The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions

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The conventional wisdom is that the puffery defense is inapplicable in securities regulation. However, appellate courts in almost every federal circuit have recently used the puffery defense to dismiss private securities fraud actions that were based on vague statements of corporate optimism. This Article demonstrates that the courts have misused the puffery defense and have improperly insulated companies from liability for their misrepresentations. It contends that the assumptions justifying the use of the puffery defense are not present in securities transactions and that the federal securities laws have expressly rejected the very doctrine underlying the puffery defense—caveat emptor. Arguing that the courts have erroneously substituted the puffery defense for a full materiality analysis, this Article offers a framework for addressing the materiality of vague statements of corporate optimism.

I. INTRODUCTION

The leading securities regulation treatise boldly declares that the puffery defense "has all but gone the way of the dodo."[1] However, recent cases[2] demonstrate that the puffery defense is alive and well and being used—and often misused—by federal courts to dismiss private securities fraud actions brought under the federal securities laws.[3]

The federal securities laws provide that an investor may bring suit[4] against a

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[1] 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3434 (3d ed. 1991).

[2] *See infra* notes 59, 77, 84, & 94–95.

[3] For purposes of this Article, "federal securities laws" means the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1994), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (1994).

[4] The federal securities laws provide several express private rights of action for fraud. *See* Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1994) (providing private right of action for false or misleading statements appearing in a registration statement); Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (1994) (providing private right of action for false or misleading statement in a prospectus or oral communication); Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r(a) (1994) (providing private right of action for false or misleading statements in

company[5] if the company makes a material misstatement in connection with the purchase or sale of a security.[6] However, if the company is able to persuade the court that its statement was mere "sales talk" (*i.e.*, that the statement was too vague, promotional, or hyperbolic), the court will designate the statement as "puffery." If the statement is labeled as puffery, it is deemed to be immaterial as a matter of law. Because one of the required elements of securities fraud—materiality—is absent, the court will dismiss the action. Clearly then, the puffery defense offers a defendant a powerful tool to avoid liability under the federal securities laws.[7] Once a court determines that a statement constitutes puffery, the company will be shielded from liability arising from that statement.

The courts have long used the puffery defense to insulate securities brokers from liability for statements such as: "This security is a great investment."[8] More recently, however, courts have extended the protections of the puffery defense to *non-broker* defendants, such as corporate officers and directors.[9] In these cases, the courts used the puffery defense to dismiss actions based on vague statements of

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documents filed with the Securities and Exchange Commission).

In addition to these express private rights of action, the courts have implied other private rights of action under the federal securities laws. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (recognizing private right of action for violations of section 10(b) of the Securities Exchange Act of 1934); J.I. Case Co. v. Borak, 377 U.S. 426, 430–31 (1964) (recognizing private right of action for violations of section 14(a) of the Securities Exchange Act of 1934).

[5] In addition to the company, a plaintiff may be entitled to bring suit against other defendants, such as the company's officers and directors, for securities fraud. For ease of reference, this Article uses the term "company" to refer to all defendants being sued for material misrepresentations under the federal securities laws.

[6] For example, Rule 10b-5, the general anti-fraud provision under the securities laws, makes it unlawful for any person "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" in connection with the purchase or sale of a security. Securities Exchange Act of 1934 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1998). Substantially identical language appears throughout the securities laws. *See, e.g.*, Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1994) (false or misleading statements appearing in a registration statement); Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (1994) (false or misleading statements in a prospectus or oral communication); Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994) (false or misleading statements made in connection with a tender offer); Securities Exchange Act of 1934 Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (1998) (false or misleading statements made in connection with a proxy statement).

[7] The puffery defense may also be used by a company to defend an enforcement action brought by the Securities and Exchange Commission. However, because the majority of cases addressing puffery have been brought by investors, as opposed to the SEC, this Article is limited to the use of the puffery defense in private securities fraud actions.

[8] *See infra* Part II.B.2.

[9] *See infra* Part II.B.3.

corporate optimism concerning future events, such as: "We expect significant growth in earnings during the next fiscal year."[10] In addition, the courts have substantially enlarged the types of statements considered to be puffery, dismissing actions based on statements characterizing present facts, such as: "During the previous quarter, we received substantial orders for our product."[11]

The increased use of puffery to dismiss private securities fraud actions against non-broker defendants and the expansion of the types of statements constituting puffery is disturbing in several respects. First, a judge accepting the puffery defense may impermissibly infringe upon the role of the fact finder. Ordinarily, whether a statement is material is a mixed question of fact and law, which should be submitted to the jury.[12] Only under extraordinary circumstances should a court supplant the role of the jury and pass on materiality as a matter of law.[13] Given this danger of displacing the jury, it is unsettling that courts have increasingly used the puffery defense to dismiss private securities actions.

The re-emergence of the puffery defense is especially worrisome considering the lack of reasoned analysis underlying the recent cases against non-broker defendants.[14] A review of these cases demonstrates that the courts have merely cited older and distinguishable puffery cases before dismissing the case before them with little or no analysis. The courts have failed to examine the rationales underlying the puffery defense to determine if it makes sense in the securities regulation context. They have failed to recognize that an investor probably would not consider a statement made by a company's Chief Executive Officer in a public document—as opposed to an oral statement made by a securities broker in a selling situation—to be mere "sales talk." Even more troubling, the courts have failed to recognize that an investor would likely attach greater significance to a Chairman's assessment of a present fact than to a prediction of a future event. In short, the courts have significantly expanded the scope of a powerful defense to dismiss potentially meritorious securities fraud actions with little or no analysis or consideration of the

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[10] *See infra* Part II.B.3.a.

[11] *See infra* Part II.B.3.b.

[12] *See infra* notes 20–21 and accompanying text.

[13] *See infra* note 22 and accompanying text.

[14] Nor have commentators given any significant attention to the puffery defense. Most commentators have simply concluded that puffery should not be a defense to securities fraud actions, often relying on the "dodo" quotation cited at the beginning of this Article. *See, e.g.*, Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750, 762 (1992) (quoting LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 717 (1988)); Donald C. Langevoort, *Disclosures That "Bespeak Caution,"* 49 BUS. LAW. 481, 487 n.42 (1994). To date, there has been only one article focusing on puffery in the securities fraud context. *See* R. Gregory Rousel, Note, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049 (1998).

effect of their decisions.

This Article attempts to provide such a reasoned and thorough analysis. After examining the rationales of puffery and the policies underlying the federal securities laws, I argue that the courts have misused the puffery defense and have improperly insulated companies from civil liability for misrepresentations. I encourage courts faced with vague statements of corporate optimism to undertake a full materiality analysis rather than relying on a simple puffery review.

This Article is divided into six parts. Part II provides the legal framework for the puffery defense. I begin with an overview of the materiality element of a securities fraud action and then continue with a discussion of puffery. I trace the development of puffery from its origins in the tort of deceit and misrepresentation to its extension into the securities regulation arena. I examine the rationales developed by the courts to explain why puffery should protect a defendant from liability for misrepresentations. I show that puffery is based on the doctrine of caveat emptor, or "let the buyer beware." I then offer an in-depth analysis of the securities cases that have addressed the puffery defense and place these cases into two distinct categories: (1) forward-looking statements and (2) statements characterizing present facts.

Part III argues that puffery should not be a defense to private securities fraud actions because the assumptions necessary to justify the use of the puffery defense are not present in securities transactions. Specifically, I show that because investors do not have equal access to information and because reasonable investors are entitled to trust a company's vague statements of corporate optimism, the puffery defense is inappropriate in private securities fraud actions. Part IV demonstrates that puffery conflicts with the policies underlying the federal securities laws. I point out that the federal securities laws have expressly rejected the very doctrine underlying the puffery defense—caveat emptor.

Part V argues that the courts have lost sight of the proper inquiry—that of materiality. I criticize the courts for erroneously substituting the puffery defense for a full materiality analysis. The courts have improperly limited their focus to the *words* or *language* of the company's statement, while ignoring such important factors as who made the statement and where the statement was made. More importantly, the courts have failed to recognize that the distinction between forward-looking statements and statements characterizing present facts should have an important effect on the court's materiality determination.

Finally, Part VI provides a framework for addressing the materiality of vague statements of corporate optimism. Arguing that the context of the company's statement must be examined, I offer a list of factors the court should consider in determining whether the misrepresentation is material. Applying this suggested approach should relegate the puffery defense in securities fraud actions back to its proper and extinct status.

II. THE LEGAL FRAMEWORK

A. *Materiality*

Not all misrepresentations are actionable under the federal securities laws. Only important, or *material*, misstatements are actionable.[15] The Supreme Court defined materiality in the landmark case of *TSC Industries, Inc. v. Northway, Inc.*[16] In that case, the Supreme Court held that a statement is material if:

> [T]here is a substantial likelihood that a reasonable [investor] would consider [the information] important in deciding how to [act].... Put another way, there must be a substantial likelihood that the disclosure of the [information] would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[17]

In determining whether a statement is material, a court faces two concerns. If the standard of materiality is set too low, then defendants will be forced to defend actions for minor misstatements, a result unintended by Congress.[18] On the other hand, if the standard of materiality is set too high, then potentially meritorious

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[15] *See supra* note 6 and accompanying text.

[16] 426 U.S. 438 (1976). Although *TSC Industries* involved an action brought under section 14(a) of the Securities Exchange Act of 1934, it is now accepted that the definition set forth in *TSC Industries* applies throughout the federal securities laws. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (adopting the *TSC Industries* definition for actions brought under section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934).

[17] *TSC Indus.*, 426 U.S. at 449. When the materiality of a contingent or speculative event, such as a potential merger, is being assessed, the courts will apply a refined version of the *TSC Industries* definition of materiality. The Supreme Court has adopted a probability/magnitude test for determining the materiality of contingent or speculative events, which requires "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event." *Basic*, 485 U.S. at 238 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

[18] The materiality requirement was imposed to ensure that plaintiffs could not recover for insignificant misstatements. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970) (stating that materiality is required to "serve[ ] the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction..., that correction of the defect or imposition of liability would not further the interests" of the securities laws).

