992).

52. A qualifying forward-looking statement is one that eventually appears in documents filed with the SEC or is contained in the annual report to shareholders. See *infra* text accompanying notes 57-60.

53. 17 C.F.R. §§ 230.175(a), 240.3b-6(a) (1992).

54. See 17 C.F.R. §§ 230.175(a), 240.3b-6(a) (1992); 1979 Safe Harbor, *supra* note 18, at 81,940.

55. See 1978 Safe Harbor Proposal, *supra* note 50, at 81,042.

56. 17 C.F.R. §§ 230.175(c), 240.3b-6(c) (1992).

Although the definition of “forward-looking information” is broad, protection under the safe harbor rules is limited by the requirement that such information have been disclosed either in documents filed with the SEC or in the annual report to shareholders.<sup>57</sup> In addition, the safe harbor protection covers forward-looking statements made prior to an SEC filing that are later reaffirmed in an SEC filing within a reasonable time.<sup>58</sup> The protection also applies to subsequent affirmations of statements that previously appeared in an SEC filing.<sup>59</sup> This means that Rules 175 and 3b-6 do not protect forward-looking information in press releases or statements to analysts, unless they also appear in SEC documents.<sup>60</sup>

The rationale for limiting safe harbor protection to statements made in SEC filings is to give the SEC a better framework for analyzing a corporation’s financial disclosures as a whole.<sup>61</sup> In addition, this limitation encourages corporations to take greater care in making forward-looking statements<sup>62</sup>—not only may their disclosures be reviewed closely by the SEC for reasonableness, but also any forward-looking statements not comporting with the requirements will lose protection under the safe harbor rules.<sup>63</sup>

The SEC indicated that it would monitor the effectiveness of its policy toward the disclosure of forward-looking information. To date, its policy

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57. See 17 C.F.R. §§ 230.175(b)(1), 240.3b-6(b)(1) (1992); see also 1979 Safe Harbor, *supra* note 18, at 81,943 (listing safe harbor coverage of statements contained in registration statements, periodic reports, annual reports to shareholders, and “other documents filed with the [SEC]”). To come within the safe harbor provisions, the annual report to shareholders must meet the requirements of Rules 14a-3(b) and (c) or Rule 14c-3(b). These provisions provide that annual reports to shareholders are not deemed to be filed with the SEC except to the extent that the corporation has specifically requested that the report be treated as part of the proxy soliciting material or has incorporated the report by reference into the proxy statements. See 17 C.F.R. §§ 240.14a-3(c), 240.14c-3(b) (1992).

58. See 17 C.F.R. §§ 230.175(b)(1), 240.3b-6(b)(1) (1992); see also 1979 Safe Harbor, *supra* note 18, at 81,943 (noting availability of safe harbor protection for forward-looking statements if later disclosed in SEC filings).

59. See 17 C.F.R. §§ 230.175(b)(1), 240.3b-6(b)(1) (1992); see also 1979 Safe Harbor, *supra* note 18, at 81,943 (noting availability of safe harbor protection for reaffirmations of statements contained in prior SEC filings, provided that such reaffirmations meet the standards of reasonable basis and good faith).

60. See 17 C.F.R. §§ 230.175(b)(1), 240.3b-6(b)(1) (1992); see also 1979 Safe Harbor, *supra* note 18, at 81,943 (noting that statements made outside of SEC filings are covered only if included in an SEC filing or annual reports to shareholders).

61. See 1979 Safe Harbor, *supra* note 18, at 81,943.

62. See *id.*

63. See *id.* While the safe harbor rules are supposed to benefit corporations which make reasonable forward-looking disclosures in good faith, several commentators have noted that the rules actually have provided little protection, especially under Rule 10b-5. Apparently, the criticisms revolve around the imprecision of the terms “reasonable basis” and “good faith.” Poole, *Management Forecasts*, *supra* note 15, at 775 n.47. However, as noted by the SEC, “there is ample precedent for the concept of good faith in other provisions of the federal securities laws.” 1979 Safe Harbor, *supra* note 18, at 81,941 (citing 15 U.S.C. §§ 78r(a), 78t(a), 78bb(e)(1), 80a-2(a)(41)(A)). For a discussion on the recent application of safe harbors to forward-looking statements, see *infra* notes 256-73 and accompanying text.

has remained relatively unchanged. Voluntary disclosure is still the rule for most forward-looking information.<sup>64</sup>

C. *Item 303 of Regulation S-K: Mandatory Disclosure of Certain Forward-Looking Information*

1. SEC's Historical Position on MD&A

The general notion that forward-looking information is encouraged but not required is substantially altered by Item 303 of Regulation S-K,<sup>65</sup> which requires the disclosure of certain forward-looking information in the MD&A section of periodic reports, proxy statements and prospectuses.<sup>66</sup> Due to its mandatory nature, the MD&A has in recent years become a focal point for the SEC in its review of the disclosure of forward-looking information.<sup>67</sup> It has developed into the single most important disclosure provision in SEC filings and other disclosure documents.<sup>68</sup>

The MD&A itself has been a required part of SEC filings since 1968.<sup>69</sup> At that time, however, it required only summary statements about unusual conditions affecting the corporation that might render its financial

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64. See 17 C.F.R. § 229.10(b) (1992) (encouraging the use of forward-looking information in documents specified by Rules 175 and 3b-6).

65. 17 C.F.R. § 229.303 (1992).

66. For a more detailed description of Item 303, see *supra* note 10.

67. See 1989 Interpretive Release, *supra* note 17, ¶ 72,436, at 62,144 (providing further guidance to improve overall compliance with MD&A disclosure requirements); see also SEC v. Bank of New England Corp., AAER-280, [1987-1991 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,755, at 63,332 (D.D.C. 1990) (alleging omissions of adverse trends in real estate market and loan portfolio which should have been discussed in MD&A); *In re American Sav. & Loan Ass'n, Exchange Act Release No. 25,788*, [1987-1991 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,663, at 63,137-39 (June 8, 1988) (alleging omission of large repurchase transactions made by the corporations which should have been discussed in the MD&A); *In re Marsh & McLennan Cos., Exchange Act Release No. 24,023*, [1982-1987 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,524, at 63,389-24 (Jan. 22, 1987) (alleging nondisclosure in the MD&A of nature and effect of corporation's investment and financing activities); *In re American Express Co., Exchange Act Release No. 23,332*, [1982-1987 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,501, at 63,349-3-49-4 (June 17, 1986) (finding MD&A deficiencies where corporation neglected to disclose reasons for earnings increase); *In re Charter Co., Exchange Act Release No. 21,647*, [1982-1987 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,448, at 63,176 (Jan. 10, 1985) (alleging nondisclosure of reasons for increased earnings and anticipated future profit reduction); SEC v. Ronson Corp., [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,464, at 96,652 (D.N.J. 1983) (finding MD&A deficiencies where corporation failed to disclose that a major customer suspended its purchases and was unlikely to resume such purchases).

68. See Ted J. Fiflis, *Financial Statements, the Management's Discussion and Analysis, and the Accounting Provisions of the Foreign Corrupt Practices Act*, C533 A.L.I.-A.B.A. 751 (June 18, 1990), available in Westlaw, JRL database.

69. See Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 4936, [1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,636 (Dec. 9, 1968).

statements inappropriate.<sup>70</sup> Although the format of the MD&A was altered in 1974 to include a discussion of variations in income statement items,<sup>71</sup> the MD&A did not evolve into a full discussion until 1980. In 1980, the SEC incorporated the MD&A into its integrated disclosure system where the MD&A evolved into a comprehensive discussion of items such as liquidity, capital resources, results of operations, trends, events, and uncertainties.<sup>72</sup> This change in the scope of the MD&A stemmed from an acknowledgment that financial statements alone, with their brief footnotes, were insufficient indicators by which to judge both the quality of past earnings and the prospects for future earnings.<sup>73</sup> The change was intended to give investors an opportunity to look at the company through the "eyes of management"<sup>74</sup> by requiring management to provide a narrative explanation of corporate financial statements, as well as a short and long-term analysis of the corporation's business.<sup>75</sup>

Since its adoption of Item 303, the SEC has conducted a continuous review of MD&A disclosures. In particular, a special project was commenced in 1987 to review the adequacy of actual MD&A disclosures.<sup>76</sup> Based on its findings in the first two phases of this project, the SEC is

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70. *See id.*

71. *See* Notice of Adoption and Amendments to Guide 22 of the Guides for Preparation and Filing of Registration Statements Under the Securities Act of 1933, Securities Act Release No. 5520, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,924 (Aug. 12, 1974).

72. *See* Amendments to Annual Report Form, Related Forms, Rules, Regulations and Guides; Integration of Securities Acts Disclosure Systems, Securities Act Release No. 6231, [1937-1982 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,301, at 62,815-17 (Sept. 2, 1980) (at the time, Item 303 was referred to as Item 11 of Regulation S-K). Approximately one year after bringing the MD&A within Regulation S-K, the SEC published a discussion of its expectations for Item 303 disclosures based on its initial assessment of responses to the new requirements. *See* Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 18,120, [1937-1982 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,321 (Sept. 28, 1981). For specifics of Item 303's current requirements, see *supra* note 10.

73. *See* Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Exchange Act Release No. 24,356, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,118, at 88,623 (Apr. 20, 1987) [hereinafter 1987 Concept Release]. MD&A disclosure items are located both on and off a corporation's principal financial statements. As such, investors are provided with a much broader range of information than that provided by strictly historical financial statements and their brief footnotes.

74. *Id.*

75. *See id.*

76. In the initial phase of the project, the SEC focused on the MD&A disclosures of 218 corporations in 12 industries. *See* 1989 Interpretive Release, *supra* note 17, ¶ 72,436, at 62,144 n.9 for a list of the industries involved. Of the 218 corporations involved, 206 were requested to amend or supplement their MD&A. *See id.* at 62,145. The second phase of the project commenced in 1988. One hundred and forty one corporations from 12 different industries were involved, with a large number again receiving comments from the SEC regarding deficiencies in their MD&A disclosures. *See id.* For a list of the industries involved, see *id.* at 62,145 n.12.

sued an interpretive release in 1989.<sup>77</sup> This release attempted to clarify the SEC's interpretation of existing MD&A requirements.<sup>78</sup> It instructed that the purpose of the MD&A is to provide "material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future."<sup>79</sup> In other words, Item 303 mandates that, under certain circumstances, corporations disclose forward-looking information.

## 2. Standard for Disclosure in the MD&A

Determining whether Item 303 imposes a duty to disclose requires two assessments:

- (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.<sup>80</sup>

As explained by the SEC in its 1989 Interpretive Release, this test is a departure from the probability/magnitude test,<sup>81</sup> announced by the Supreme Court in *Basic Inc. v. Levinson*,<sup>82</sup> for determining "materiality" under Rule 10b-5. The significance of this departure is that, of the two, Item 303's test has a lower threshold for finding a duty to disclose.<sup>83</sup>

The existence of a different standard for the disclosure of forward-

77. *See id.* at 62,143.

78. *See id.*

79. 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,841.

80. *Id.* at 62,843.

81. *See id.* at 62,843 n.14:

MD&A mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure—*i.e.*, reasonably likely to have a material effect. This specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic Inc. v. Levinson*, is inapposite to Item 303 disclosure.

*Id.* (citation omitted).

82. 485 U.S. 224 (1988). The probability/magnitude test is defined as a balancing of the "probability that [an] event will occur [against] the anticipated magnitude of the event in light of the totality of the company activity." *Id.* at 238 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

83. It is helpful to visualize the difference between the tests in mathematical terms. With respect to the first step of Item 303's test, Former SEC Commissioner Fleischman has suggested that "reasonably likely" may be in the 40% probability range. *See* Edward H. Fleischman, *The Intersection of Business Needs and Disclosure Requirements: MD&A*, Address to the Eleventh Annual Southern Securities Institute, at 12 (Mar. 1, 1991). With respect to the second step, one commentator has noted that "the MD&A [test] requires the probability [of occurrence] to be assumed at 100% unless it can be determined to be

looking information in the MD&A is not inconsistent with *Basic*. In *Basic*, the Court was concerned with the disclosure of one very specific type of forward-looking information—preliminary merger negotiations.<sup>84</sup> In determining whether there was a duty to disclose such information, the Court applied the probability/magnitude test. It limited its decision to the merger context, however, expressly stating that it was not addressing the applicability of its test to the disclosure of projections or other forward-looking information.<sup>85</sup> In practice, most courts have dispensed with the probability/magnitude test when determining whether disclosure of projections is required.<sup>86</sup> Therefore, it is not surprising that Item 303 also dispenses with that test.