In addition, if the materiality standard is set too low, there is a danger that investors will be swamped with too much information. As the Supreme Court noted, "if the standard of materiality is unnecessarily low, ... management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." *TSC Indus.*, 426 U.S. at 448–49.

hand, if the standard of materiality is set too high, then potentially meritorious actions will be erroneously dismissed as a matter of law.[19]

As a mixed question of fact and law, materiality is ordinarily decided by the trier of fact.[20] As the Supreme Court recognized in *TSC Industries*: "The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact."[21] However, under certain limited circumstances, a district court is permitted to bypass the jury and rule on materiality as a matter of law. For such an action to be appropriate, the statement must be "so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality."[22] When a court determines that a statement constitutes puffery, it is making such a determination.[23]

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conducive to informed decisionmaking." *TSC Indus.*, 426 U.S. at 448–49.

[19] In addition, if the materiality standard is set too high, investors will be deprived of information necessary for informed decisionmaking. This would frustrate the disclosure policies underlying the federal securities laws. *See TSC Indus.*, 426 U.S. at 448.

[20] *See id.* at 450.

[21] *Id.*

[22] Shapiro v. UJB Fin. Corp., 964 F.2d 272, 280–81 n.11 (3d Cir. 1992); *accord* Parnes v. Gateway 2000, Inc., 122 F.3d 539, 546 (8th Cir. 1997) (holding that a court may not rule as a matter of law unless "a reasonable investor could not be swayed by an alleged misrepresentation"); Grossman v. Novell, Inc., 120 F.3d 1112, 1118 (10th Cir. 1997) (holding that a court may rule as a matter of law if the statement is "plainly immaterial"); Anderson v. Aurotek, 774 F.2d 927, 931 (9th Cir. 1985) (stating that materiality "can be resolved on summary judgment only if the established omissions or misstatements are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality'" (quoting *TSC Indus.*, 426 U.S. at 438)); Goldman v. Belden, 754 F.2d 1059, 1067 (2d Cir. 1985) (holding that a court may not rule as a matter of law "unless [the facts] are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance"); Huddleston v. Herman & MacLean, 640 F.2d 534, 544 n.14 (5th Cir. 1981) ("Only when the facts are so obviously important [or unimportant] to an investor that reasonable minds cannot differ on the question of materiality may the ultimate materiality issue properly be resolved as a matter of law."), *aff'd. in relevant part*, 459 U.S. 375 (1983) (alteration in original).

[23] As one court noted:

> Strictly speaking, the securities laws recognize no distinct "puffing" exception. To say that a statement is mere "puffing" is, in essence, to say that it is immaterial, either because it is so exaggerated ("You cannot lose.") or so vague ("This bond is marvelous.") that a reasonable investor would not rely on it in considering the "'total mix' of [available] information."

Hoxworth v. Blinder, Robinson & Co., Inc., 903 F.2d 186, 200–01 (3d Cir. 1990) (quoting *TSC Indus.*, 426 U.S. at 449).

B. *Puffery*

1. *Puffery as a Defense to the Tort of Deceit or Fraudulent Misrepresentation*

The courts have recognized that puffery is a defense to the tort of deceit or fraudulent misrepresentation.[24] Puffery is a term of art encompassing statements considered to be non-actionable "sales talk."[25] Such sales talk may involve the quality[26] of a product being sold, such as a statement by a car salesperson that a particular automobile is the "best" on the market,[27] or may involve the value[28] of a product being sold, such as a statement by a salesperson that his product is a "bargain."[29]

In early cases addressing the actionability of sales talk, the courts held in favor of the sellers, reasoning that such statements constituted mere opinion and that opinions were non-actionable because they were not statements of fact.[30] Over time,

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[24] For a general discussion of the tort of misrepresentation, see W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105 (5th ed. 1984).

The concept of puffery also appears in other areas of substantive law. For example, in contract law, if a court determines that a seller's statements constitute puffery, the statements will not constitute an express warranty under the Uniform Commercial Code. *See* 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 9-4, at 487 (4th ed. 1995). In addition, puffery provides a defense to actions for false advertising brought under section 43(a) of the Lanham Act. *See* 1A LOUIS ALTMAN, CALLMANN ON UNFAIR COMPETITION, TRADEMARKS AND MONOPOLIES § 5.19 (4th ed. 1981). In criminal law, puffery is also a factor a court may consider in sentencing a defendant for drug offenses under the United States Sentencing Guidelines. *See, e.g.*, United State v. Desimone, 119 F.3d 217, 229 (2d Cir. 1997) (noting that, in determining defendant's intent to sell a stated quantity of drugs, a court should consider whether defendant's statements constituted "mere puffery").

[25] *See* RESTATEMENT (SECOND) OF TORTS § 542 cmt. e (1977) (stating that "loose general statements made by sellers in commending their wares . . . are commonly known as 'puffing,' or 'sales talk'").

[26] *See* KEETON ET AL., *supra* note 24, § 109, at 756 (stating that a common example of puffery involves "loose general statements made by sellers in commending their wares").

[27] *See, e.g.*, Hughes v. Hertz Corp., 670 So. 2d 882, 885 (Ala. 1995) (finding statement that automobile was a "fine" car to be puffery).

[28] *See* KEETON ET AL., *supra* note 24, § 109, at 758 (stating that the "value, or financial worth, of property is regarded as a matter of opinion . . . as to which 'puffing' and exaggeration are normally to be expected").

[29] *See, e.g.*, Reeb v. Daniels Lincoln-Mercury Co., Inc., 389 S.E.2d 367, 369 (Ga. App. 1989) (holding statement that automobile was a "better buy" than other cars on the market to be puffery).

[30] *See, e.g.*, Holbrook v. Connor, 60 Me. 578, 580–81 (1872) (finding statements that land contained "large" deposits of oil and was of "great value" to be non-actionable expressions of

courts began to recognize that statements of opinion could be actionable, because they were factual in at least one way: a statement of opinion rests on the factual representation that the statement was made in good faith, that the speaker believed the truth of the statement when made.[31]

Courts, however, continued to dismiss cases brought by purchasers against their sellers for sales talk, reasoning that such statements of opinion were immaterial or, similarly, that the purchaser was not entitled to rely on such statements.[32] According to the courts, such sales talk was so obviously unimportant as to be non-actionable. For example, in the early case of *Kimball v. Bangs*,[33] a seller of a heating device made various representations to his purchaser, including statements that the product "was of great value," that the product would produce heat without dirt, smell, or smoke, and that the product would be cheaper than burning wood or coal.[34] When these representations turned out to be untrue, the purchaser sued the seller for deceit. The trial court found for the seller, and the purchaser appealed.[35] The Supreme Judicial Court of Massachusetts affirmed, reasoning that such seller's statements "fall within what is known as 'dealer's talk,' and are not sufficient foundation for an action of deceit. The law recognizes the fact that men will naturally overstate the value and qualities of the articles which they have to sell. All men know this, and a buyer has no right to rely upon such statements."[36]

Judge Learned Hand echoed the reasoning of *Kimball* in his classic statement of puffery:

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opinion).

[31] *See* KEETON ET AL., *supra* note 24, § 109, at 755.

[32] The concepts of materiality and reliance are interrelated. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 13.5B, at 806 (3d ed. 1996) (stating that "the reliance requirement is a corollary of materiality"). While materiality asks whether a reasonable investor would find information important, reliance asks whether the investor actually relied on that information. Because an investor would presumably not rely on unimportant information in making a decision, the two inquiries are related.

In federal securities fraud actions, this relationship between materiality and reliance can be seen in the adoption of a rebuttable presumption of reliance upon the plaintiff's showing of materiality. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988) (accepting the fraud-on-the-market theory, which posits that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on public *material* misrepresentations . . . may be presumed") (emphasis added); Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–54 (1972) (recognizing the presumption of reliance in cases involving non-disclosure of *material* information).

[33] 11 N.E. 113 (Mass. 1887).

[34] *See id.* at 113.

[35] *See id.*

[36] *Id.* at 114.

> There are some kinds of talk which no sensible man takes seriously, and if he does he suffers from his credulity. If we were all scrupulously honest, it would not be so; but, as it is, neither party usually believes what the seller says about his own opinions, and each knows it.[37]

The rationale underlying these cases was that the purchaser must have understood that the seller was exaggerating the quality or value of his product, and if he did not, then he would pay for his ignorance.[38] In other words, these cases were based on the doctrine of caveat emptor—let the buyer beware.

Caveat emptor has been a prevailing theory of law in America since the early nineteenth century.[39] Caveat emptor is based on several different assumptions. First, it assumes that the parties are on equal footing, with equal access to information.[40] The doctrine is based on the understanding that the purchaser is free to examine, judge, and test the product himself before he purchases it. Thus, it assumes that the purchaser is able to protect his own interests. According to the doctrine of caveat emptor, because a purchaser can draw his own conclusions as to the quality and value of the product, he is able to discount the sales talk made by the seller. Therefore, such sales talk is non-actionable.

Second, the doctrine of caveat emptor assumes that the purchaser has no reason to trust a seller's sales talk.[41] According to caveat emptor, the purchaser and seller are dealing at arm's length. Because the parties owe no duties to each other, they should not trust each other. In other words, under ordinary circumstances, a purchaser should have no reason to believe a seller's opinion. The courts, however,

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[37] Vulcan Metals Co. v. Simmons Mfg. Co., 248 F. 853, 856 (2d Cir. 1918).