In addition to setting forth a materiality test to govern disclosures in the MD&A, the 1989 Interpretive Release attempted to draw a clearer distinction between the permissive disclosure of certain forward-looking information,<sup>87</sup> such as forecasts, and the mandatory disclosure of other forward-looking information,<sup>88</sup> such as presently known data that will have an impact on future operating results.<sup>89</sup> Not only is this distinction important to application of the Item 303 test, it also reaffirms the SEC's general position that not all forward-looking information must be disclosed.<sup>90</sup> In the instructions to Item 303<sup>91</sup> and in the 1989 Interpretive

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close to zero, whereas *Basic* allows the probability of occurrence to be estimated at any point from zero to 100%." Fifiis, *supra* note 68, at \*5.

84. See *Basic*, 485 U.S. at 230.

85. The Court stated, "We do not address here any other kinds of contingent or speculative information, such as earnings forecasts or projections." *Id.* at 232 n.9.

86. See *infra* notes 124-47 and accompanying text (describing the numerous approaches taken by courts in Rule 10b-5 actions to the disclosure of forward-looking information). Moreover, Item 303 accommodates *Basic* by making an exception for preliminary merger negotiations. See 1989 Interpretive Release, *supra* note 17, ¶ 73,197, at 62,851-52 ("While Item 303 could be read to impose a duty to disclose otherwise undisclosed preliminary merger negotiations, . . . [the SEC will not require] . . . a discussion of the impact of [preliminary merger] negotiations [in the MD&A] where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction.").

87. The SEC's current position on permissive disclosures is set forth in 17 C.F.R. § 229.10(b) (1992). See *supra* note 7.

88. The SEC's current policy on mandatory disclosures is set forth in Item 303 of Regulation S-K. See 17 C.F.R. § 229.303 (1992); see also *supra* note 10 (highlighting the relevant provisions of Item 303).

89. The distinction between required and optional disclosures as articulated by the SEC in its 1987 Concept Release and as reaffirmed in its 1989 Interpretive Release on MD&A, is as follows:

Required disclosure [in the MD&A] is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects* . . . .

In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.

1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,842.

90. See 17 C.F.R. § 229.10(b) (1992) (setting forth SEC's general policy of encouraging but not requiring disclosure of projections).

91. See 17 C.F.R. § 229.303(a), instruction 7 (1992).

Release,<sup>92</sup> the SEC has continued to encourage corporations to discuss both types of forward-looking information by re-emphasizing its position that the safe harbor protection of Rules 175 and 3b-6 applies both to mandatory and to optional forward-looking disclosures.<sup>93</sup>

Since 1989, the SEC has continued to review MD&A compliance, following up with a third and fourth phase of its project.<sup>94</sup> Apparently there has been little discernible improvement in MD&A disclosures, for the SEC often has found compliance to be deficient and has required corporations to amend their MD&A or has referred their cases to the Division of Enforcement.<sup>95</sup>

### 3. *In re Caterpillar, Inc.*: An SEC Crackdown on MD&A

Apparently dissatisfied with the effectiveness of its pronouncements on MD&A disclosure requirements, in March 1992 the SEC initiated its first action predicated solely on MD&A violations.<sup>96</sup> *Caterpillar* has been termed a "message case" intended to communicate that the SEC requires "improved disclosures" of known trends and uncertainties.<sup>97</sup> Although the SEC imposed no penalties on Caterpillar, other than requiring Caterpillar to end its Item 303 violations and to establish procedures for ensuring compliance, this action is expected to be a precursor to more aggressive SEC enforcement of MD&A disclosure requirements.<sup>98</sup>

Focusing on the MD&A section of Caterpillar's 1989 Form 10-K and first quarter 1990 Form 10-Q, the SEC found inadequate disclosure of the risk of lower earnings in 1990 as well as the lack of any attempt to quantify the impact of lower earnings, as required under Item 303.<sup>99</sup>

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92. See 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,842.

93. See 17 C.F.R. § 229.303(a), instruction 7 (1992); 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,842.

94. See 1989 Interpretive Release, *supra* note 17, ¶ 72,436, at 62,145, 62,145 n.13 (describing third phase and listing industries involved); *Accounting and Disclosure: MD&A*, 22 Sec. Reg. & L. Rep. (BNA) 80 (Jan. 12, 1990) (describing fourth phase as involving previously targeted corporations). In addition, the SEC established a separate task force to review the MD&As of banks and thrifts. See *SEC May Bring Enforcement Action for Inadequate Junk Bond Disclosures*, 22 Sec. Reg. & L. Rep. (BNA) 1287 (Sept. 14, 1990).

95. See, e.g., *SEC v. Bank of New England Corp.*, AAER-280, [1987-1991 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,755, at 63,332 (D.D.C. Dec. 21, 1990) (alleging that BNE Corp.'s MD&A failed to adequately disclose "that certain adverse trends indicating a deterioration in the New England real estate market as well as in [the bank's] loan portfolio were reasonably likely to have material adverse effects on [the bank's] future [loan losses] and related provisions and net income"). For a detailed analysis of SEC enforcement actions in this area, see *infra* text accompanying notes 207-37.

96. See *Caterpillar*, *supra* note 11, at 63,050.

97. See *Caterpillar Settles SEC Charges It Made Inadequate MD&A Disclosures*, 24 Sec. Reg. & L. Rep. (BNA) 447 (Apr. 3, 1992).

98. See Dennis J. Block & Jonathan M. Hoff, *The SEC's 'Caterpillar' Order: Trends In MD&A Disclosure*, N.Y. L.J., July 2, 1992, at 5.

99. See *Caterpillar*, *supra* note 11, at 63,055-56.

Caterpillar's Brazilian subsidiary ("CBSA") had been exceptionally profitable in 1989 as a result of several extraordinary factors<sup>100</sup> that were caused by Brazil's hyperinflation that year. Moreover, CBSA was a major contributor to Caterpillar's 1989 earnings, accounting for approximately five percent of Caterpillar's revenues and twenty-three percent of its net profits.<sup>101</sup> While Caterpillar reflected these earnings on its consolidated financial statements, it did not disclose management's knowledge of CBSA's uncertain future earnings or the significance of CBSA to Caterpillar's overall earnings.<sup>102</sup>

In January 1990, prior to the filing of its 1989 Form 10-K, Caterpillar management recognized that there were substantial uncertainties as to whether CBSA would repeat its exceptional performance, in light of anticipated sweeping economic reforms by a new administration in Brazil.<sup>103</sup> At a February 1990 board meeting, more than two weeks before Caterpillar filed its 1989 Form 10-K, Caterpillar's Directors were told that "Brazil was 'volatile' and that 'the impact of Brazil is so significant to reduced 1990 projected results, [management] felt it was necessary to explain it [to the directors] in some detail.'"<sup>104</sup> At the same meeting, the Board reviewed and approved the final draft of the 1989 Form 10-K, including the MD&A.<sup>105</sup> Despite the Board's detailed knowledge of these uncertainties, Caterpillar's 1989 Form 10-K merely indicated that "[s]ales in Brazil . . . could be hurt by post-election policies which will likely aim at curbing inflation."<sup>106</sup> The Form 10-K did not indicate that a decline in CBSA's future results would have a material adverse effect on Caterpillar's bottom line in 1990.<sup>107</sup>

The SEC found that Caterpillar's 1989 Form 10-K did not adequately discuss management's uncertainty about CBSA's 1990 performance. Caterpillar's failure to include information required by Item 303 left investors with an incomplete picture of Caterpillar's financial condition and denied them the opportunity to see the company through the "eyes of management."<sup>108</sup> Specifically, the Form 10-K failed to disclose "known uncertainties reasonably likely to have a material effect on Caterpillar's future results of operations, due to CBSA's questionable ability to repeat its 1989 performance."<sup>109</sup>

Similarly, in its first quarter 1990 Form 10-Q, Caterpillar did not dis-

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100. These extraordinary factors include currency gains, export subsidies, and interest income.

101. *See id.* at 63,051.

102. *See id.*

103. *See id.*

104. *Id.* (alteration in original).

105. *See id.* at 63,052.

106. *Id.* at 63,053 n.4.

107. *See id.*

108. *Id.* at 63,055; *see also supra* text accompanying note 74 (describing purpose of MD&A).

109. *Caterpillar, supra* note 11, at 63,055.



cuss the growing body of knowledge available to it about the uncertainties of CBSA's profitability. In March 1990, a new administration took office in Brazil and sweeping economic and monetary changes were immediately instituted in an effort to bring Brazil's hyperinflation under control.<sup>110</sup> At the April 1990 board meeting, before Caterpillar's first quarter 1990 Form 10-Q was filed, Caterpillar's management gave a presentation discussing the likely negative effects that the economic reforms in Brazil would have on CBSA's sales and profits: "Brazil is volatile and difficult to predict. [Its] recently announced economic reforms have made the situation even more uncertain. . . . [It is management's conclusion that] profits in Brazil will be substantially lower than in 1989."<sup>111</sup> However, Caterpillar's Form 10-Q contained only the following statement about Brazil: "[D]emand increased . . . despite the uncertainty of the Brazilian economy. The Company hasn't changed its outlook from what was stated in its 1989 annual report."<sup>112</sup> Based on the facts presented to the Board and known by management, the SEC found that "management could not [have] conclude[d] that lower earnings from CBSA were not reasonably likely to occur."<sup>113</sup>

The SEC opined that Caterpillar's 1989 Form 10-K and first quarter 1990 Form 10-Q should have discussed the future uncertainties regarding CBSA's operations, including the possible risk of Caterpillar having materially lower earnings as a result of that risk.<sup>114</sup> In addition, the SEC noted that to the extent reasonably practicable, Caterpillar should have quantified the impact of such risk.<sup>115</sup>

*Caterpillar* is significant in that it demonstrates the SEC's resolve to enforce Item 303 more aggressively through use of its newly authorized cease and desist powers.<sup>116</sup> In addition, it may have a broad impact with respect to the standard for disclosure of "known trends, events or uncertainties," as set forth in the SEC's 1989 Interpretative Release.<sup>117</sup>

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110. *See id.* at 63,051-52.

111. *Id.* at 63,052.

112. *Id.* at 63,053 n.4.

113. *Id.* at 63,055. As stated earlier, the test of materiality under Item 303 requires disclosure unless management determines that known trends and uncertainties are "not reasonably likely" to have a material effect. *See supra* text accompanying note 80.

114. Interestingly, even if Caterpillar had segregated the figures for CBSA, thereby highlighting the large contribution it made to Caterpillar's revenues and profit, the SEC still would have required a full discussion of CBSA's risky operations. *See Caterpillar, supra* note 11, at 63,051 n.1, 63,055 n.10 ("[E]ven if Caterpillar's financial statements had displayed CBSA's results on a segregated basis . . . that would not have obviated the requirement that the CBSA's operations be discussed in the MD&A section of Caterpillar's periodic reports.").

115. *See id.* at 63,055-56.

116. In 1990, under the Securities Enforcement Remedies and Penny Stock Reform Act, 15 U.S.C. § 78a-3, the SEC was granted unprecedented cease and desist powers. These powers enable the SEC, among other things, to enforce more effectively compliance with its disclosure regulations. For further discussion of this topic, see *infra* note 194.

117. *See infra* notes 169-87, 196-55, and accompanying text.

The implications of *Caterpillar* to private securities litigation, however, is uncertain. Item 303 of Regulation S-K does not provide a private right of action for shareholders. Moreover, the SEC did not allege that *Caterpillar* had violated Rule 10b-5. Indeed, because MD&A disclosure is based upon a lower standard of disclosure than is typically applied to forward-looking information,<sup>118</sup> it is not clear whether a Rule 10b-5 claim based on MD&A deficiencies would be viable. There is some indication in post-*Caterpillar* decisions, however, that a Rule 10b-5 claim based on such deficiencies may be viable.<sup>119</sup>

## II. THE COURTS' APPROACH TO THE DISCLOSURE OF FORWARD-LOOKING INFORMATION

To date, no court has imposed Rule 10b-5 liability for an Item 303 violation.<sup>120</sup> The cases dealing with the issue of nondisclosure of forward-looking information, however, indicate that the courts' reluctance to impose Rule 10b-5 liability for Item 303 violations may be a result of their general reluctance to impose Rule 10b-5 liability for nondisclosure of any forward-looking information.<sup>121</sup> Thus, it is instructive to analyze courts' treatment of the nondisclosure of forward-looking information, outside of the Item 303 context.