[38] Similarly, the Second Restatement recognizes:

> It is common knowledge and may always be assumed that any seller will express a favorable opinion concerning what he has to sell; and when he praises it in general terms, without specific content or reference to facts, buyers are expected to and do understand that they are not entitled to rely literally upon the words.

RESTATEMENT (SECOND) OF TORTS § 542 cmt. e (1977).

[39] For an exhaustive description of the development of the doctrine of caveat emptor, see Walter H. Hamilton, *The Ancient Maxim Caveat Emptor*, 40 YALE L.J. 1133 (1931).

[40] For example, in an early fraudulent misrepresentation case, a court justified its holding in favor of a seller by reasoning that "[t]hese parties were dealing at arm's length and on equal grounds, and their own judgments were to be their guide in coming to conclusions. It is proved that [the purchaser] had the fullest opportunity, of which he availed, to examine the property, and afterwards [purchased it]." Miller v. Craig, 36 Ill. 109, 111 (1864).

[41] *See* KEETON ET AL., *supra* note 24, § 109, at 755. The treatise stresses that the common law had a "highly individualistic attitude" toward the bargaining process, in which the "parties are expected to deal at arm's length and to beware of one another, and each is supposed to be competent to look after his own interests, and to draw his own conclusions." *Id.*

recognize that under certain circumstances a purchaser *is* entitled to rely on a seller's opinion. When the purchaser and seller are not in fact dealing at arm's length, but have a relationship of trust and confidence, the courts do not punish the purchaser for trusting the seller. Thus, the courts have developed an exception to the doctrine of caveat emptor when a fiduciary or other close relationship exists between the transacting parties.[42]

As courts began to recognize that the assumptions underlying the doctrine were no longer present, the doctrine of caveat emptor became disfavored. The doctrine has been curtailed or rejected in several substantive areas. For example, in contract law, it has been largely replaced with implied warranties of merchantability[43] and fitness for a particular purpose.[44] In real property law, the courts have replaced caveat emptor with the implied warranty of habitability in residential property transactions.[45] In securities regulation, it has been replaced by a mandatory disclosure system.[46]

2. *The Puffery Defense in Cases Against Brokers under the Federal Securities Laws*

Because puffery is a defense against actions for misrepresentation, defendants attempted to extend the common law defense to actions based on misstatements under the federal securities laws. At first, these cases involved claims against brokers, where dissatisfied customers sued their brokers for statements regarding the quality of the security. For example, a broker might have told a client that a particular security constituted a "marvelous"[47] investment. Or a broker might have made representations concerning the future return on an investment, such as that the customer would make "good money"[48] or would receive a "significant tax-free return"[49] on a particular security.

Most courts held that these kinds of statements by brokers constituted non-

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[42] Such relationships included family relationships, traditional fiduciary relationships such as those between attorney and client and between the executor and a beneficiary of an estate, and other close relationships in which trust is customarily reposed in another person. *See id.* at 760.

[43] *See* U.C.C. § 2-314 (1998) (creating implied warranty of merchantability).

[44] *See* U.C.C. § 2-315 (1998) (creating implied warranty of fitness for a particular purpose).

[45] For a good discussion of the causes of the rejection of the doctrine of caveat emptor in real property transactions, see Alan M. Weinberger, *Let the Buyer Be Well Informed?—Doubting the Demise of Caveat Emptor*, 55 MD. L. REV. 387, 394–97 (1996).

[46] *See infra* notes 113–14 & 132 and accompanying text.

[47] *See* Zerman v. Ball, 735 F.2d 15, 21 (2d Cir. 1984).

[48] *See* Newman v. L.F. Rothschild, 651 F. Supp. 160, 163 (S.D.N.Y. 1986).

[49] *See* Cohen v. Prudential-Bache Sec., Inc., 713 F. Supp. 653, 657 (S.D.N.Y. 1989).

actionable puffery.[50] The courts implicitly adopted the caveat emptor reasoning of non-securities cases, stressing that a reasonable investor could not have found such statements to be important. As one court stated:

> Courts have recognized a category of statements by brokers which are better characterized as "puffery" than as material misstatements. When a broker calls a bond "marvelous," or says a stock is so "red hot" that the investor "could not lose," or claims that his primary purpose is to make money for the customer, the reasonable investor is presumed to understand that this is nothing more than the "common puff of a salesman," not a material factual misstatement.[51]

The courts have, however, rejected the puffery defense in one particular circumstance. When a broker promises a *specific* return on the investment, as opposed to a general promise of profitability, the courts will not accept the puffery defense.[52] For example, in *Newman v. L.F. Rothschild*,[53] a broker told his customers that they would earn a return of 20% to 30% without risk. The court rejected the broker's argument that such a statement constituted puffery, reasoning that the "inclusion of a specific percentage . . . puts the misrepresentation in a different category"[54] from those statements constituting puffery. According to these cases, when a broker includes a specific percentage in his statement, it is reasonable for an

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[50] *See Zerman*, 735 F.2d at 21 (holding broker's statement that bonds constituted a "marvelous" investment to be non-actionable under the federal securities laws); *Cohen*, 713 F. Supp. at 658 (holding that broker's statement that the customer would receive "a very strong cash flow without risk to her initial investment" approached puffery); *Newman*, 651 F. Supp. at 163 (holding broker's statement that the customer would "make good money" on a security to be non-actionable under the federal securities laws); Rotstein v. Reynolds & Co., 359 F. Supp. 109, 113 (N.D. Ill. 1973) (holding broker's statement that a security was "red hot" to be non-actionable under the federal securities laws); Bowman v. Hartig, 334 F. Supp. 1323, 1328 (S.D.N.Y. 1971) (holding broker's statement that the customer would make "substantial profits without extraordinary speculative risk" to be non-actionable under the federal securities laws); *see also* Marc I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 BROOK. L. REV. 1503, 1522 (1996) (recognizing that "courts allow brokers to engage in certain nonactionable puffery").

[51] *Newman*, 651 F. Supp. at 163 (citations omitted).

[52] *See* Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87, 92 (D. Mass. 1989) (holding that a broker's guarantee of a 10% return on investment was not puffery); *Cohen*, 713 F. Supp. at 658 (holding that a broker's statement promising a 13.4% return on investment was not puffery); Newman v. L.F. Rothschild, 662 F. Supp. 957, 959 (S.D.N.Y. 1987) (holding that a broker's guarantee of a 20% to 30% return on investment was not puffery); *Rotstein*, 359 F. Supp. at 113 (holding that a broker's promise that a stock's price would reach $30 per share was not puffery).

[53] 662 F. Supp. at 957.

[54] *Id.* at 959.

investor to believe the broker's statement.[55]

Although courts have been willing to use the puffery defense to dismiss actions against brokers, the Securities and Exchange Commission (SEC) has been unwilling to accept the puffery defense in its enforcement actions. The SEC has consistently rejected the use of the puffery defense, holding that the defense is inapplicable in the securities regulation context.[56]

3. *The Puffery Defense in Securities Cases Against Non-Brokers*

Non-broker defendants, such as companies and their officers and directors, also seized on the puffery defense and attempted to use it to dismiss actions brought against them for material misstatements under the federal securities laws. These actions were based on the company's vague statements of corporate optimism.[57] A

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[55] *See Cohen*, 713 F. Supp. at 658 (stating that the promise of a return of 13.4% without risk was not "so unbelievable that an investor could not reasonably rely upon it").

[56] *See In re* John R. Brick, 46 S.E.C. 43, 52 n.23 (1975) (stating that "the concept of puffing has no place in these consumer-protection statutes"); *In re* C.R. Richmond & Co., No. 3-4656, 1975 SEC LEXIS 2555, *14 (Aug. 15, 1975) (stating that "lax merchandising standards epitomized by such terms as 'puffing' are antithetical to the anti-fraud provisions of the securities statutes"); *In re* Cortlandt Investing Corp., 44 S.E.C. 45, 50 (1969) (stating that "the doctrine of *caveat emptor*, from which the concept of 'puffing' is derived, can have little application under the antifraud provisions of the securities acts"); *In re* Norman Pollisky, 43 S.E.C. 852, 856 (1968) (same); *In re* Irving Friedman, 43 S.E.C. 314, 319 (1967) (stating that "the doctrine of caveat emptor, from which the concept of 'puffing' is derived, can have little application to the merchandising of securities"); *In re* Marketlines, Inc., No. 3-227, 1966 SEC LEXIS 2387, *35 (Mar. 16, 1966) (stating that the "lax merchandising standards epitomized by such terms as 'puffing' are antithetical to the anti-fraud provisions of the securities statutes"); *In re* Hamilton Waters & Co., 42 S.E.C. 784, 790 (1965) (stating that puffery "has little application under the anti-fraud provisions of the securities laws"); *In re* Spear & Staff, Inc., 42 S.E.C. 549, 553 (1965) (stating that "lax merchandising standards epitomized by such terms as 'puffing' are antithetical to the anti-fraud provisions of the securities statutes"); *In re* Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963) (stating that "[t]he doctrine of *caveat emptor* 'can have little application to the merchandising of securities'") (quoting *In re* B. Fennekohl & Co., 41 S.E.C. 210, 216 (1962)); *In re* Diotron, Inc., No. 24W-2492, 1963 SEC LEXIS 2449, *48–49 (July 31, 1963) (same); *In re* N. Sims & Co., 40 S.E.C. 573, 575 (1961) (holding puffery inapplicable in securities regulation context).

For additional discussion of the *Fennekohl* case, *see infra* notes 110–12 and accompanying text.

[57] These vague statements of corporate optimism are a type of "soft" information. Soft information is a term of art comprising several different categories of information, including forward-looking statements, such as projections and forecasts, as well as opinions, statements of motives and purposes, and evaluations. *See* Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 255 (1972). The term "soft" information is used to distinguish this type of information from historical, or "hard," information. *See id.* at 254–55.

review of these cases indicates that the courts have applied the puffery defense in two distinct situations: (1) when a company has made a vague forward-looking statement,[58] and (2) when a company has made a vague statement characterizing present facts.

a. *A Company's Vague Forward-Looking Statements*

The majority of puffery cases involve optimistic forward-looking statements made by companies. There are three different types of vague forward-looking statements that have been labeled non-actionable puffery: (1) statements predicting a company's financial performance, (2) statements predicting the success of a new product, and (3) statements predicting the effect of management strategies or practices.

Many of the securities cases brought against non-broker defendants that address puffery involve predictions of the company's financial performance, such as optimistic statements of future company earnings, revenues, sales, or growth.[59]

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[58] Forward-looking statements are "statements concerning the future, such as projections, forecasts, predictions, and statements concerning plans and expectations." *Id.* at 255.

[59] *See* Weiner v. Quaker Oats Co., 129 F.3d 310, 313 (3d Cir. 1997) (company stated it was "'confident' of achieving at least 7% real earnings growth" in the next fiscal year); Parnes v. Gateway 2000, Inc., 122 F.3d 539, 542 (8th Cir. 1997) (company stated it "anticipate[d] significant growth"); *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1427 (3d Cir. 1997) (company stated that it "believe[d] [it could] continue to grow net earnings at a faster rate than sales" and that it was "comfort[able]" with analyst projections of earnings per share); Suna v. Bailey Corp., 107 F.3d 64, 69 (1st Cir. 1997) (company stated it "expect[ed] continued revenue growth"); San Leandro Emergency Med. Plan v. Philip Morris Cos., 75 F.3d 801, 806 (2d Cir. 1996) (company stated it was "optimistic" about future earnings); Hillson Partners Ltd. Partnership v. Adage, Inc., 42 F.3d 204, 206 (4th Cir. 1994) (company stated that "significant sales gains should be seen as the year progresses" and that "1992 will produce excellent results"); Malone v. Microdyne Corp., 26 F.3d 471, 473 (4th Cir. 1994) (company stated it was "comfortable" with analyst earnings estimates); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 283–84 n.12 (3d Cir. 1992) (company stated that it "look[ed] to the future with great optimism"); *In re* Boston Tech., Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,174, at 90,574 (D. Mass. Feb. 5, 1998) (company stated that it believed it would "experience the same rate of growth [experienced in 1995] in fiscal 1996"); Schoenhaut v. American Sensors, Inc., 986 F. Supp. 785, 792 n.9 (S.D.N.Y. 1997) (company stated that "it anticipated increasing customer demand"); Gilford Partners, L.P. v. Sensormatic Elec. Corp., No. 96-C4072, 1997 U.S. Dist. LEXIS 19032, *5 (N.D. Ill. Nov. 12, 1997) (company stated that "its European revenues would grow by at least 20%"); *In re* V-Mark Software, Inc. Sec. Litig., 928 F. Supp. 122, 123 (D. Mass. 1996) (company stated that it was "comfortable" with analysts' earnings estimates); Gross v. Summa Four, Inc., [1995–1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,999, at 93,872 (D.N.H. Nov. 8, 1995) (company stated that it "continue[d] to be enthusiastic about our opportunities to grow").

Related to these kind of optimistic statements concerning a company's future financial performance are statements concerning the worth or value of the company's *securities*, such as a

Companies often make general forward-looking statements in their annual reports to shareholders or in meetings with securities analysts. For example, a company may state that it expects to achieve "significant" earnings. If the company experiences disappointing results, investors may bring suit under the federal securities laws contending that the prediction constituted a material misstatement. The courts have generally held that these kinds of vague statements of corporate optimism constitute non-actionable puffery.

An example of this approach can be found in *Parnes v. Gateway 2000, Inc.*[60] In *Parnes*, a company stated in its prospectus that it "anticipate[d] significant growth in the future."[61] Within a year, the company's earnings per share dropped dramatically, and investors brought suit contending that the company's statement constituted a material misrepresentation under several provisions of the federal securities laws.[62] The district court dismissed the complaint,[63] and the plaintiffs appealed. The Eighth Circuit affirmed, holding that the company's statement constituted puffery and was therefore immaterial as a matter of law.[64]

The Eighth Circuit began its analysis by conceding that materiality is ordinarily a question for the jury.[65] However, the court pointed out that "[w]here a reasonable investor could not have been swayed by an alleged misrepresentation,"[66] a court is entitled to rule on materiality as a matter of law. The court noted that "some statements are so vague and such obvious hyperbole that no reasonable investor would rely upon them."[67] The court reasoned: "[S]oft, puffing statements generally lack materiality because the market price of a share is not inflated by vague statements predicting growth. No reasonable investor would rely on these statements, and they are certainly not specific enough to perpetrate a fraud on the market."[68] After citing several other puffery cases, the court held that the statement

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statement by an officer that his company's securities constitute a "good investment." *See* Howard v. Haddad, 962 F.2d 328, 329 (4th Cir. 1992). In *Howard*, the Fourth Circuit found that statement to constitute puffery. *See id.* at 331. In coming to this conclusion, the court relied on cases holding that similar statements made by brokers to their clients were immaterial. *See id.* at 331 n.11. For a discussion of the use of puffery in cases involving brokers, see *supra* Part II.B.2.

[60] 122 F.3d 539 (8th Cir. 1997).

[61] *Id.* at 542.

[62] *See id.* at 544.

[63] *See id.* at 545.

[64] *See id.* at 547.

[65] *See id.* at 546.

[66] *Id.*

[67] *Id.* at 547.

[68] *Id.* (quoting Hillson Partners Ltd. Partnership v. Adage, Inc., 42 F.3d 204, 211 (4th Cir. 1994)).

that the company expected "significant" growth constituted puffery.[69]

In cases involving predictions of a company's financial performance, the courts have drawn a distinction between general optimistic statements, which constitute puffery, and specific predictions of financial performance, which do not.[70] If the company attaches a number or range of numbers to its prediction, the courts will reject the puffery defense.[71] For example, in *Weiner v. Quaker Oats Co.*,[72] a company stated that it was "confident" that it would achieve "at least 7% real earnings growth"[73] in the following fiscal year. When earnings did not live up to these expectations, investors sued. The district court dismissed the action, ruling that the company's statement constituted immaterial puffery.[74] The Third Circuit reversed, observing that the statement was not a "vague expression of optimism."[75] Because it was a "specific figure regarding a particular, defined time period,"[76] the Third Circuit held that the statement was not puffery.

The puffery defense may also be implicated when a company makes statements predicting the success of a new product.[77] At the launch of a new product,

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[69] *See id.*

[70] This distinction between general and specific statements has also been made by courts in cases against securities brokers. *See supra* notes 52–55 and accompanying text.

[71] *See* Weiner v. Quaker Oats Co., 129 F.3d 310, 320 (3d Cir. 1997) (holding that a prediction of "at least 7% real earnings growth" was not puffery because it "was a specific figure regarding a particular, defined time period"); *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1428 & n.14 (3d Cir. 1997) (holding that a statement that a company was "comfortable" with analysts' projections of earnings per share of $1.20 to $1.30 was not puffery because it was "an agreement with a specific forecast range"); Suna v. Bailey Corp., 107 F.3d 64, 70 (1st Cir. 1997) (noting the importance of "specific numbers" in assessing the materiality of a prediction); *In re* V-Mark Software, Inc. Sec. Litig., 928 F. Supp. 122, 123–24 (D. Mass. 1996) (holding that a statement that a company was "comfortable" with analysts' earnings estimates of 32 cents to 33 cents per share was not puffery because it "mentioned definite earnings and precise revenue numbers"); Schaffer v. Timberland Co., 924 F. Supp. 1298, 1314 (D.N.H. 1996) (noting that a statement by a company that is "sufficiently specific" may be actionable). *But see* Raab v. General Physics Corp., 4 F.3d 286, 289 (4th Cir. 1993) (holding that a statement that a company expected an "annual growth rate of 10% and 30% over the next several years" constituted puffery).

[72] 129 F.3d at 310.

[73] *Id.* at 313.

[74] *See id.* at 314.

[75] *Id.* at 320.

[76] *Id.*

[77] *See* Glassman v. Computervision Corp., 90 F.3d 617, 635 (1st Cir. 1996) (statement that the company expected a new product to "broaden the number of customers in existing accounts as well as attract new customers" was puffery); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1118 (D. Nev. 1998) (statement that a new hotel and casino would "become the symbol of Las Vegas" was puffery); Vosgerichian v. Commodore Int'l, 832 F. Supp. 909, 916 (E.D. Pa. 1993) (statements that product was "revolutionary" and could "change the world" were puffery);

companies often issue press releases or make other public statements touting the qualities and features of the product along with optimistic statements about the product's potential for success. If the product does not turn out to be as wonderful as its press, investors may bring suit contending that the company's statement constituted a material misrepresentation. The courts have held that these types of statements constitute non-actionable puffery.

A good example of this type of puffery case is *In re Storage Technology Corp. Securities Litigation*.[78] In that case, a company official stated that the company was "proud" of its new computer and predicted that it would be a "blowout winner."[79] Soon after, however, the company disclosed that it was experiencing significant production problems with the new product.[80] The company's stock price declined,[81] and disappointed investors brought suit under several provisions of the federal securities laws.[82] Reasoning that no reasonable investor would have been misled by the company's statement, the district court held that the company's vague forward-looking statement constituted immaterial puffery.[83]

The puffery defense has also been used by courts to dismiss actions based on a company's descriptions of its management strategies.[84] When a company informs the market of its current strategies, it also often makes optimistic statements that the strategy will be beneficial to the company. If the strategy does not prove to be successful, investors may bring suit against the company, contending that the statement constituted a material misrepresentation. The courts have determined that these statements constitute non-actionable puffery.