### A. *Current Standards for Determining Whether Forward-Looking Information Must Be Disclosed*

Since no specific statutory or regulatory obligation, other than Item 303 of Regulation S-K, imposes an affirmative duty to disclose forward-looking information, courts have looked to antifraud statutes to find whether and when such a duty arises.<sup>122</sup> Although courts have been influenced by the SEC's position on this issue,<sup>123</sup> it is apparent that the courts' approaches have not evolved completely with the SEC's. Today,

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118. See *supra* notes 81-83 and accompanying text.

119. See *infra* text accompanying notes 169-87.

120. This Note uses the term "Item 303 violation" to refer to the nondisclosure of forward-looking information that is required to be disclosed in the MD&A pursuant to Item 303 of Regulation S-K.

121. To date, Item 303 violations have not been actively pursued in the courts under Rule 10b-5. However, the nondisclosure of other forward-looking information, such as projections which may be voluntarily disclosed under 17 C.F.R. § 229.10(b), have been pursued. The cases discussed in this section deal with forward-looking information other than that required to be disclosed under Item 303 of Regulation S-K.

122. The language of Rule 10b-5 states that "[i]t shall be unlawful for any person . . . (b) [t]o . . . omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . ." 17 C.F.R. § 240.10b-5(b) (1992). See Block et al., *Affirmative Duty*, *supra* note 14, at 1245-55 (discussing exceptions to the general rule that there is no duty to disclose material information when the corporation is not trading in its own stock).

123. See *supra* notes 19-64 and accompanying text for a review of the SEC's approach to forward-looking disclosures outside the Item 303 context.

there are at least four different approaches<sup>124</sup> to assessing the duty to disclose forward-looking information in Rule 10b-5 actions.<sup>125</sup> Regardless of which of the four standards are applied though, few cases have found liability for omitted forward-looking information.

### 1. Traditional Exclusion Standard

Under the traditional view, a corporation never has a duty to disclose forward-looking information.<sup>126</sup> This approach has its origins in the SEC's traditional position that projections were inherently misleading.<sup>127</sup> Now that the SEC has substantially modified its policy, however, some argue that this approach is no longer supportable.<sup>128</sup> Despite the SEC's move toward encouraging forward-looking disclosures, though, the First and Second Circuits on occasion do apply this test.<sup>129</sup>

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124. These approaches, discussed *infra* text accompanying notes 124-47, have received extensive analysis and discussion elsewhere. See J. Robert Brown, Jr., *The Regulation of Corporate Disclosure 205-12* (Prentice Hall 1992 Supp.); Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 Md. L. Rev. 1114 (1987); Janet E. Kerr, *A Walk Through the Circuits: The Duty to Disclose Soft Information*, 46 Md. L. Rev. 1071 (1987); Poole, *Management Forecasts*, *supra* note 15, at 765; Richard P. Brull, Note, *Trigger Disclosure: A Proposal For The Disclosure Of Projections of Future Economic Performance by Target Companies During Tender Offers*, 56 Geo. Wash. L. Rev. 313 (1988); Jude Sullivan, Note, *Materiality of Predictive Information After Basic: A Proposed Two-Part Test of Materiality*, 1990 U. Ill. L. Rev. 207.

It should also be noted that the approaches of some courts simply do not fit into any of the four categories. See *Garcia v. Cordova*, 930 F.2d 826, 830 (10th Cir. 1991) ("While we do not attempt to synthesize these [four] approaches here, we agree with the Fifth Circuit that in each case the dispositive factors are the nature of the undisclosed predictive information and its importance, reliability and investor impact as determined from the facts of each case."); *Isquith v. Middle S. Utils., Inc.*, 847 F.2d 186, 205 n.14, 206 (5th Cir.) ("We make no attempt today either to examine in detail the several approaches which the various circuits have endorsed or to determine when, or even if, predictive information must be disclosed . . ."), *cert. denied*, 488 U.S. 926 (1988).

125. As alluded to earlier, there exists a variety of approaches to the disclosure of forward-looking information that are not inconsistent with the Supreme Court's opinion in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). See *supra* text accompanying notes 84-86. Given the Supreme Court's statement that it was not addressing the applicability of its probability/magnitude test to the disclosure of forward-looking information, other than preliminary merger negotiations, *Basic*, 485 U.S. at 232 n.9, courts have dispensed with the probability/magnitude test when determining whether disclosure of projections is required. See, e.g., *Garcia*, 930 F.2d at 829 n.1:

We do not feel obligated to apply that test to the facts of this case . . . inasmuch as the Supreme Court in *Basic* specifically limited its decision to the context of merger negotiations and disavowed any attempt to "address . . . any other kinds of contingent or speculative information, such as earnings forecasts or projections."

126. The leading case applying this approach is *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292-94 (2d Cir. 1973).

127. See *supra* text accompanying notes 23-26; see also Poole, *Management Forecasts*, *supra* note 15, at 781 (arguing that the traditional approach "is an anachronism with no place in the modern investment environment").

128. See Poole, *Management Forecasts*, *supra* note 15, at 781.

129. See, e.g., *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227,

## 2. Reasonable Certainty Standard

Some courts have held that no affirmative duty to disclose forward-looking information arises unless such information is "reasonably certain."<sup>130</sup> Courts applying the reasonable certainty standard have noted the changed SEC position from that of a total ban to an encouragement of forward-looking disclosure. These courts, however, appear to be more focused on the fact that forward-looking disclosure is still not mandatory.<sup>131</sup>

This approach affords great deference to management's decisions about disclosing forward-looking information, a deference which suggests that a fairly high standard of reasonable certainty is required before a court would find a duty to disclose.<sup>132</sup> For example, without even going into an analysis of the reliability or relevance of the information withheld,<sup>133</sup> courts have upheld management determinations not to disclose internal projections. Such management decisions have been upheld even when the projections differed significantly from published statements.<sup>134</sup> This approach fails to recognize, however, that internal projections are not necessarily unreliable or lacking in reasonable certainty.<sup>135</sup>

Given the SEC's encouragement of forward-looking disclosures and its command for disclosure of the particular forward-looking information described by Item 303, some commentators have criticized courts' reluctance to find a duty to disclose.<sup>136</sup> Nevertheless, this position continues to be maintained in the Fourth, Seventh, and Ninth Circuits.<sup>137</sup>

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1233, 1234-35 (1st Cir. 1984) (applying traditional approach to nondisclosure of projections because SEC policy was to discourage disclosure projections at time statements were issued); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1550 (S.D.N.Y. 1985) (applying traditional approach to financial projections despite change in SEC policy because new disclosure policy is only voluntary and not mandatory), *rev'd in part*, 927 F.2d 667 (2d Cir. 1990); *Flum Partners v. Child World, Inc.*, 557 F. Supp. 492, 499 (S.D.N.Y. 1983).

130. *See, e.g., Walker v. Action Indus., Inc.*, 802 F.2d 703, 710 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980).

131. *See, e.g., Walker*, 802 F.2d at 709 ("[W]e believe that a further transition, from permissive disclosure to required disclosure, should be occasioned by congressional or SEC adoption of more stringent disclosure requirements for financial projections, rather than by the courts.").

132. *See Poole, Management Forecasts, supra* note 15, at 785.

133. *See Panter v. Marshall Field & Co.*, 646 F.2d 271, 292-93 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

134. *See id.* at 292.

135. *See Poole, Management Forecasts, supra* note 15, at 783.

136. *See id.* at 784 n.110.

137. *See, e.g., In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991) (holding that internal projections lacking "reasonable certainty" did not have to be disclosed); *Walker v. Action Indus., Inc.*, 802 F.2d 703, 709 n.11, 710 (4th Cir. 1986) (stating that "it would appear prudent to release only those projections that are reasonably certain"), *cert. denied*, 479 U.S. 1065 (1987); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 292 (7th Cir.) (although court stated it was not specifically adopting any of the various positions held by other circuits, court supported release of reasonably certain forward-looking information), *cert. denied*, 454 U.S. 1092 (1981).

### 3. Substantial Certainty Standard

The Sixth Circuit has employed a "substantial certainty" standard, which analyzes disclosure solely in terms of reliability.<sup>138</sup> Under this approach, forward-looking information generally need not be disclosed unless it is "virtually as certain as hard facts."<sup>139</sup> As a practical matter, this standard virtually precludes the finding of an affirmative duty to disclose by creating an insurmountable barrier. Forward-looking information, particularly in the form of projections, is by its nature uncertain due to the potentially large number of assumptions used.<sup>140</sup>

Critics of the substantial certainty approach argue that it ignores the importance of forward-looking information and utilizes an archaic and unattainable standard inconsistent with modern SEC policies and philosophies.<sup>141</sup> This standard, however, continues to be used in the Sixth Circuit.<sup>142</sup>

### 4. Balancing Approach

The Third Circuit has taken a unique position on the disclosure of forward-looking information by adopting a balancing test<sup>143</sup> which takes into account the relevance and reliability of forward-looking information. According to this approach, courts must "ascertain the duty to disclose [forward-looking] information on a case-by-case basis, by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note."<sup>144</sup>

Of all the standards applied by courts today, this goes farthest toward requiring the disclosure of forward-looking information. Unlike the traditional exclusion and reasonable certainty standards,<sup>145</sup> this approach

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138. See *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

139. *Id.*

140. See J. Robert Brown, Jr., *Corporate Communications and the Federal Securities Laws*, 53 Geo. Wash. L. Rev. 741, 798 n.257; see also Janet H. Doyle, *Disclosure of Forecasts and Projections*, 2 Insights (P-H) No. 6, at 10 (Feb. 1992), available in Westlaw, JRL database (describing projections as "what-if" scenarios that are based on hypothetical assumptions).

141. See, e.g., Poole, *Management Forecasts*, supra note 15, at 790 (calling the substantial certainty standard a "step backward toward the outmoded traditional . . . view").

142. See *Radol v. Thomas*, 772 F.2d 244, 252-53 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986); *Rice v. Hamilton Oil Corp.*, 658 F. Supp. 446, 448 (D. Colo. 1987).

143. See *Flynn v. Bass Bros. Enters., Inc.*, 744 F.2d 978 (3d Cir. 1984).

144. *Id.* at 988. Factors reflecting the relevance of the information, include its importance to the shareholders' impending decision, its uniqueness, and the availability of other more reliable sources of information. See *id.* Reliability is determined by assessing the facts upon which the soft information was based, the qualifications of those who prepared it, its original purpose, and the degree of subjectivity or bias reflected in its preparation. See *id.*

145. See *Walker v. Action Indus., Inc.*, 802 F.2d 703, 709 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1550 n.8 (S.D.N.Y. 1985), *aff'd in part, rev'd in part*, 927 F.2d 667 (2d Cir. 1990).

views the movement by the SEC from a policy of discouraging disclosure to one of encouraging disclosure as a significant recognition of the importance of forward-looking information.<sup>146</sup> To date, this balancing approach appears to have been employed solely within the Third Circuit.<sup>147</sup>

## B. Judicial Treatment of MD&A Deficiencies

Prior to *Caterpillar*, most courts rejected outright Rule 10b-5 claims based on Item 303 violations. Since the SEC issued its March 1992 cease and desist order in *Caterpillar*, however, courts seem to be somewhat more willing to explore the possibility of imposing securities fraud liability for Item 303 violations.

### 1. Pre-*Caterpillar* Cases

Prior to the *Caterpillar* action in March 1992, only courts in the Third and Ninth Circuits had addressed whether Rule 10b-5 liability may be imposed for Item 303 violations.<sup>148</sup> Just as these circuits differed in their approach to the disclosure of forward-looking information in general,<sup>149</sup> they also differed in their approach to the issue of whether Rule 10b-5 liability may be imposed for Item 303 violations.<sup>150</sup> The Third Circuit indicated a willingness to impose liability, while the Ninth Circuit was firm in its position that Item 303 of Regulation S-K does not impose a duty to disclose under Rule 10b-5.