In re Storage Tech. Corp. Sec. Litig., 804 F. Supp. 1368, 1372 (D. Colo. 1992) (statement that a new product would be a "blowout winner" was puffery).

[78] 804 F. Supp. at 1368.

[79] *Id.* at 1372.

[80] *See id.* at 1371.

[81] *See id.*

[82] *See id.*

[83] *See id.* at 1372.

[84] *See* Lasker v. New York State Elec. & Gas Corp., 85 F.3d 55, 57 (2d Cir. 1996) (statement that the company's "diversification activities demonstrate our commitment to create earnings opportunities out of the challenges to utility deregulation" held to be puffery); *In re* Boston Tech., Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,174, at 90,578 (D. Mass. Apr. 15, 1998) (statement that the company was "highly focused on providing enhanced services specifically for the needs of the wireless service" marketplace held to be puffery); Simon v. American Power Conversion Corp., 945 F. Supp. 416, 428 (D.R.I. 1996) (statement that the company recognized the "significance of newly emerging international markets and the vast potential for [its] products in these areas of the world" held to be puffery); Bentley v. Legent Corp., 849 F. Supp. 429, 432 (E.D. Va. 1994) (statement that the company's expense controls were "tight" held to be puffery).

In *Lasker v. New York State Electric & Gas Corp.*,[85] NYSEG, a public utility, obtained authorization to invest in certain unregulated businesses.[86] In its Annual Report on Form 10-K, NYSEG informed its investors of its diversification strategy, but assured them that it would "not compromise its financial integrity."[87] It described the company's diversification activities and then stated that "[t]hese diversification activities demonstrate our commitment to create earnings opportunities out of the challenges to utility deregulation."[88] Unfortunately, NYSEG's diversification strategy led to losses, and the company was forced to cut its dividend.[89] Investors brought suit against the utility, contending that the statements constituted material misrepresentations.[90] The district court dismissed the complaint,[91] and the Second Circuit affirmed, holding that the statements of management strategies constituted non-actionable puffery.[92] In reaching this conclusion, the Second Circuit reasoned that "[a] reasonable investor would not believe that, by merely making the broad, general statements . . ., NYSEG had insured against the risks inherent in diversification."[93]

b. *A Company's Vague Statements Characterizing Present Facts*

The second category of puffery cases involve a company's vague statements characterizing present facts. Many of these cases involve statements characterizing the status of on-going transactions affecting the company[94] or current or past company performance.[95] If the company's assessment of these facts was untrue

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[85] 85 F.3d at 55.

[86] *See id.* at 56.

[87] *Id.*

[88] *Id.* at 57.

[89] *See id.*

[90] *See id.*

[91] *See id.*

[92] *See id.* at 59.

[93] *Id.*

[94] *See* Eisenstadt v. Centel Corp., 113 F.3d 738, 741 (7th Cir. 1997) (statement that the bidding process in an auction of the company was going "very well" and "very smoothly" held to be puffery); *In re* Healthco Int'l Inc. Sec. Litig., 777 F. Supp. 109, 115 (D. Mass. 1991) (statement that the company was "comfortable" that a merger "would close before the late February deadline" held to be puffery). Although each of these cases involved the disclosure of a speculative or contingent event, neither court conducted the probability/magnitude test for materiality set forth by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). For a discussion of the probability/magnitude test, see *supra* note 17.

[95] *See* Grossman v. Novell, Inc., 120 F.3d 1112, 1121 (10th Cir. 1997) (holding statement that the company had achieved "substantial success" in integrating the sales forces of two merged

when made, investors may bring suit arguing that the statement constituted a material misrepresentation. In general, however, the courts have determined that these assessments constitute non-actionable puffery.

For example, in *Eisenstadt v. Centel Corp.*,[96] the board of directors of Centel Corp. ("Centel") determined that their company should be sold.[97] Management decided to conduct an auction where prospective purchasers were invited to make bids to buy the company.[98] During the time the auction was open, Centel stated that the bidding process "continue[d] to go very well" and was progressing "very smoothly."[99] In actuality, however, it was not; Centel had realized that it was going to receive fewer bids than it had anticipated.[100] Ultimately, the auction failed, and Centel negotiated a sale to another company at a much lower price than expected.[101] The price of Centel stock, which had risen to $48 per share on the date of the announcement of the auction,[102] fell to $32 per share on the date of the announcement of the private sale.[103] Shareholders who had purchased Centel stock after the announcement of the auction brought suit under various provisions of the federal securities laws, contending that Centel's statement constituted a material

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companies and statement that the merger process had been moving "faster than we thought" to be puffery); Gross v. Summa Four, Inc., 93 F.3d 987, 995 (1st Cir. 1996) (finding statement that a company had received "significant orders" for its product to be puffery); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1219 (1st Cir. 1996) (holding statement that a company's transition to selling a new kind of product was "going reasonably well" and that the company was "healthy" to be puffery); Searls v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995) (finding statement that company was "recession-resistant" to be puffery); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1118 (D. Nev. 1998) (holding statement that the opening of the company's new hotel was going "very smoothly" and that a "steady stream of people" were visiting to be puffery); *In re* Nokia Corp. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,195, at 90,705 n.3 (S.D.N.Y. May 6, 1998) (finding statement that "we have seen continued strengthening" in market position and that the "market position in its main businesses continued to improve" to be puffery); Freedman v. Value Health, Inc., 958 F. Supp. 745, 760–61 (D. Conn. 1997) (refusing to rule as a matter of law that statement that a company was a "thriving business" was puffery); Schaffer v. Timberland Co., 924 F. Supp. 1298, 1314 (D.N.H. 1996) (holding statement that retail demand for the company's product "was not a problem" and that the brand remained "strong" not to be puffery); *In re* Apple Computer Sec. Litig., 672 F. Supp. 1552, 1572 (N.D. Cal. 1987) (finding statement that the company's personal computer "is clearly being recognized as an important force in the office market" to be puffery).

[96] 113 F.3d at 738.

[97] *See id.* at 740.

[98] *See id.*

[99] *Id.* at 741.

[100] *See id.*

[101] *See id.* at 742.

[102] *See id.* at 740.

[103] *See id.* at 742.

misrepresentation.[104] Centel argued that its statement constituted puffery, and the Seventh Circuit agreed. The court reasoned:

> We doubt that nonspecific representations that an auction process is going well or going smoothly could . . . influence a reasonable investor to pay more for stock than he otherwise would. *Everybody* knows that someone trying to sell something is going to look and talk on the bright side. You don't sell a product by bad mouthing it. . . . It would be unreasonable for investors to attach significance to *general* expressions of satisfaction with the progress of the seller's efforts to sell, just as it would be unreasonable for them to infer from a potential bidder's apparent lack of enthusiasm that the bidder was uninterested rather than just jockeying for a better price.[105]

III. THE ASSUMPTIONS NECESSARY TO JUSTIFY THE PUFFERY DEFENSE ARE NOT PRESENT IN SECURITIES TRANSACTIONS

As the preceding section of this Article demonstrates, courts have relied on the common law puffery defense to dismiss private actions brought under the federal securities laws. However, these courts have failed to recognize that the assumptions justifying the use of the puffery defense are not present in securities transactions. The puffery defense is based on the doctrine of caveat emptor—let the buyer beware.[106] As discussed above,[107] caveat emptor is based on two assumptions: (1) that the parties have equal access to information; and (2) that the parties have no reason to trust each other. As the following analysis demonstrates, these two assumptions are not necessarily valid in securities transactions. Because the assumptions justifying the puffery defense do not apply, courts should not use the puffery defense as a grounds for dismissing actions brought under the federal securities laws.

A. *Investors Do Not Have Equal Access to Information*

The doctrine of caveat emptor assumes that the buyer and seller have equal access to information.[108] By making a physical examination of the product, the buyer can draw his own conclusions as to its quality and value. In other words, the buyer is free to "look under the hood" and "kick the tires" before he makes the

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[104] *See id.* at 740.

[105] *Id.* at 745.

[106] *See supra* notes 32–38 and accompanying text.

[107] *See supra* notes 40–41 and accompanying text.

[108] *See supra* note 40 and accompanying text.

purchase. Therefore, according to the doctrine of caveat emptor, the seller's exaggerated statements concerning the product should assume no significance to the buyer, who is able to discount the sales talk through his own investigation.

Obviously, an investor cannot make a similar physical examination of a security. Therefore, it would appear that the doctrine of caveat emptor has no application to a securities transaction. In fact, this is the position taken by the SEC.[109] For example, in *In re B. Fennekohl & Co.*,[110] the SEC rejected a broker's argument that his exaggerated statements to a client constituted non-actionable puffery.[111] The SEC reasoned:

> The concept of "puffing" is derived from the doctrine of *caveat emptor* and arises primarily in the sale of tangibles where it appears that examination by the purchaser may offset exaggerated statements and expressions of opinion by the salesman. It can have little application to the merchandising of securities.[112]

At first glance, this appears to be correct. It is true that a physical examination of a security certificate would not enable an investor to discount a company's optimistic statements. However, this analysis is overly simplistic. The investor has other resources available that may allow him to come to his own independent conclusions concerning the company's statement. Specifically, the investor has access to information disclosed by the company, either voluntarily, or more likely, pursuant to the federal securities laws. Therefore, it is necessary to determine whether a company's disclosures puts the investor and the company on equal footing, justifying a defense based on the doctrine of caveat emptor.

The federal securities laws are based on a philosophy of full and fair disclosure.[113] Under certain circumstances, companies are required to make significant disclosures to their investors.[114] The mandatory disclosure system was

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[109] For a listing of administrative cases holding that the doctrine of caveat emptor is inconsistent with the sale of a security, see *supra* note 56.

[110] 41 S.E.C. 210 (1962).

[111] *See id.* at 216.

[112] *Id.* at 212. Only a handful of courts have recognized this distinction. *See* SEC v. First Am. Bank & Trust Co., 481 F.2d 673, 680 (8th Cir. 1973) (citing *Fennekohl*); Nivram Corp. v. Harcourt Brace Jovanovich, Inc., 840 F. Supp. 243, 252 n.16 (S.D.N.Y. 1993) (citing *Fennekohl*); Flournay v. Peyson, 701 F. Supp. 1370, 1376 (N.D. Ill. 1988) (citing *Fennekohl*).

[113] For a good description of the adoption of the disclosure philosophy underlying the federal securities laws, see 1 LOSS & SELIGMAN, *supra* note 1, at 171–206.

[114] These disclosures are made in specific disclosure documents that must contain certain information deemed important to an investment decision. The disclosure document will include information about the company, such as a description of the company's business, a description of the company's management, and the company's financial statements. If the disclosure document relates to a specific transaction, the disclosure document will also contain information relevant to

an attempt to "level the playing field" and correct the informational asymmetries existing between a company and the investing public. Although the mandatory disclosure system goes a long way toward placing the investor and the company on equal footing, it does not entirely succeed.

First, the federal securities laws do not always require the disclosure of information in a securities transaction. For example, certain sales of securities are exempt altogether from the disclosure requirements of the federal securities laws.[115] Similarly, the federal securities laws do not always require a company to make disclosure when it is requesting its shareholders to vote their securities.[116] Finally, not all companies are required to make on-going disclosures in the form of annual and quarterly reports.[117] In these instances, unless a company makes voluntary

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the transaction. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 244 (2d ed. 1997).

[115] The federal securities laws make it unlawful to sell securities unless a registration statement is in effect. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994). However, there are several important exemptions that will permit a sale without disclosure. Section 3 of the Securities Act of 1933 exempts certain types of securities from all regulation under the federal securities laws. *See* Securities Act of 1933 § 3, 15 U.S.C. § 77c (1994). Section 4 of the Securities Act of 1933 exempts certain transactions from the disclosure requirements of the federal securities laws. *See* Securities Act of 1933 § 4, 15 U.S.C. § 77d (1994). For example, section 4(2), commonly called the private placement exemption, permits a company to sell its securities to certain types of investors without preparing a registration statement. Investors purchasing securities in a private placement, therefore, may not receive any disclosure from the company. For a general discussion of the exemptions under the Securities Act of 1933, see HAZEN, *supra* note 32, § 4.1, at 163.

[116] The federal securities laws make it unlawful for a company to solicit proxies unless the company has provided its shareholders with a proxy statement, a specific type of disclosure document. *See* Securities Exchange Act Rule 14a-3, 17 C.F.R. § 240.14a-3 (1998). However, the proxy rules are intended to reach only larger, more established, companies. Their scope is limited to the solicitation of proxies relating to securities registered under section 12 of the Securities Exchange Act of 1934. *See* Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (1994). A company is required to register a class of securities under section 12 in only two instances. First, the company must register the security if it is traded on a national securities exchange. *See* Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l(b) (1994). Second, the company must register the security if the company has assets exceeding $10 million and has more than 500 shareholders of record. *See* Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g) (1994); Securities Exchange Act of 1934 Rule 12g-1, 17 C.F.R. § 240.12g-1 (1998). For a general discussion of the proxy rules, see HAZEN, *supra* note 32, § 11.2, at 555.

[117] The federal securities laws require that certain companies make periodic disclosure in the form of annual and quarterly reports. However, this disclosure requirement is limited to companies with a class of securities registered under section 12 of the Securities Exchange Act of 1934 and to companies with an effective registration statement. *See* Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m(a) (1994); Securities Exchange Act of 1934 § 15(d), 15 U.S.C. § 78o(d) (1994). For a general discussion of the periodic disclosure requirements, see HAZEN, *supra* note 32, § 9.3, at 414.

disclosure, investors will not have the information necessary to draw their own conclusions as to a company's vague statement of corporate optimism.

Even if the federal securities laws *do* require disclosure, the disclosure may not necessarily place the investor and the company on equal footing. Because the company prepares the disclosure document, the investor obtains the information second-hand; it has been filtered by the company. It is one thing to be able to look under the hood to determine whether a car is in good working condition. It is quite another thing to make that determination from a *description* of the engine prepared by the seller. Second-hand information does not have the same utility to an investor.

More importantly, no matter what information is disclosed to the investing public, the company and its representatives will *always* have additional, and often better, information than the public. Even the federal securities laws, with their significant disclosure obligations, do not require the company to disclose all information to the public.[118] As the Supreme Court recognized, "[s]hareholders know that directors usually have knowledge . . . far exceeding the normal investor's resources."[119]

The company's superior access to information is especially true of the kinds of vague statements of corporate optimism that the courts have determined to constitute puffery. An examination of the different categories of vague statements reveals that the information underlying these statements is particularly within the control of the company.

1. *A Company's Vague Forward-Looking Statement*

A company's prediction of financial performance, such as a statement that it expects "strong" earnings in the next fiscal year, may be based on the results of sophisticated models using assumptions that are unavailable to investors. In order to understand and assess a company's forward-looking statement, an investor needs to know the underlying assumptions.[120] However, a company is not required to

[118] Significantly, the federal securities laws do not generally require a company to disclose forward-looking statements or other soft information. *See* HAZEN, *supra* note 32, § 3.7, at 154. For a discussion of a company's limited obligation to disclose forward-looking statements, see Joel Seligman, *The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953, 1962–75 (1995).

[119] Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1091 (1991).

[120] The importance of the underlying assumptions to an investor's appreciation of a company's forward-looking statement is well recognized. For example, in recommending that the SEC permit companies to make voluntary disclosure of forward-looking statements, the Advisory Committee on Corporate Disclosure noted that the assumptions underlying the forward-looking statement constituted important information to many investors because they "provide[ ] a framework for the analysis of the projection." ADVISORY COMM. ON CORP. DISCLOSURE, 95TH CONG., 1ST SESS., REPORT TO THE SEC. AND EXCH. COMM'N 358 (Comm. Print 1977). Similarly,

disclose to its investors the methodologies or assumptions underlying its forward-looking statements.[121] Therefore, the investor is unable to come to his own conclusions concerning the accuracy of the company's statement and cannot discount the company's statement as being overly enthusiastic.[122] Because the investor and the company do not have equal access to information, the doctrine of caveat emptor is inapplicable, and the puffery defense should not be applied.

Similarly, when a company launches a product and states, for example, that the product will be a "success," it is basing this prediction on information unavailable to investors. Presumably, before making such a statement, the company will have undertaken product feasibility studies and marketing research studies. These studies are normally unavailable to the company's investors. Therefore, an investor will not be able to make his own assessment as to the product's likelihood of success. Once again, because of the information asymmetries existing between the company and the investor, the puffery defense should not be used to dismiss securities fraud actions.

Finally, a company's disclosure of its management strategy and objectives, such as a statement that it will seek out a particular market segment, is based on information that is not available to its investors. The decision to pursue a particular strategy is made by a company's officers and directors, presumably after careful consideration and an assessment of other alternatives. Investors are not ordinarily

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the SEC, in promulgating a safe harbor for the disclosure of forward-looking statements, stressed that the disclosure of the company's underlying assumptions is "an important factor in facilitating investors' ability to comprehend and evaluate" the forward-looking statement. Safe Harbor Rule for Projections, Securities Act Release No. 33-6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,942 (June 25, 1979).

[121] The SEC does not require the disclosure of a company's underlying assumptions for the company to receive the protections of the safe harbor rule for the disclosure of forward-looking statements. *See* Securities Act of 1933 Rule 175, 17 C.F.R. § 230.175 (1998). However, several courts have indicated that the disclosure of the underlying assumptions is necessary in order for an investor to gain an appreciation for the forward-looking statement and to prevent the statement from becoming misleading. *See* COX ET AL., *supra* note 114, at 78. For an argument that the SEC should adopt an interpretive release to help companies determine when and how they should disclose the assumptions underlying their forward-looking statements, see Seligman, *supra* note 118, at 1981–86.

[122] If the company discloses sufficient cautionary language that indicates that the projection or forecast may not be realized, the company may be able to use a different defense—the "bespeaks caution" doctrine—to protect itself from civil liability under the anti-fraud provisions of the federal securities laws. For a good introduction to the bespeaks caution doctrine, see Langevoort, *supra* note 14, at 481. In addition, the company may be able to rely on a statutory safe harbor modeled on the judicially created bespeaks caution doctrine. For an introduction to the statutory safe harbor, see Carl W. Schneider & Jay A. Dubow, *Forward-Looking Information—Navigating in the Safe Harbor*, 51 BUS. LAW. 1071 (1996). For additional discussion of the bespeaks caution doctrine, see *infra* notes 157–58 and accompanying text.

privy to the meetings and deliberations made by a company's management. Therefore, investors are not in a position to determine whether the company's statement concerning its strategy and objectives is overly optimistic or not. Because investors and the company do not have equal access to information, the doctrine of caveat emptor is inapplicable, and the puffery defense should not be used by courts to dismiss securities fraud actions.

2. *A Company's Vague Statement Characterizing Present Facts*

As the preceding section demonstrates, the information that is necessary for investors to draw their own conclusions as to a company's forward-looking statement is not generally available to investors. Similarly, the information that will enable investors to assess a company's vague statement characterizing present facts is also unavailable to the investors. For example, when a company states that negotiations with a potential merger partner are proceeding "well," it is basing this statement on information that is not generally available to investors. Such a characterization of the status of an on-going transaction may be made only upon an evaluation of many intangibles—a participant's tone of voice, facial expression, word choice, etc.[123] The company's investors are not able to assess first-hand the ebb and flow of the negotiation process. Unless investors have an alternative source, the only information they will have concerning the status of a merger would come from the company itself. Clearly then, investors do not have the information to make their own assessment of an on-going transaction. Therefore, they would be unable to offset the company's optimistic statement with their own conclusion.