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146. See *Flynn*, 744 F.2d at 986-88.

147. See, e.g., *Walter v. Holiday Inns, Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,344, at 95,757 (3d Cir. 1993) (applying *Flynn*); *Hoffman Elec., Inc. v. Emerson Elec. Co.*, 754 F. Supp. 1070, 1081 (W.D. Pa. 1991) (applying *Flynn* in determining duty to disclose forward-looking statements); *In re Bell Atlantic Corp. Sec. Litig.*, Civ.A.Nos. 91-0514, 91-0518, 91-0531, 91-0673, 91-0748, 1991 WL 234236, at \*3-4 (E.D. Pa. Oct. 30, 1991) (same); *In re Craftmatic Sec. Litig.*, 703 F. Supp. 1175, 1180 (E.D. Pa. 1989) (using the *Flynn* analysis, court concluded that omitted information was "highly speculative and would have provided only minimal aid—if any—to prospective shareholders"), *aff'd in part, rev'd in part*, 890 F.2d 628 (3d Cir. 1990).

148. See *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991); *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1483 (N.D. Cal. 1992); *Alfus v. Pyramid Technology Corp.*, 764 F. Supp. 598, 607-08 (N.D. Cal. 1991); *Bell Atlantic*, 1991 WL 234236, at \*8-9.

149. See *supra* text accompanying notes 130-37, 143-47. The Third Circuit has employed a balancing test, while the Ninth has applied a reasonable certainty test.

150. In fact, their differences have continued post-*Caterpillar*. Compare *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 558 (D.N.J. 1992) (in analyzing alleged omissions in MD&A section of prospectus, court looked to language of document to determine whether known uncertainties were disclosed) with *In re Lyondell Petrochemical Co. Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,335, at 95,704-05 (9th Cir. 1993) (refusing to analyze alleged omissions in MD&A section of prospectus after reading Instruction 7 to Item 303 to mean that forward-looking information need not be disclosed).

a. *Pre-Caterpillar Indications That Rule 10b-5 Claims Based on Item 303 Violations May Be Viable*

Although never actually imposing Rule 10b-5 liability for Item 303 violations, at least one court in the Third Circuit intimated a willingness to impose such liability if presented with the correct factual scenario. Prior to *Caterpillar*, the Eastern District of Pennsylvania addressed the issue in *In re Bell Atlantic Corp. Securities Litigation*.<sup>151</sup> There the plaintiffs initiated an action under Rule 10b-5, alleging that Bell's third quarter 1990 Form 10-Q violated Item 303(b) of Regulation S-K<sup>152</sup> because it failed to disclose any "known trends, demands, commitments, events or uncertainties which are reasonably likely to have material effects on a [corporation]'s financial condition or results of operations."<sup>153</sup> The court ultimately dismissed this allegation because plaintiffs failed to allege the specific events, trends, or transactions that Bell did not disclose and, therefore, failed to state a case for an Item 303(b) violation.<sup>154</sup>

Despite dismissing the case, the court gave some indication of how it would have ruled if the plaintiffs had alleged with specificity the events, trends, and transactions that defendants failed to disclose. Relying on the 1989 Interpretive Release for guidance, the court noted that if a corporation knows of events that are reasonably likely to have a material impact with respect to changes in liquidity, capital resources, or results of operations, the failure to disclose them in a Form 10-Q would violate Item 303(b).<sup>155</sup> The Third Circuit's willingness to analyze Item 303 in a Rule 10b-5 action and to apply the test established in the 1989 Interpretive Release indicates that, at least in the Third Circuit, some progress has been made toward bringing the courts' approach to the disclosure of forward-looking information in line with the SEC's.

b. *Pre-Caterpillar Rejection of Rule 10b-5 Claims Based on Item 303 Violations*

Courts in the Ninth Circuit have dealt with this issue more frequently.<sup>156</sup> In contrast to the Third Circuit, these courts were unwilling

151. 1991 WL 234236 (E.D. Pa. Oct. 30, 1991).

152. Item 303(b) of Regulation S-K pertains to MD&A disclosures in the Form 10-Q quarterly reports filed with the SEC. See 17 C.F.R. § 229.303(b) (1992).

153. *Bell Atlantic*, 1991 WL 234236, at \*8 (citing 1989 Interpretive Release, *supra* note 17, at 62,842 n.7).

154. See *id.* at \*8-\*9.

155. See *id.* at \*8.

156. Plaintiff attorneys used the Ninth Circuit to test the viability of Rule 10b-5 claims premised on Item 303 violations. The initial cases were all dismissed, however, because plaintiffs failed to allege the violation of Item 303 which, at a minimum, requires allegations of an omission in SEC filings. See, e.g., *In re Sun Microsystems, Inc. Sec. Litig.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,504, at 97,636-37 (N.D. Cal. 1990) (10b-5 claim based on Item 303 violations dismissed as "flawed" because plaintiffs alleged omissions only in the press release announcing quarterly results but failed to allege omissions in an SEC filing); *Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1517-18 (N.D. Cal. 1990) (same) [*"Alfus I"*]; *In re Gap Sec. Litig.*, [1989-1990 Transfer Binder]

to impose Rule 10b-5 liability on corporations for Item 303 violations.

The case which set the tone for the Ninth Circuit's approach to Rule 10b-5 claims based on Item 303 violations was *Alfus v. Pyramid Technology Corp.*<sup>157</sup> ("*Alfus II*"). In *Alfus II*, the court concluded that an Item 303 violation does not inevitably result in Rule 10b-5 liability for nondisclosure, for under Rule 10b-5 "[s]uch a duty to disclose must be *separately shown*."<sup>158</sup> Plaintiff's Rule 10b-5 claims alleged that Pyramid violated Item 303 by failing to disclose in its annual and quarterly reports known adverse data about softening demand and technological problems.<sup>159</sup> Focusing on the SEC's 1989 Interpretive Release wherein the SEC rejected the probability/magnitude test of *Basic* in favor of a "reasonably likely to have [a] material effect" test, the court concluded that allegations of Item 303 violations would not be actionable under Rule 10b-5.<sup>160</sup>

The position in *Alfus II* was reaffirmed by the Ninth Circuit in *In re Convergent Technologies Securities Litigation*.<sup>161</sup> In *Convergent Technologies*, plaintiff alleged that pursuant to Item 303 of Regulation S-K, defendant was required to disclose in its prospectus internal cost projections pertaining to its new product line. Noting that it was not passing on the relevance of Regulation S-K to the Rule 10b-5 claims before it,<sup>162</sup> the court expressly rejected a duty to disclose forward-looking data, relying on the statement in Instruction 7 to Item 303 that "'forward-looking' information need not be disclosed in Regulation S-K

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Fed. Sec. L. Rep. ¶ 94,724, at 93,908-09 (N.D. Cal. 1988) (same); see also *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 514, 516 (9th Cir. 1991) (although court's analysis differed from the earlier cases, here also, plaintiffs alleged an omission in a press release but not an SEC filing).

Shortly after these "test" cases, plaintiff attorneys corrected their earlier mistakes and, in future cases, merely alleged omissions in both the press release and the corresponding SEC filing. See *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1477 (N.D. Cal. 1992). It should be noted that, generally, the purpose of the press releases at issue in these cases is to pre-announce the corporation's annual or quarterly results. Therefore, the press release and the corresponding annual or quarterly SEC filing essentially mirror each other.

157. 764 F. Supp. 598 (N.D. Cal. 1991).

158. *Id.* at 608 (emphasis added).

159. See *id.* at 607; see also *Alfus I*, 745 F. Supp. at 1517 (providing further factual background).

160. *Alfus II*, 764 F. Supp. at 608. The court's reasoning, however, seems somewhat flawed in that *Basic*'s probability/magnitude test generally is not used to determine the duty to disclose forward-looking information other than the duty to disclose preliminary merger negotiations. See *supra* notes 81-83, 125, and accompanying text. For a more recent approach to the issue in the Ninth Circuit, see *infra* notes 186-87 and accompanying text.

161. 948 F.2d 507 (9th Cir. 1991).

162. See *id.* at 516. The court gave no reason for its treatment of the cost projections at issue as voluntary disclosure items rather than as known trends, events, and uncertainties required by Item 303. Such projections, arguably, were known uncertainties that should have been disclosed. See *id.* at 510 (noting that prior to its March 1983 prospectus, Convergent Technologies' management became aware of serious pricing and cost problems with the product line).



filings."<sup>163</sup> This position generally has been followed in the Ninth Circuit, even though the court in *Convergent Technologies* did not analyze the nature of the forward-looking information at issue, but merely presumed that such information was a permissive disclosure.

The decision in *In re Verifone Securities Litigation*<sup>164</sup> exemplifies how courts in the Ninth Circuit have applied the position taken in *Convergent Technologies*. In *Verifone*, plaintiffs alleged that the defendant's Forms 10-Q for the first and second quarters of 1990 failed to disclose that its earnings were atypically boosted by one-time orders and that such earnings were not likely to be repeated in the forthcoming quarters.<sup>165</sup> Referring to required Item 303 disclosures as "known *historic* trends,"<sup>166</sup> rather than as known trends reasonably likely to affect the future, the court dismissed the case, holding that Item 303 of Regulation S-K "does not provide a basis of liability where a corporation fails to 'disclose' the future."<sup>167</sup>

## 2. Post-Caterpillar Cases

After the *Caterpillar* decision in March 1992, courts in the First, Second, Third, and Ninth Circuits addressed whether Rule 10b-5 liabilities could be imposed pursuant to Item 303 violations.<sup>168</sup> Although none of the courts ultimately imposed liability for Item 303 violations, it appears that courts in at least three of the four circuits may be willing to do so.

### a. Circuits Currently Demonstrating Support for Imposition of Rule 10b-5 Liability Based on MD&A Deficiencies

Although to date no liability has been found, district courts in Connecticut and New Jersey have indicated that a Rule 10b-5 action based on Item 303 violations may be viable.<sup>169</sup>

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163. *Id.* at 516. It is very misleading for the court to have focused so narrowly on this Instruction. In the 1987 Concept Release, *supra* note 73, at 88,624, the SEC explained that Instruction 7 is not intended to distract from the requirements expressly set forth in Item 303.

164. 784 F. Supp. 1471 (N.D. Cal. 1992).

165. *See id.* at 1477.

166. *Id.* at 1483 (emphasis added).

167. *Id.* (citing *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991)). As with the court in *Convergent Technologies*, the court here construed Item 303 as not requiring the disclosure of forward-looking information. A review of SEC enforcement actions and interpretive releases, however, indicates that the data at issue in *Verifone* was clearly of the type required to be disclosed under Item 303. *See infra* notes 223-30 and accompanying text (indicating that Item 303 requires disclosure of extraordinary results, such as those involved in *Verifone*).

168. *See In re Lyondell Petrochemical Co. Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,335, at 95,704-05 (9th Cir. Jan. 29, 1993); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 27-28 (1st Cir. 1992); *Ferber v. Travelers Corp.*, 802 F. Supp. 698, 711 (D. Conn. 1992); *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 558 (D.N.J. 1992); *In re Cypress Semiconductor Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,060, 94,698 (N.D. Cal. Sept. 23, 1992).

169. *See Ferber*, 802 F. Supp. 698 (D. Conn. 1992); *Trump Casino*, 793 F. Supp. 543

In *Ferber v. Travelers Corp.*,<sup>170</sup> plaintiffs alleged violations of Rule 10b-5 for Travelers' failure, in its third quarter 1989 Form 10-Q and first and second quarter 1990 Forms 10-Q, to adequately identify and describe negative trends throughout its real estate asset portfolios.<sup>171</sup> Performing the two-step analysis set forth in the SEC's 1989 Release,<sup>172</sup> the Connecticut district court found that plaintiff's nondisclosure claim failed as a matter of law because Travelers' MD&A section did in fact disclose " 'known trends' and 'uncertainties' " as required by Item 303.<sup>173</sup> Plaintiff's claim was therefore dismissed.<sup>174</sup>

In *In re Donald J. Trump Casino Securities Litigation*,<sup>175</sup> plaintiffs alleged that Trump Casinos' prospectus failed to disclose, as required by Item 303, that there were known uncertainties regarding whether sufficient revenues could be generated to cover the debt service on the Taj Mahal.<sup>176</sup> The court dismissed the allegation, finding repeated warnings in the prospectus that there were "uncertainties" as to the Taj Mahal partnership's ability to service its debt.<sup>177</sup> Trump Casinos' prospectus clearly stated that the Taj Mahal had no history of earnings, that its operations would be subject to the risks that accompany the establishment of a new business, and that its ability to service debt was dependent on many factors not within its control.<sup>178</sup> Given these disclosures, the court stated that no reasonable jury could find that the prospectus " 'omitted to state' " uncertainties regarding the partnerships' ability to generate funds.<sup>179</sup>

Although the courts in *Ferber* and *Trump Casino* ultimately found no Rule 10b-5 liability for Item 303 violations, their analyses indicate an acceptance, at least in principle, of Item 303 violations as a basis for Rule 10b-5 actions.<sup>180</sup> However, though both cases demonstrated the courts' willingness to apply the test set forth in the SEC's 1989 Interpretive Re-

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(D.N.J. 1992). The courts dismissed these cases after determining that the defendants had, in fact, met the applicable standard for disclosure in such actions and that, contrary to plaintiffs' allegations, there were no omissions of information that should have been disclosed. See, e.g., *Ferber*, 802 F. Supp. at 711 (stating that plaintiff's allegation of a material omission for failure to comply with Item 303 failed as "a matter of law").

170. 802 F. Supp. 698 (D. Conn. 1992).

171. See *id.* at 711.

172. See *supra* text accompanying note 80.

173. *Ferber*, 802 F. Supp. at 711.

174. See *id.*

175. 793 F. Supp. 543 (D.N.J. 1992).

176. See *id.* at 558.

177. See *id.*

178. See *id.*

179. *Id.*

180. See also *Greenstone v. Cambex Corp.*, 975 F.2d 22 (1st Cir. 1992). In *Cambex*, the First Circuit acknowledged the test set forth in Item 303. However, it was uncertain as to whether that was the appropriate standard to apply. See *id.* at 28 ("We need not investigate the merits of this claim, . . . nor need we decide whether the appropriate standard is . . . 'reasonabl[e] likel[i]hood' or some other standard] . . . [for the Complaint] fails adequately to specify facts that would meet any [standard].").

lease on MD&A, their analyses are of limited precedential value because neither court provided a detailed discussion of their application of that test.

b. *Weakening Resistance to the Imposition of Rule 10b-5 Liability for MD&A Deficiencies*

The strength of the Ninth Circuit's pre-*Caterpillar* opposition to allowing Rule 10b-5 claims for Item 303 violations has yet to be directly tested in the post-*Caterpillar* disclosure environment. Based on recent actions,<sup>181</sup> it is unclear whether courts in that circuit are as staunchly opposed as they formerly were. There is some indication, in fact, that their initial hard-line approach has somewhat softened.

In *In re Lyondell Petrochemical Co. Securities Litigation*,<sup>182</sup> the Ninth Circuit was presented with the question of whether Item 303 imposes a duty to disclose internal projections. Plaintiffs alleged under Rule 10b-5 that Lyondell's prospectus failed to disclose internal projections that Lyondell had provided to its bank in connection with its public offering. In recognition of Item 303's distinction between presently known data that will have an impact upon future operating results and other forward-looking data,<sup>183</sup> the court concluded that projections are not a required disclosure under Item 303.<sup>184</sup> Because the *Lyondell* court dealt with projections rather than known trends and uncertainties, this case does not necessarily signal that the Ninth Circuit would refuse to impose Rule 10b-5 liability for Item 303 violations if presented with the correct factual scenario.<sup>185</sup>

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181. See *In re Lyondell Petrochemical Co. Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,335, at 95,704-05 (9th Cir. Jan. 29, 1993) (holding that financial forecasts are voluntary disclosures under 17 C.F.R. § 229.10(b) and are therefore not required to be disclosed under Item 303); *In re Jenny Craig Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,337, at 95,723 (S.D. Cal. Dec. 19, 1992) (holding that allegations of nondisclosures in the MD&A support Rule 10b-5 claims); *In re Cypress Semiconductor Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,060, at 94,698 (N.D. Cal. Sept. 23, 1992) (dismissing claim asserting a private right of action under Item 303 of Regulation S-K).

182. [Current Transfer Binder] Fed. Sec. L. Rep. ¶ 97,335 (9th Cir. Jan. 29, 1993).

183. See *id.* at 95,705 n.6 ("Instruction 7 of [Item 303(a)] provides in pertinent part: 'Registrants are encouraged, but not required, to supply forward-looking information. This is to be distinguished from presently known data which will impact upon future operating results, such as known future increases in costs . . . .'").

184. See *id.* at 95,705. The court's refusal to require the disclosure of projections is entirely consistent with Item 303 of Regulation S-K. Compare 17 C.F.R. § 229.303 (requiring the disclosure of known trends and uncertainties) with 17 C.F.R. § 229.10(b) (encouraging the disclosure of projections).

185. Unlike the Ninth Circuit's approach in *Convergent Technologies* where the court refused to require the disclosure of projections even though such projections indicated management's knowledge of pricing and cost problems and other uncertainties in the profitability of its product line, the Ninth Circuit's approach in *Lyondell* differed. Compare *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 510 (9th Cir. 1991) with *Lyondell*, [Current Transfer Binder] Fed. Sec. L. Rep. ¶ 97,335, at 95,704. In *Lyondell*, there was no indication that the projections reflected management's knowledge of future

In fact, in at least one instance, there has been an indication that courts in the Ninth Circuit may be stepping back from their original position opposing Rule 10b-5 liability for MD&A deficiencies. In *In re Jenny Craig Securities Litigation*,<sup>186</sup> the court declined to dismiss plaintiff's allegations of noncompliance with Item 303, noting that such claims "lend additional support to plaintiffs' [Rule 10b-5] claims."<sup>187</sup> This case may represent a shift in attitude within the Ninth Circuit.

### III. THE DUTY TO DISCLOSE FORWARD-LOOKING INFORMATION IN THE MD&A

Item 303 of Regulation S-K expressly creates an affirmative duty to disclose forward-looking information regarding the impact of events, trends, and uncertainties on a corporation's future liquidity, capital resources, and results of operations.<sup>188</sup> Such a regulation ensures that investors are provided with information about the future prospects of a corporation—an important factor in the investment decision.<sup>189</sup> Moreover, it increases the quality of information reaching investors by establishing certain standards of reliability. Item 303 is a valuable pro-investor disclosure provision because essentially, there is no better way for investors to view a corporation than through the "eyes of management."

Although Item 303 is a move in the right direction toward full and fair disclosure, its effectiveness depends upon corporate compliance with its requirements. To date, however, compliance has been problematic.<sup>190</sup> Prior to its enforcement action in March 1992 against Caterpillar, the SEC seemed more interested in studying and publicly debating disclosure compliance than enforcing it.<sup>191</sup> The courts, too, have been of little

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problems. In fact, the court indicated that "[t]he outcome of the present case would be entirely different had plaintiff alleged Lyondell's internal predictions were based on existing . . . factors known only to the [Lyondell]." *Id.* It would appear, therefore, that the *Lyondell* court made a correct determination that the forward-looking information at issue was not required to be disclosed by Item 303 but was merely a voluntary disclosure under 17 C.F.R. § 229.10(b). Given that factual scenario, the outcome in *Lyondell* is not inconsistent with the outcomes in *Ferber v. Travelers Corp.*, 802 F. Supp. 698 (D. Conn. 1992) and *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543 (D.N.J. 1992) which dealt with forward-looking information that was required by Item 303.

186. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,337 (S.D. Cal. Dec. 19, 1992).

187. *Id.* at 95,723.

188. See 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,841-42.

189. See, Poole, *Improving the Reliability*, *supra* note 16, at 550. The investment decision-making process is future-oriented. With access to forward-looking information about a corporation, investors can better analyze a security's expected risk and return and therefore make sounder investment decisions.

190. See, e.g., 1989 Interpretive Release, *supra* note 17, ¶ 72,436, at 62,145 (noting that 206 of 218 corporations in phase I of its review and 139 of 141 corporations in phase II were requested to amend or supplement their MD&A or upgrade future compliance with Item 303).

191. See *id.*

assistance in enforcing compliance with Item 303's disclosure obligation. They have been, in some instances, completely unwilling to enforce Item 303 through the securities fraud provisions,<sup>192</sup> and in others uncertain about where to draw the line in determining whether there is a duty to disclose under Item 303.<sup>193</sup> The combined result is that, although the disclosures required under Item 303 are extremely valuable to investors, Item 303 has not been enforced in a way that assures this information reaches investors.

A. *Imposition of Rule 10b-5 Liability for Nondisclosures in the MD&A*

The problem of non-compliance with Item 303 may be partially remedied by the grant of unprecedented cease and desist powers to the SEC in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.<sup>194</sup> It is apparent from the March 1992 *Caterpillar* order that the SEC is willing to use its new power to force compliance with Item 303's requirements. In fact, some commentators expect that in the future, "the [SEC] will be less likely to settle similar alleged misconduct with a cease-and-desist order and will, instead, seek to ratchet upward the penalties to be imposed."<sup>195</sup>

In addition to the SEC's willingness to use its enforcement powers, corporate management is likely to face other strong incentives to comply with Item 303's disclosure requirements. In particular, it appears that

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192. See *supra* notes 157-67 and accompanying text.

193. See *supra* notes 151-55, 169-80, and accompanying text.

194. The Securities Enforcement Remedies Act gives the SEC broad authority to enter cease and desist orders restraining any violation of the securities laws by any person (or corporation). See 15 U.S.C. § 78u-3 (Supp. II 1990). This new authority was used by the SEC in its enforcement action against *Caterpillar* for MD&A violations. See *Caterpillar*, *supra* note 11, at 63,050.

The SEC's new cease and desist powers represent a significant increase over those powers previously held by the SEC under the authority of § 15(c)(4) of the 1934 Act. This section gave the SEC limited authority to enter orders compelling compliance with §§ 12, 13, 14, and 15 of the 1934 Act. The existence of this authority, however, was largely ineffective for the SEC was not given the corresponding power to enter penalties for non-compliance with its order. See Harold S. Bloomenthal & Samuel Wolff, *Emerging Trends In Securities Law* (1991 ed.).

Under the new provisions, the SEC may enter an order against any person (or corporation) violating the securities laws and direct such person (or corporation) to "cease and desist from committing or causing such violation and any future violation." 15 U.S.C. § 78u-3(a) (Supp. II 1990). In addition, the SEC may order the corporation to take specific steps to effect compliance within a period of time specified by the SEC and if the cease and desist order is violated, the SEC may initiate a proceeding to impose a civil penalty. See 15 U.S.C. § 78u(d)(3)(A) (Supp. II 1990). In addition, in any cease and desist proceeding, the SEC may order disgorgement of any profit obtained as a result of the violation. See 15 U.S.C. § 78u-3(e) (Supp. II 1990). Thus, the SEC now has a powerful weapon to enforce the securities laws.

195. Pitt et al., *supra* note 12, at 487 (indicating that, to date, the SEC's activity in the area of MD&A disclosures demonstrates similarities to an enforcement pattern commonly used by the SEC).

with the SEC's recent focus on MD&A disclosure requirements in *Caterpillar*, courts may begin to put aside their reluctance toward imposing a duty to disclose forward-looking information in the MD&A. Corporate management may therefore find its once overlooked disclosures (or nondisclosures) now subject to scrutiny from two sides of the legal system—the administrative side in SEC enforcement actions and the judicial side in Rule 10b-5 nondisclosure actions.