Similarly, when a company states that current retail demand for its products is "good," investors do not generally have information that will enable them to offset the company's optimism. Unless journalists publish conflicting reports, or investors undertake an informal survey of the company's customers, investors will not be able to draw their own conclusions as to the demand for the company's products. The company has a virtual monopoly on the information underlying its statement. Once again, because the assumption that is necessary to justify the use of the puffery defense is absent, the courts should not use puffery to dismiss securities fraud actions.

B. *A Reasonable Investor May Trust a Company's Optimistic Statements*

The doctrine of caveat emptor is premised on the principle that there is, and

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[123] For a discussion of the important role non-verbal communication plays in the negotiation process, see DONALD G. GIFFORD, LEGAL NEGOTIATION: THEORY AND APPLICATIONS 127–32 (1989).

should be, a distrust between the buyer and the seller.[124] In other words, a purchaser, if acting reasonably, does not trust the sales talk of a seller. This is so because the purchaser understands that a seller commonly exaggerates in order to consummate the sale of a product.[125] In addition, because the seller is a stranger to the purchaser, the purchaser has no reason to believe the seller's statements of quality and value.[126] These assumptions are not necessarily valid in a securities transaction. In fact, there are several differences present in a securities transaction that may allow a reasonable investor to trust a company's vague statement of corporate optimism.

First, a company making a vague statement of corporate optimism may not be acting as a seller at all. Certainly, a company making a prediction of financial performance, or a statement concerning a new product, may do so when it is issuing securities. However, it is just as likely to make such a statement when it is *not* selling securities, such as in an earnings announcement or in an annual report to investors. If the company is not acting as a seller, the investor would not necessarily conclude that the company is exaggerating in order to make sure that its securities were sold.[127] Thus, it is more reasonable for the investor to trust the company's optimistic statement. When a company is not selling securities, then, one of the assumptions justifying puffery does not apply. Therefore, the puffery defense should not be used to protect a company from civil liability under the federal securities laws.

Second, the investor and the company may not be strangers to each other. If the investor is an existing shareholder of the company, the company, through its officers and directors, owes fiduciary duties to the investor.[128] As the Supreme Court noted,

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[124] *See supra* note 41 and accompanying text.

[125] *See supra* note 36 and accompanying text.

[126] *See supra* notes 41–42 and accompanying text.

[127] Of course, a company has incentive to make optimistic statements, even if it is not selling securities. A company is concerned with its stock price, and, presumably, optimistic statements will cause an increase in the price of a company's stock. Given this incentive, it could be argued that reasonable investors should automatically discount all optimistic statements made by a company because they should know that the company is making the optimistic statement to drive up the market price of the company's stock. Such an argument, however, proves too much. Such an argument leads to the conclusion that investors are not entitled to trust *any* optimistic statements made by a company. Such a sweeping conclusion is obviously erroneous. Furthermore, such an outcome would conflict with the policies underlying the federal securities laws. *See infra* Part IV.

[128] A complete discussion of the fiduciary duties owed by a company's officers and directors would exceed the scope of this Article. However, put simply, officers and directors owe a duty of care and a duty of loyalty to their corporation. *See* 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Pt. IV, at 137 (1994). The duty of care requires officers and directors:

it is "common knowledge" that officers and directors must "exercise their judgment in the shareholders' interest."[129] Given these fiduciary duties, it becomes more reasonable for the investor to believe the company's optimistic statements.[130]

Finally, the anti-fraud provisions of the federal securities laws make it more likely that a reasonable investor would believe the company's optimistic statements. Investors know that the securities industry is highly regulated. They understand that a company risks substantial liability for false or misleading statements.[131] Therefore, it is more reasonable for investors to believe a company's statements made in connection with the purchase or sale of a security than statements made by a seller in connection with the sale of a tangible product. Because one of the assumptions underlying the puffery defense is absent, the courts should not use puffery to dismiss securities fraud actions.

IV. THE PUFFERY DEFENSE CONFLICTS WITH THE POLICIES UNDERLYING THE FEDERAL SECURITIES LAWS

The federal securities laws explicitly rejected the doctrine of caveat emptor, replacing it with a policy of full and fair disclosure.[132] Puffery, on the other hand,

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> [T]o perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

Id. § 4.01, at 138. The duty of loyalty requires the directors and officers to act fairly. *See id.* § 5.01, at 205.

[129] Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1091 (1991).

[130] Even the common law doctrine of caveat emptor acknowledged that a relationship of trust and confidence justified the purchaser's trust in the seller. *See supra* note 42 and accompanying text.

[131] *See supra* notes 4–6 and accompanying text.

[132] As the Supreme Court has noted, a "fundamental purpose" of the federal securities laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); *accord* Central Bank v. First Interstate Bank, 511 U.S. 164, 171 (1994); Basic, Inc. v. Levinson, 485 U.S. 224, 235 (1988); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Wilko v. Swan, 346 U.S. 427, 431 (1953). One commentator has noted that the recent enactment of the statutory safe harbor modeled on the bespeaks caution doctrine may indicate some congressional approval of the doctrine of caveat emptor. *See* Roussel, *supra* note 14, at 1071 n.98. However, such limited acceptance certainly does not signal a return to the "let the buyer beware" environment that existed prior to the enactment of the federal securities laws.

is firmly grounded on the doctrine of "let the buyer beware."[133] The conflict between these two policies is readily apparent and can be demonstrated through a simple example. Assume that an officer of a corporation is asked to comment on the development of a new product. He responds that it is going "well." In actuality, however, it is not. Investors bring suit, contending that the statement constituted a material misrepresentation under the federal securities laws. The company argues that the officer's statement constituted non-actionable puffery. If a court agrees, then it is sending a message to investors that they cannot believe the company's disclosure. It is saying that, even though the company's officer said that the transaction was going "well," investors should have second-guessed the honesty of the officer and the accuracy of the statement. In effect, the court is signaling a return to the doctrine of caveat emptor, a result clearly at odds with the policies of the federal securities laws.

Puffery is based on the assumption that a purchaser should not trust a seller's optimistic statements. It encourages and rewards a distrust between the parties to a transaction. The federal securities laws, however, do not intend to encourage distrust between investors and companies. On the contrary, the federal securities laws were enacted to create an environment in which an investor *should* trust a company's disclosure.

One of the primary goals underlying the enactment of the federal securities laws was the restoration of public confidence in the securities markets.[134] Congress recognized that, prior to the federal securities laws, sellers routinely made exaggerated statements concerning their securities.[135] The unfortunate truth revealed by the Great Depression was that many of these representations were false, leading to an environment in which investors could not trust a seller's, or a company's, statements. Congress sought to address, and correct, this distrustful environment by enacting federal laws requiring honest disclosure to investors.

Congress took several significant steps to restore investors' trust in statements made by companies. Most importantly, numerous anti-fraud provisions were

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[133] *See supra* notes 32–39 and accompanying text.

[134] President Roosevelt, in urging congressional action, noted that the enactment of federal securities laws was necessary to "bring back public confidence." *Message from the President—Regulation of Security Issues*, 77 CONG. REC. 937 (1933) [hereinafter *Message from the President*]. The legislative history of the federal securities laws indicates that Congress agreed that this was an important objective of the federal securities laws. *See* S. REP. NO. 73-47, at 1 (1933) (stating that "[c]onfidence must and may be restored upon the enduring basis of honesty with the public").

[135] *See* S. REP. NO. 73-47, at 2 (1933) (noting that "billions of dollars" of securities were sold through "incomplete, careless, or false representations"); H.R. REP. NO. 73-85, at 2 (1933) (criticizing that sellers often made "[a]lluring promises of easy wealth").

included in the federal securities laws.[136] The SEC was established to enforce these provisions.[137] Moreover, investors were authorized to bring private actions to enforce the anti-fraud provisions.[138]

Lawmakers justified the additional regulation and exposure to liability that would be imposed by the federal securities laws by reasoning that a company owes special duties to its investors. For example, President Roosevelt explained that the federal securities laws should lead to "a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others."[139] This recognition that a company has a special, almost fiduciary, relationship with its investors appears throughout the legislative history of the federal securities laws.

In enacting the Securities Act of 1933, Congress returned again and again to the theme that those who sell securities to the public act as trustees. For example, in the Senate Report, the special position of trust held by a company's directors was used by Congress to explain the imposition of civil liability for a false or misleading statement appearing in a registration statement,[140] even though the directors may have acted without scienter.[141] Congress reasoned that "he should suffer the loss

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[136] *See* Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1994) (false or misleading statements in a registration statement); Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (1994) (false or misleading statements in a prospectus or oral communication); Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994) (false or misleading statements made in offer or sale of securities); Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994) (false or misleading statements made in connection with a tender offer); Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r(a) (1994) (false or misleading statements in documents filed with the SEC).

In addition, the SEC exercised the authority delegated by Congress to promulgate additional anti-fraud rules. *See* Securities Exchange Act of 1934 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1998) (false or misleading statements made in connection with the purchase or sale of a security); Securities Exchange Act of 1934 Rule 14a-9, 17 C.F.R. § 240.14a-9 (1998) (false or misleading statements appearing in proxy solicitation materials).

[137] The SEC was created as part of the original enactment of the Securities Exchange Act of 1934. *See* Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (1994). For a discussion of the SEC's enforcement powers, see HAZEN, *supra* note 32, § 9.5, at 420.

[138] *See supra* note 4.

[139] *Message from the President*, *supra* note 134.

[140] In general, the Securities Act of 1933 requires that an issuer desiring to sell securities to the public must disclose certain information in a registration statement, a specific type of disclosure document. *See* Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (1994). Section 11 of the Securities Act of 1933 imposes liability for false or misleading statements appearing in that registration statement. *See* 15 U.S.C. § 77k (1994).