### 1. Duty of Disclosure Under Rule 10b-5

Under Rule 10b-5, the general rule is that there is no affirmative duty to disclose all material information.<sup>196</sup> This means that Rule 10b-5 liability cannot be based on a failure to disclose material information unless an affirmative duty to disclose exists. Courts, however, have created numerous exceptions to the general rule. Among the specific circumstances that trigger an affirmative duty to disclose are when a corporate insider trades on confidential information, when a corporation has made incomplete or misleading prior disclosures, and when a statute or regulation requires disclosure.<sup>197</sup> Since Item 303 of Regulation S-K creates a mandatory disclosure requirement, under the third exception listed above, it also creates an affirmative duty to disclose the type of forward-looking information specified in the regulation. Therefore, a violation of Item 303, arguably, is sufficient for imposition of Rule 10b-5 liability. Courts may decide to seize the opportunities offered by this exception and enforce the affirmative duties of Item 303 under Rule 10b-5.<sup>198</sup>

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196. See *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *Chiarella v. United States*, 445 U.S. 222, 230 (1980); *Milton v. Van Dorn Co.*, 961 F.2d 965, 968 n.4 (1st Cir. 1992); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7th Cir. 1989); *Taylor v. First Union Corp.*, 857 F.2d 240, 243 (4th Cir. 1988), *cert. denied*, 489 U.S. 1080 (1989); *Jett v. Sunderman*, 840 F.2d 1487, 1493 (9th Cir. 1988); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987); *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985); *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 984 (3d Cir. 1984); *Staffin v. Greenberg*, 672 F.2d 1196, 1202 (3d Cir. 1982); *Alfus v. Pyramid Technology Corp.*, 764 F. Supp. 598, 601 (N.D. Cal. 1991); *Johnston v. Wilbourn*, 760 F. Supp. 578, 582 (S.D. Miss. 1991); *Dillon v. Militano*, 731 F. Supp. 634, 638 n.6 (S.D.N.Y. 1990); *Holstein v. Armstrong*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,801, at 98,855 (N.D. Ill. 1990); *Tew v. Chase Manhattan Bank, N.A.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,903, at 94,999-001 (S.D. Fla. 1990); *Antinoph v. Laverell Reynolds Sec., Inc.*, 703 F. Supp. 1185, 1189 (E.D. Pa. 1989); *Jaroslawicz v. Engelhard Corp.*, 704 F. Supp. 1296, 1299 (D.N.J. 1989); *Lessner v. Casey*, 681 F. Supp. 415, 416 (E.D. Mich. 1988).

197. See *Glazer v. Formica Corp.*, 964 F.2d 149, 156-57 (2d Cir. 1992); *Royal Business Group v. Realist, Inc.*, 933 F.2d 1056, 1065 (1st Cir. 1991); *Backman v. Polaroid Corp.*, 910 F.2d 10, 12-13 (1st Cir. 1990); *Roeder v. Alpha Indus. Inc.*, 814 F.2d 22, 25 (1st Cir. 1987); *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1128 (D. Del. 1988); *Block et al., Affirmative Duties*, *supra* note 14, at 1245-55 (discussing these and additional affirmative disclosure duties); *Victor Brudney, A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 Va. L. Rev. 723, 726-27, 736-48 (1989); *Carl W. Schneider, Soft Information: Counseling on Disclosure*, 18th Annual Instit. on Sec. Reg. 351, 358-80 (1986).

198. Despite the affirmative disclosure duty created by Item 303, there appear to have been few attempts to base Rule 10b-5 claims on Item 303 violations. Of the few attempts,

## 2. Standard to Be Applied in Rule 10b-5 Cases

The question of whether Rule 10b-5 liability may be imposed for failure to comply with the affirmative duty established by Item 303 has been relatively untested in the courts.<sup>199</sup> The few courts that have attempted to sort through the requirements of Item 303 have taken expected but disappointingly inconsistent approaches to the imposition of Rule 10b-5 liability for MD&A deficiencies. At one end of the spectrum are courts which interpret Item 303 as not requiring the disclosure of any forward-looking information.<sup>200</sup> At the other end of the spectrum are courts that recognize an affirmative duty to disclose, but that appear easily satisfied that the Item 303 test has been met.<sup>201</sup> From this variety of approaches,

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none have succeeded. The reasons for this are many. First, although the language of Item 303 sets up a mandatory disclosure requirement, it is possible that Item 303 was misperceived by the courts as only an experimental part of the SEC's disclosure system. For example, when the Advisory Committee conducted its review of the SEC's disclosure policies in 1978, it had recommended that the SEC establish experimental programs to improve, among other things, the management discussion and analysis section, which it deemed to be potentially one of the most valuable sections of a disclosure report. See Advisory Committee Report, *supra* note 5, at 88,667-68; see also *Walker v. Action Indus. Inc.*, 802 F.2d 703, 709 (4th Cir. 1986) ("We perceive the current SEC regulatory environment to be [in] an experimental stage regarding [forward-looking] disclosures."), *cert. denied*, 479 U.S. 1065 (1987). A second possible explanation of why there have been so few Rule 10b-5 actions based on Item 303 violations, is that, at least until the 1989 Interpretive Release, there was little guidance for plaintiffs attorneys to fashion a Rule 10b-5 claim out of such violations. That plaintiff lawyers were uncertain of how to bring such a claim is evident from the early Ninth Circuit cases. See *supra* note 156. In those cases, they failed to allege a violation of SEC disclosure rules. Whatever the public opinion was on MD&A, whether MD&A was viewed as a serious provision or as a mere experiment, it is clear that today the SEC regards it as an extremely important section that requires greater attention.

199. The issue of whether Item 303 imposes an affirmative disclosure duty, however, has received considerable attention from commentators. See, e.g., Fifiis, *supra* note 68; Pitt et al., *supra* note 12; Dennis J. Block & Jonathan M. Hoff, *MD&A Disclosures in a Weak Economy*, N.Y. L.J., Feb. 28, 1991, at 5; Dennis J. Block & Jonathan M. Hoff, *The SEC's 'Caterpillar' Order: Trends In MD&A Disclosure*, N.Y. L.J., July 2, 1992, at 5.

200. See *supra* notes 156-67 and accompanying text.

201. See *Ferber v. Travelers Corp.*, 802 F. Supp. 686 (D. Conn. 1992); *In re Bell Atlantic Corp. Sec. Litig.*, 1991 WL 234236, at \*8-\*9 (E.D. Pa. Oct. 31, 1991). Although the court in *Bell Atlantic*, recognized the test set forth by Item 303 and even cited examples from the 1989 Interpretive Release, its discussion indicates that it may have applied that test incorrectly. The *Bell Atlantic* court indicated that the "reasonable likelihood" test of Item 303 would have been satisfied by a numerical chart contained in the Form 10-Q which listed growth in revenues for the preceding quarter. *Id.* Although the historical data contained in the chart numerically demonstrated a negative trend in earnings, the SEC, in its 1987 Concept Release specifically stated that facts disclosed elsewhere in an SEC filing must also be analyzed in the MD&A section if they are reasonably likely to have an impact on future earnings. See 1987 Concept Release, *supra* note 73, at 88,623. Since the SEC's concept release implies the need for more than a chart to satisfy the Item 303 test, it appears that the *Bell Atlantic* court's statement, implying that it would have found that the alleged omissions had been disclosed, contradicts SEC requirements.

The *Ferber* court's analysis appears to be more in line with the Item 303 test. There, the court reviewed Traveler's SEC filings to determine whether Travelers had discussed trends in the local real estate market, as well as trends in Travelers' portfolios. However, though the court treated Item 303 as the source of an affirmative disclosure duty, it

it is evident that courts are not yet comfortable with using Item 303 to impose an affirmative duty to disclose forward-looking information.<sup>202</sup>

Item 303, however, does impose an affirmative duty to disclose. Plaintiff attorneys therefore can be expected to continue basing Rule 10b-5 claims on Item 303 violations. In light of this affirmative duty and the expectation of increased litigation, it is unacceptable for the courts to continue approaching the issues raised in these suits in the inconsistent ways that they have to date. If, in Rule 10b-5 actions, courts are unwilling or unable to apply the Item 303 materiality test as written, the question is whether the same result can be obtained if courts apply their own tests to nondisclosures in the MD&A.<sup>203</sup> To ascertain whether this is possible, it is necessary to compare the forward-looking disclosures which the SEC has required under Item 303 against the forward-looking disclosures that courts have required under their own tests.<sup>204</sup>

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hedged its finding by analyzing whether the filings as a whole were sufficiently cautionary about the future. An analysis of the overall cautionary nature of SEC filings is proper only in determining a corporation's liability for representations, not omissions. See *infra* notes 256-73 and accompanying text (discussing safe harbor protection for forward-looking statements, not omissions). To treat omissions otherwise would bypass the function of the MD&A, which is to allow investors to view the corporation through the eyes of management. For example, a court focused solely on the overall cautionary language of an SEC filing might be satisfied by a statement that "the economy is uncertain and future earnings may be lower, due to increases in nonperforming loans," whereas the affirmative duty imposed by Item 303 may require a statement closer to "nonperforming loans increased X% over the last two years; there is no foreseeable improvement; if the trend continues, there is a potential loss of \$Y1-\$Y2; the corporation is currently attempting to combat this problem with Plans Z1, Z2 and Z3." It is unclear whether the *Ferber* court would have been satisfied by cautionary language alone. The *Trump Casino* court, however, was clearly satisfied. This result is undesirable. Like the SEC's safe harbor provisions, the "bespeaks caution" doctrine, see *infra* notes 271-73, is intended to encourage forward-looking disclosures by protecting such disclosures once made. This intention is obviously defeated if the doctrine is applied to protect omissions.

202. The reluctance of the courts to find an affirmative duty to disclose may possibly stem from their unwillingness to use the materiality test for Item 303 disclosures, as set forth in the 1987 Concept Release and the 1989 Interpretive Release. Courts may be uncomfortable with the fine distinction drawn by the test:

Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*. . . .

In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.

1989 Interpretive Release, *supra* note 17, ¶ 73, 193, at 62,842. Without guidance, it can be difficult to determine whether information falls into the required disclosure category or the optional disclosure category. See, e.g., James J. Maiwurm, *Annual Disclosure in a Declining Economy—Some Year-End Reminders*, 5 Insights (P-H), at 3 (Jan. 1991) (describing the distinction as "a wide and murky grey area").

203. See *supra* notes 124-47 and accompanying text (describing approaches to the disclosure of forward-looking information outside of the Item 303 context).

204. In making this comparison, one should keep in mind that courts have addressed the duty to disclose forward-looking information entirely outside of the Item 303 context. As such, they have not analyzed the cases from the standpoint of whether a statute or regulation imposes an affirmative disclosure duty, but rather, whether an affirmative disclosure duty arose in order to make the corporation's prior disclosures not misleading.



a. *Material Information That the SEC Would Require to Be Disclosed Under Item 303*

Since the adoption of Item 303 of Regulation S-K, there have been several SEC enforcement actions alleging MD&A deficiencies. In addition, the SEC has issued interpretive guidance on the disclosure requirements of Item 303. From these items it is possible to extrapolate broader categories of forward-looking information which the SEC would find to be material under the Item 303 test.<sup>205</sup> The SEC has and most likely will continue to find an affirmative duty to disclose the following types of forward-looking information under Item 303.<sup>206</sup>

i. *Changes in a Significant Component of the Corporation's Business*

The SEC enforcement actions and interpretive releases indicate that whenever known trends, events, and uncertainties are likely to affect a significant component of the corporation's business—for example, a subsidiary which is a major contributor to the corporation's bottom line or a customer which purchases a large percentage of the corporation's output—the corporation should make a disclosure in the MD&A. Moreover, it is evident that simply breaking the financial statements into segments is insufficient. A full discussion of the events affecting the component and their expected impact on the corporation is necessary. For instance, in *Caterpillar*,<sup>207</sup> the SEC noted that CBSA had accounted for a

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Court have used this approach largely because, other than the duty imposed by the MD&A regulations, there is no statutorily-imposed duty to disclose forward-looking information. See *supra* notes 124-47 and accompanying text.

205. In addition to its enforcement actions and detailed examples from actual MD&As that were filed, the SEC has occasionally generated its own hypothetical examples of information that may be required to be disclosed in the MD&A. One such example, included in the 1987 Concept Release, contains the following information:

1. Material changes in product mix or in the relative profitability of lines of business;
2. Material changes in advertising, research, development, product introduction or other discretionary costs;
3. The acquisition or disposition of a material asset other than in the ordinary course of business;
4. Material and unusual charges or gains, including credits or charges associated with discontinuation of operations;
5. Material changes in assumptions underlying deferred costs and the plan for amortization of such costs;
6. Material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; and
7. The closing of a material facility or material interruption of business or completion of a material contract.

1987 Concept Release, *supra* note 73, at 88,624.

206. For additional categories extrapolated solely from the *Caterpillar* release, see Pitt et al., *supra* note 12, at 488-90.

207. The *Caterpillar* opinion has been described as a "meaningful document, offering significant guidance . . . as to the interpretation of [the SEC's] disclosure requirements." *Id.* at 487. The SEC's opinion emphasizes certain factors that it apparently believes

significant portion (23%) of Caterpillar's net profits in 1989.<sup>208</sup> The SEC concluded that any "reasonably likely" negative changes in CBSA's operations therefore should have been disclosed in Caterpillar's MD&A because Caterpillar's own bottom line would be significantly affected.<sup>209</sup> Moreover, the SEC noted that the mere display of CBSA's results on a segregated basis would not have obviated the need to discuss CBSA's operations in Caterpillar's MD&A.<sup>210</sup>

In *In re American Express Co.*,<sup>211</sup> the SEC found MD&A deficiencies in Amex's 1981 and 1982 SEC filings. The corporation's MD&A failed to discuss its insurance subsidiary's reinsurance transactions which accounted for forty percent of Amex's 1981 and 1982 revenues.<sup>212</sup> The reinsurance transactions at issue had been implemented to shift the subsidiary's income to periods when the rest of the insurance industry showed decreased earnings.<sup>213</sup> Although Amex's MD&A discussed the increased earnings of its insurance subsidiary, it did not attribute the gain to the reinsurance transactions at issue or indicate that the gain was responsible for forty percent of Amex's revenue.<sup>214</sup> Nor did its MD&A discuss that such gains were not reasonably likely to be repeated.

Similarly, in *Securities Exchange Commission v. Ronson Corp.*,<sup>215</sup> the SEC indicated that Ronson's MD&A was deficient for failing to discuss the effect on Ronson's operating results that were reasonably likely to occur from the alteration in a major customer's manufacturing process. The customer, which accounted for approximately fifteen percent of Ronson's revenues, was making technological changes that Ronson expected to result in a thirty to fifty percent reduction in purchases.<sup>216</sup> Although Ronson's financial data reflected both a decline in sales and the importance of that customer, the SEC found Ronson's MD&A deficient because it did not disclose Ronson's knowledge of its customer's alterations and the reasonably likely reduction in future purchases.<sup>217</sup>

In its 1989 Interpretive Release, the SEC gave an example of a sufficient MD&A in a hypothetical situation similar to that at issue in *Ronson*.<sup>218</sup> In the example, the MD&A disclosed that a principal customer accounting for approximately thirty percent of revenues intends to termi-

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should have alerted management to the need for further MD&A disclosures. See *Caterpillar*, *supra* note 11 and accompanying text.

208. See *Caterpillar*, *supra* note 11, at 63,051.

209. See *id.* at 63,055.

210. See *id.* at 63,051 n.1.

211. Exchange Act Release No. 23,332, 35 SEC Docket 1163 (June 17, 1986).

212. See *id.* at 1164.

213. See *id.*

214. See *id.* at 1164-65, 1169-70.

215. Litigation Release No. 10,093, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,464 (Aug. 15, 1983).

216. See *id.* at 96,653.

217. See Exchange Act Release No. 19,212, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,275, at 85,479 (Nov. 4, 1982).

218. See 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,847.

nate all purchases next quarter due to recently developed in-house capabilities.<sup>219</sup> The hypothetical MD&A also discussed the company's expectations that this would have a material adverse effect on revenues and income.<sup>220</sup> In addition, the example disclosed that although efforts were being made to develop new customers, it was expected to take six months to generate replacement revenues.<sup>221</sup>

## ii. Industry Trends

The SEC enforcement actions have also indicated that a corporation must disclose in its MD&A the reasonably likely impact of any trends in its industry and environment. In *Securities Exchange Commission v. Bank of New England*,<sup>222</sup> the SEC found the bank's second quarter 1989 MD&A to be deficient despite various quantitative disclosures indicating negative trends. In the bank's second quarter Form 10-Q, the bank listed its ratio of loan loss reserves to total loans and non-performing assets. In addition, it made quantitative disclosures of non-performing asset levels, as well as general comments on the "softness" in the New England real estate market and economy. The bank's MD&A was found deficient, however, because it failed to discuss the bank's knowledge that the market was reasonably likely to continue its downward trend, thereby increasing non-performing asset levels and having substantial negative effects on future net income.

## iii. Extraordinary Results

The SEC has indicated that a corporation must discuss in its MD&A any extraordinary or one-time financial results. Included in this discussion should be the reasons for the extraordinary results, as well as the reasons why such results are not likely to recur. Although not expressly focusing on this factor, the SEC's opinion in *Caterpillar* noted that Caterpillar's Brazilian subsidiary CBSA had an "exceptionally profitable year" in 1989.<sup>223</sup> As CBSA's 1989 profit was disproportionate as an historical matter and because management knew that such profits were not reasonably likely to continue, this factor should have been discussed in Caterpillar's MD&A.

In *In re Charter Co.*,<sup>224</sup> the SEC found MD&A deficiencies for Charter's failure to discuss the one time favorable earnings effect of its treatment of annuity rollovers. Charter made a marketing decision to match interest rates offered by its competitor on annuity contracts. As a result,

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219. *See id.*

220. *See id.*

221. *See id.*

222. Litigation Release No. 12,743, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,755 (D.D.C. 1990).

223. *See Caterpillar*, *supra* note 11, at 63,051.

224. Exchange Act Release No. 21,647, [1982-1987 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,448 (Jan. 10, 1985).

many of its existing annuity holders surrendered their contracts and purchased new contracts offering higher rates. Charter treated these rollovers as a restructuring of existing contracts at higher rates, rather than as a termination of one contract and issuance of a new contract. The result was favorable to Charter's earnings in the year the contracts were rolled over but Charter expected significantly reduced future profit.<sup>225</sup> The SEC held that Charter's footnote discussing the transaction was not sufficient.<sup>226</sup> Charter should have described in the MD&A the full consequences of the transaction, making clear the likelihood that future profitability was expected to be substantially reduced.<sup>227</sup>

In another example contained in its 1989 Interpretive Release, the SEC favorably cited the MD&A of a corporation which experienced a forty-seven percent increase in operating income from the previous year.<sup>228</sup> In its MD&A, the corporation discussed the fact that nearly all of the increase was attributable to the completion of a major contract at a cost below that anticipated.<sup>229</sup> The corporation noted that it expected future operating income to be significantly less because, as a result of a slowdown in the industry, only a portion of the profit generated by the completed contract was expected to be replaced by new contracts.<sup>230</sup>

#### iv. Pending Events

The SEC's enforcement and interpretive releases indicate that pending events—for example, renegotiations of credit agreements—must be disclosed, as well as the likely outcome and the effect on the corporation. In *In re Van Landingham and Patzke*,<sup>231</sup> the corporation filed its 1983 Form 10-K three weeks prior to filing for bankruptcy. Its MD&A contained no mention of any liquidity problems even though in the period prior to the filing the corporation had experienced loss of trade credit and its banks had requested restrictive covenants as conditions to renewing existing credit lines. The corporation's MD&A contained a brief discussion of one of the requested covenants, but no discussion of the others and no disclosure of the disagreement between the corporation and its banks.<sup>232</sup> In addition, though the corporation had generated several proposals for resolving its cash problems, none were disclosed in the MD&A. The SEC held that the corporation's MD&A was deficient. It should have disclosed the implications of the corporation's discussions with its banks and the effects that its proposals could have had on its

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225. *See id.* at 63,172.

226. *See id.* at 63,176.

227. *See id.*

228. *See* 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,843.

229. *See id.*

230. *See id.*

231. Exchange Act Release No. 23,249, [1982-1987 Accounting Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,502 (June 20, 1986).

232. *See id.* at 63,349-9.

liquidity.<sup>233</sup>

In its 1989 Interpretive Release, the SEC provided an example of an acceptable MD&A in a situation similar to that in *Van Landingham*.<sup>234</sup> The MD&A discussed the corporation's violation of certain debt agreements. Moreover, although the corporation's lenders were allowing it to remain in violation, the MD&A discussed the possible effects if a default were declared.<sup>235</sup> The MD&A indicated that a capital infusion of \$4 million would be necessary to cure the default and that the company was currently considering various alternatives, including a sale of assets or common stock.<sup>236</sup>

#### v. Changes in Management's Perspectives

The SEC enforcement releases imply that any new information that is presented in detail to the Board of Directors may need further discussion in the MD&A. In the *Caterpillar* release, the SEC noted that, although Caterpillar's management had typically managed and analyzed the corporation on a consolidated basis, in 1989 it began to present to the Directors CBSA's results separately.<sup>237</sup> Under Item 303, the SEC would require disclosure of any forward-looking information viewed by management as so significant and reasonably likely to occur that it must be explained in detail to the directors.

In each of the five foregoing situations, the corporate defendant knew of trends, events, or uncertainties which were likely to have an impact upon the corporation's future financial results. The SEC has indicated that in those situations, the Item 303 test is met and an affirmative duty therefore arises.<sup>238</sup>

#### b. Comparison of SEC's Results with Results Obtained by the Courts

Due either to the courts' unwillingness or inability to apply the Item 303 materiality test, the remaining question is whether the approaches currently employed by the courts in Rule 10b-5 actions yield the same results as the approach laid out in Item 303 and taken by the SEC in its enforcement actions. The four basic approaches employed by the courts, however, appear insufficient in that regard.

The traditional approach<sup>239</sup> clearly does not yield the same result as Item 303's materiality test. This approach holds that all predictive information is immaterial as a matter of law. Therefore, courts utilizing this

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233. *See id.* at 63,349-10.

234. *See* 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,845.

235. *See id.*

236. *See id.*

237. *See Caterpillar*, *supra* note 11, at 63,051.

238. Corporate management must include a discussion of these items if the corporation is to avoid an SEC enforcement action.

239. *See supra* text accompanying notes 126-29.

approach would never find a duty to disclose the forward-looking information required by Item 303.

The reasonable certainty approach<sup>240</sup> presents a similar problem. Under that approach, courts will not impose a duty to disclose unless the forward-looking information is reasonably certain. Much of the information required to be disclosed under the Item 303 materiality test is “reasonably certain” in the sense that management knows a current event is likely to have an impact on the future. The second prong of Item 303’s test, however, also requires the disclosure of known events whose potential impact management cannot determine with certainty.<sup>241</sup> At least with regard to this latter category of information, the reasonable certainty test would render a different result than the Item 303 test.

The substantial certainty test<sup>242</sup> suffers from the same problem as the reasonable certainty test. By not requiring disclosure of forward-looking information unless it is “virtually as certain as hard facts,”<sup>243</sup> this test would not require disclosure of forward-looking information falling under the second prong of Item 303’s test—known events whose impact cannot be determined with certainty.<sup>244</sup> In this regard, the substantial certainty test would yield results inconsistent with those obtained by the Item 303 test.

The balancing test employed by the Third Circuit<sup>245</sup> comes closest to yielding results consistent with Item 303’s materiality test. Even this test, however, falls short of requiring the same disclosures as the Item 303 test. Factors bearing on the relevance of information, such as its availability from other sources, might permit courts to find sufficient, disclosure that the Item 303 test would find inadequate. For example, Item 303 would require discussion of information in the MD&A even if information bearing on the issue was quantitatively included in the same filing.<sup>246</sup> The balancing test, however, might find irrelevant a discussion of information that is already included in quantitative form.<sup>247</sup> Under that situation, the balancing test would lead to a different result than Item 303’s materiality test.

### c. *Closing the Gap*

The approaches currently used by the courts clearly are insufficient in

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240. See *supra* notes 130-37 and accompanying text.

241. See *supra* text accompanying note 80.

242. See *supra* text accompanying notes 138-42.

243. *Starkman v. Marathon Oil Co.*, 722 F.2d 231, 241 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

244. See *supra* text accompanying note 80.

245. See *supra* text accompanying notes 143-47.

246. See 1989 Interpretive Release, *supra* note 17, ¶ 73,193, at 62,843.

247. See *In re Bell Atlantic Corp. Sec. Litig.*, 1991 WL 234236, at \*8-\*9 (E.D. Pa. Oct. 30, 1991) (indicating court would have found Item 303 satisfied by quantitative chart in filing, even though there was no discussion of the impact reasonably likely to result from the trend indicated in the chart).

that they would yield results inconsistent with those that the SEC intended.<sup>248</sup> Under any of the approaches currently taken by the courts, forward-looking information would be disclosed less frequently than if the Item 303 materiality test were properly implemented. This disparity is undesirable.

Courts must modernize their approach to the disclosure of forward-looking information. For more than a decade, they have lagged behind the SEC in this area.<sup>249</sup> Now that the SEC is progressing further, by mandating the disclosure of known trends, events, demands, and uncertainties that are reasonably likely to have a material future impact, the distance between the SEC and the courts will widen unless there is a response from the courts.

The most logical response, and the response that would move the courts closest toward the SEC's position, would be for courts to adopt the materiality test set forth in the SEC's 1989 Interpretive Release.<sup>250</sup> Although to date, the courts have indicated discomfort with doing so, there is an immense amount of information available to guide courts through the process of applying that test. The courts' unease appears to derive primarily from the test's fine distinction between known trends, events, demands, and uncertainties and the anticipation of those events.<sup>251</sup> To date, however, courts have not looked to SEC enforcement actions or the examples contained in the SEC's interpretive release<sup>252</sup> in attempting to sort through the difference. These materials should be used by the courts. They provide invaluable background on the issue and help clarify the meaning of a test whose language is unclear to the courts.<sup>253</sup> Not only do these materials help to clarify the test, but in

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248. Nor is the problem resolved by courts that have refused to adopt any of the four general approaches. *See Garcia v. Cordova*, 930 F.2d 826 (10th Cir. 1991); *Isquith v. Middle S. Utils.*, 847 F.2d 186 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988). These courts utilize a case-by-case approach. They take into consideration the policy interests of requiring disclosure, the nature of the particular predictive information, and the specific facts indicating importance, reliability, and investor impact. *See, e.g., id.* at 206. Again, the results of this test can be expected to differ from the results of the Item 303 test with respect to information whose impact management cannot predict with certainty.

249. *See supra* notes 122-47 and accompanying text.

250. *See supra* text accompanying note 80.

251. The SEC, in its 1989 Interpretive Release, attempted to clarify the distinction between the different types of forward-looking information. *See supra* note 89. Courts and management alike appear to have difficulty distinguishing between the two. However, with respect to the remaining portion of Item 303's materiality test, *see supra* text accompanying note 80, there appears to be less confusion or at least, to date, no action has focused on the "reasonably likely [to have a material effect]" aspect of the test.

252. *See supra* text accompanying notes 205-38.

253. In addition, it is useful to review the accounting standards governing this area of disclosure. One commentator has suggested that the distinction between known trends, events and uncertainties and anticipations of the future has its antecedents in the auditor's distinction between "projections," which are extrapolations from historic data, and "forecasts" which are hypothetically assumed future events. *See Fiflis, supra* note 68, at \*3; *see also Doyle, supra* note 140, at \*1 ("To bring [forward-looking information] more into mainstream disclosure, there should be greater recognition of the interplay between

some instances they may strongly suggest a resolution to a particular factual situation before a court. For instance, had the court in *In re Verifone Securities Litigation*<sup>254</sup> reviewed the SEC materials, it may have decided that the forward-looking information at issue in that case—decreased future earnings due to non-renewal of one-time orders—was required to be disclosed.<sup>255</sup> Although a review of SEC enforcement actions and interpretive releases cannot be expected to provide an easy answer in all or even most cases, it will provide the courts with some necessary guidance in applying the Item 303 materiality test. Therefore, it appears unnecessary for courts to develop yet another test, when doing so would only mean backtracking over ground already covered by the SEC.

### B. Safe Harbor Protection for Item 303 Disclosures

One expected result of the SEC bringing further enforcement actions and the courts imposing Rule 10b-5 liability for 303 violations is increased compliance with Item 303's forward-looking disclosure requirements. In transforming nondisclosures into affirmative forward-looking statements, however, corporations will be exposed to greater liability under the federal securities laws for their representations, rather than their omissions. Once disclosed, the forward-looking statements required by Item 303 will be subject to the same requirements of accuracy and completeness as any other public statement made by a corporation. As a result, the importance of the SEC safe harbor rules, Rules 175 and 3b-6,<sup>256</sup> will grow.

SEC Rules 175 and 3b-6 provide safe harbors for forward-looking information disclosed in periodic reports, proxy materials, and prospectuses.<sup>257</sup> These provisions state that a disclosure will not be deemed fraudulent unless "it is shown that such statement was made . . . without a reasonable basis or was disclosed other than in good faith."<sup>258</sup> Although the safe harbor rules explicitly cover Item 303 disclosures and voluntary forward-looking disclosures,<sup>259</sup> it appears that courts have infrequently relied on these rules in determining Rule 10b-5 liability for any type of forward-looking statements. Given the expected increase in forward-looking disclosures, what is required is a more concerted effort by the courts to offer a safe harbor to corporations that have complied with the relevant disclosure rules.

Although application of the safe harbor provisions has been infrequent, there appears to be a developing trend toward protection of for-

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legal and accounting concepts in determining when prospective . . . information . . . should be used."). Although the MD&A distinction is not identical to the auditing distinction, the underlying nature of the MD&A and accounting concepts are similar.

254. 784 F. Supp. 1471 (N.D. Cal. 1992).

255. See *supra* notes 164-67 and accompanying text.

256. See 17 C.F.R. §§ 230.175, 240.3b-6 (1992).

257. See *supra* text accompanying notes 50-63.

258. 17 C.F.R. §§ 230.175(a), 240.3b-6 (1992).

259. See *supra* text accompanying note 56.



ward-looking statements. In two recent Seventh Circuit cases, the court applied Rule 175, granting summary judgment for the defendants in one action<sup>260</sup> and dismissing the other action.<sup>261</sup> In *Wielgos v. Commonwealth Edison Co.*,<sup>262</sup> Commonwealth shareholders asserted that the corporation lacked a reasonable basis for the cost projection disclosed in its 1983 prospectus that later turned out to be inaccurate. Commonwealth included in its prospectus a projection of the cost of completing a nuclear reactor that it was building. The projection had been prepared nine months prior to the prospectus and was out of date, but the court found the cost projection to have a reasonable basis because the prospectus incorporated Commonwealth's latest quarterly report which discussed the expected increase in costs.<sup>263</sup> Moreover, the court reasoned that since Rule 175 assumes investors are sophisticated and can understand the limits of a projection,<sup>264</sup> corporations need not disclose tentative internal projections that differ from disclosed projections, unless such internal projections are so certain that the published figures are misleading.<sup>265</sup> The court granted summary judgment for Commonwealth because plaintiffs failed to meet their burden of showing that Commonwealth's projections were made without a reasonable basis or without good faith.<sup>266</sup>

The Seventh Circuit again applied Rule 175 in *Roots Partnership v. Lands' End, Inc.*<sup>267</sup> Lands' End discussed its earnings goals in its 1989 Form 10-K and in various press releases.<sup>268</sup> Plaintiffs alleged that defendant's goal of ten percent pre-tax profits lacked a reasonable basis because it differed from internal projections which indicated an expected pre-tax profits of 9.38%. The court found that this differential did not suggest Lands End's predictions "fell outside the realm of reasonable probability [or] lacked a reasonable basis."<sup>269</sup> It dismissed the case be-

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260. See *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989).

261. *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411 (7th Cir. 1992).

262. 892 F.2d 509 (7th Cir. 1989).

263. See *id.* at 512.

264. See *id.* at 515.

265. See *id.* at 516 (noting that to require the disclosure of tentative estimates would mean "that once the annual cycle of estimation begins, a [corporation would have to] cease selling stock until it has resolved internal disputes and is ready with a new projection").

266. See *id.* at 513 (noting that the only question before the court was whether the statements lacked a reasonable basis because plaintiffs had not attempted to establish a lack of good faith).

267. 965 F.2d 1411 (7th Cir. 1992).

268. Given that the forward-looking information at issue appeared in a Form 10-K rather than a registration statement or prospectus, the court would have correctly considered this case under Rule 3b-6. Rule 3b-6 provides a safe harbor for statements in documents required by the 1934 Act as opposed to Rule 175, which provides a safe harbor for statements in documents required by the 1933 Act. Since the language of both Rules is identical, however, the outcome would have been the same. For an indication of how courts would apply Rule 3b-6, see *In re Bally Mfg. Sec. Corp. Litig.*, 141 F.R.D. 262, 271-273 (N.D. Ill. 1992) (dismissing case because plaintiffs failed to allege facts sufficient to defeat Rule 3b-6's safe harbor).

269. *Roots*, 965 F.2d at 1418.

cause plaintiffs failed to sufficiently allege the lack of good faith or a reasonable basis in making the prediction.<sup>270</sup>

Other circuits, though not relying on Rules 175 or 3b-6, have begun to apply essentially what is a common law safe harbor rule for forward-looking statements.<sup>271</sup> This rule, also known as the "bespeaks caution" doctrine, applies primarily to offering materials that are accompanied by forward-looking statements. To the extent that such materials are accompanied by *adequate* cautionary language,<sup>272</sup> the included forward-looking statements are not actionable as securities fraud. To date, it appears that this doctrine has been adopted in four circuits.<sup>273</sup>

The courts' application of Rules 175 and 3b-6 and of the "bespeaks caution" doctrine brings the law in the area of forward-looking disclosures more in-line with the framework established by the SEC. Even today, however, only half of the circuits apply such safe harbor protection to forward-looking disclosures. Moreover, the safe harbor provisions appear to be applied primarily to forward-looking statements contained in offering materials. This practice leaves uncovered a wide range of other forward-looking statements, particularly those appearing in periodic reports and proxy statements. If Item 303 is to be enforced by the courts under Rule 10b-5 and by the SEC under their cease and desist powers, then courts must give effect to all statutory provisions, or their functional equivalents, that are expressly applicable to Item 303 disclosures. To require the disclosure of forward-looking information by corporations who might otherwise not do so, but to not allow those corporations to use the safe harbor statutory provisions that protect mandatory forward-looking disclosures, would produce an unjust result.

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270. *See id.*

271. *See Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991) (dismissing securities claims pertaining to forward-looking statements in offering materials); *I. Meyer Pincus & Assoc. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991) (same); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040-41 (6th Cir. 1991) (dismissing securities claims pertaining to forward-looking statements in press release); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991) (dismissing securities claims pertaining to forward-looking statements made in registration statement and prospectus).

272. Although the adequacy of the cautionary statements is to be decided on a case-by-case basis, it is clear that in all instances mere boilerplate risk statements will be insufficient to invoke the protection of this doctrine. *See, e.g., In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 553 (D.N.J. 1992).

273. Those circuits include the First, Second, Sixth, and Eighth. *See supra* note 271 for a list of the relevant cases; *see also Barrios v. Paco Pharmaceutical Servs., Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,373, at 95,973-74 (S.D.N.Y. Mar. 4, 1993) (involving forward-looking statements in private placement memoranda); *In re Worlds of Wonder Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,355, at 95,811-814 (N.D. Cal. Jan. 20, 1993) (involving forward-looking statements in prospectus); *Porter v. Shearson Lehman Bros. Inc.*, 802 F. Supp. 41, 57 (S.D. Tex. Aug. 3, 1992) (same); *Shochat v. Weisz*, 797 F. Supp. 1097, 1110-12 (E.D.N.Y. June 23, 1992) (involving forward-looking statements in private placement memoranda); *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543 (D.N.J. Jun. 2, 1992) (involving forward-looking statements in prospectus).

## CONCLUSION

A major objective of the federal securities laws is to provide investors with relevant information upon which to base investment decisions. Forward-looking information is among the most vital information because it deals with the essence of the investment process—the expected return on the investment. While the SEC's evolving efforts to achieve investor understanding is laudable, the standards for disclosure, particularly as they relate to forward-looking information, remain uncertain.

Although the SEC's policy regarding the mandatory disclosure of forward-looking information is satisfactory, the distinction that the SEC has drawn between required and optional disclosures is so subtle that corporations and courts alike find Item 303 of Regulation S-K difficult to apply. This, in turn, has resulted in corporations neglecting to disclose valuable information to investors.

The SEC ultimately may need to clarify what it means by "known trends, events and uncertainties." In the interim, however, courts must look to SEC enforcement materials and interpretive releases for guidance in determining whether there is a duty to disclose. In addition, the courts need to adopt a unified approach to granting a safe harbor to corporations disclosing forward-looking information. The unified approach should be based on the safe harbor requirements set forth by the SEC in Rules 175 and 3b-6. Only after the current confusion regarding the mandatory disclosure of forward-looking information in the MD&A is resolved, can the problem regarding disclosure of other forward-looking information, such as forecasts, be confronted.