[141] Section 11 of the Securities Act of 1933 does not contain a scienter requirement. Instead, civil liability for non-issuer defendants may be imposed for negligent behavior. *See* Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1994). An issuer is strictly liable for material

who occupies a position of trust in the issuing corporation toward the stockholders, rather than the buyer of stock who must rely on what he is told."[142]

The importance of the relationship between the company and the investing public was also emphasized in the House Report, which dedicates an entire section to a discussion of trusteeship.[143] The drafters, in addressing the imposition of civil liability under the Securities Act of 1933, explained:

> [The] essential characteristic [of civil liability] consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. Honesty, care, and competence are the demands of trusteeship.[144]

The recognition that a company has special responsibilities to its investors is not limited to situations in which a company is selling its securities. The theme reappears in the legislative history of the Securities Exchange Act of 1934. The House Report contains a thoughtful discussion of the duties owed under the federal securities laws. The Report states:

> If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship . . . supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system.[145]

As the legislative history of the federal securities laws makes clear, Congress intended to hold companies to a fiduciary-like standard of conduct. In particular, Congress intended that companies should make honest disclosure and that investors should be entitled to believe this disclosure. The puffery defense, however, undercuts this policy. If courts continue to apply the puffery defense, investors will be forced to question the veracity of a company's optimistic statements, leading to

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misrepresentations appearing in its registration statement. *See id.*

[142] S. REP. NO. 73-47, at 5 (1933).

[143] Section I.6 of the House Report is entitled "The Imposition of Standards of Trusteeship." H.R. REP. NO. 73-85, at 5 (1933).

[144] *Id.*

[145] H.R. REP. NO. 73-1383, at 5 (1934).

a distrustful investment environment based on the doctrine of caveat emptor. Such a result conflicts with one of the fundamental objectives of the federal securities laws.

This conclusion was recognized in *Anschutz Corp. v. Kay Corp.*[146] In that case, Anschutz Corp. (Anschutz) purchased from Kay Corp. (Kay) an interest in a mining corporation.[147] During the negotiations, Kay stated the mine was worth two million dollars.[148] This valuation was inaccurate.[149] Anschutz brought suit under the federal securities laws, and Kay contended that its statement constituted non-actionable puffery.[150] Kay relied primarily on Judge Learned Hand's classic statement concerning puffery contained in *Vulcan Metals Co. v. Simmons Manufacturing Co.*:

> The reason of the rule [of puffery] lies, we think, in this: There are some kinds of talk which no sensible man takes seriously, and if he does he suffers from his credulity. If we were all scrupulously honest, it would not be so; but, as it is, neither party usually believes what the seller says about his own opinions, and each knows it.[151]

The *Anschutz* court rejected this reasoning. Noting that *Vulcan Metals* was decided prior to the enactment of the federal securities laws, the district court questioned whether Judge Learned Hand's analysis continued to be valid.[152] The district court stated: "[W]e strongly doubt whether Judge Hand would have adopted the same approach today in view of the heightened standards of disclosure established by the federal securities laws enacted fifteen and sixteen years after the *Vulcan* decision."[153] Because the district court recognized that puffery was in conflict with the policies underlying the federal securities laws, it refused to apply the puffery defense. Other courts should do the same.

V. THE COURTS HAVE ERRONEOUSLY SUBSTITUTED THE PUFFERY DEFENSE FOR A MATERIALITY ANALYSIS

When a court uses the puffery defense to dismiss an action brought under the federal securities laws, it has presumably concluded that the company's statement

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[146] 507 F. Supp. 72 (S.D.N.Y. 1981).

[147] *See id.* at 73.

[148] *See id.*

[149] *See id.*

[150] *See id.*

[151] 248 F. 853, 856 (2d Cir. 1918), *quoted in Anschutz*, 507 F. Supp. at 74.

[152] *See Anschutz*, 507 F. Supp. at 74.

[153] *Id.*

was immaterial as a matter of law.[154] However, a close examination of the cases shows that most courts have not in fact conducted a materiality analysis. Instead, they have relied almost exclusively on the words of the company's statement, while ignoring other factors that might lead a reasonable investor to conclude that the statement was important to the investment decision. In effect, the courts have erroneously substituted the puffery defense for a proper materiality analysis.

A. *The Puffery Defense Fails To Consider the Importance of the Context of the Statement to the Materiality Determination*

As discussed above,[155] a statement is material "if there is a substantial likelihood that a reasonable [investor] would consider [the information] important in deciding how to [act]."[156] The materiality of a statement cannot be assessed by examining the statement in isolation. Only by examining the surrounding circumstances can a court determine whether the statement would assume significance to a reasonable investor.

The recognition that materiality is relative, or contextual, in nature can be seen in the cases adopting the "bespeaks caution" doctrine. The bespeaks caution doctrine provides that a prediction, forecast, or other type of forward-looking statement is immaterial as a matter of law if it is accompanied by sufficient cautionary language.[157] For example, assume that a court is determining the materiality of a company's statement that its new product will be introduced in the next year. In assessing materiality, the court will not look only at the statement. The court will also examine any cautionary language accompanying the statement that discloses the risk that the forward-looking statement may not come true. As the Third Circuit explained:

> [M]ateriality is a relative concept, so that a court must appraise a misrepresentation or omission in the complete context in which the author conveys it. In other words, a particular misrepresentation or omission significant to a reasonable investor in one

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[154] *See supra* note 23 and accompanying text.

[155] *See supra* note 17 and accompanying text.

[156] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[157] *See In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 371 (3d Cir. 1993). The courts have also reasoned that the bespeaks caution doctrine protects a defendant from liability because the cautionary language prevents reasonable reliance on the defendant's forward-looking statements and prevents the forward-looking statement from becoming false or misleading. *See* Langevoort, *supra* note 14, at 487 (explaining why "cautionary language can cause dismissal"). For an in-depth discussion of the different rationales explaining why cautionary language may operate to protect a defendant from liability under the federal securities laws, see Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619, 630–38 (1997).

document or circumstance may not influence a reasonable investor in another.[158]

Thus, courts should assess the materiality of a statement by reference to its surrounding circumstances.

The materiality of a company's vague statement of corporate optimism should not be assessed merely by examining the words of that statement. Yet that is precisely what most courts have done.[159] For example, in *Hillson Partners Ltd. Partnership v. Adage, Inc.*,[160] a company stated that it was "on target toward achieving the most profitable year in its history"[161] and that its operations "should significantly improve."[162] In determining that these statements constituted puffery, the court limited its analysis to the statements themselves. After examining the company's language, the court determined that these statements were too "vague" to be material.[163] According to the court, then, the statements constituted immaterial puffery.[164]

Certainly these statements *were* vague, and, taken in isolation, perhaps a reasonable investor would not place much significance on them. However, there were surrounding circumstances that might have led a reasonable investor to come to a different conclusion. Specifically, these statements were made in the company's quarterly reports filed with the SEC.[165] This factor might have led a reasonable

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[158] *Taj Mahal Litig.*, 7 F.3d at 369 (citations omitted); *accord* Grossman v. Novell, Inc., 120 F.3d 1112, 1120 (10th Cir. 1997) (stating that the bespeaks caution doctrine "stands for the 'unremarkable proposition that statements must be analyzed in context'") (quoting Rubinstein v. Collins, 20 F.3d 160, 167 (5th Cir. 1994)); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir. 1994) (same).

[159] A few courts have recognized that context plays a role in determining whether a company's statement constitutes puffery. *See* Howard v. Haddad, 962 F.2d 328, 331 (4th Cir. 1992) (stating that "[w]e agree that the atmosphere in which statements are made may bear on their materiality"); Casella v. Webb, 883 F.2d 805, 808 (9th Cir. 1989) (stating that "[w]hat might be innocuous 'puffery' or mere statement of opinion standing alone may be actionable as an integral part of a representation of material fact when used to emphasize and induce reliance upon such a representation"); Simon v. American Power Conversion Corp., 945 F. Supp. 416, 428 (D.R.I. 1996) (recognizing that the context in which a statement was made may "lead an investor to downplay" the significance of the statement); Schaffer v. Timberland Co., 924 F. Supp. 1298, 1313 (D.N.H. 1996) (stating that "the court will not dismiss a complaint on vagueness grounds if the alleged statements are such that, given the surrounding circumstances, a reasonable investor may have relied on the statements and predictions").

[160] 42 F.3d 204 (4th Cir. 1994).

[161] *Id.* at 212.

[162] *Id.*

[163] *See id.*

[164] *See id.*

[165] *See id.*

investor to place some significance on these statements, despite their vagueness.[166] The investor would have known that the statements were made in a formal written document and that the document was prepared after careful deliberation. Furthermore, the investor would have known that statements appearing in a document filed with the SEC create the potential for significant liability under the anti-fraud provisions of the federal securities laws. Therefore, it would seem that a reasonable investor *could* have found these statements to be significant, despite their vagueness.

The *Hillson* court did not recognize this. The court limited its examination to the statement itself and thereby failed to see that the context of the statement transformed a promotional, perhaps unimportant, statement into one that a reasonable investor could have found to be significant. Essentially, the court took an impermissible shortcut. By looking only at the vagueness of the language and ignoring its context, the court failed to conduct a full materiality analysis.

Naturally, the effect of context on the materiality determination cuts both ways. Just as the surrounding circumstances may lead a reasonable investor to attach *more* significance to a company's statement, the surrounding circumstances may also lead a reasonable investor to attach *less* significance to a company's statement. To date, the courts have not recognized that context may lead to a determination that a company's vague statement is nonetheless material. However, a few courts have used the statement's context as additional support for their holdings that the vague statement was *immaterial* as a matter of law.[167]

For example, in *Simon v. American Power Conversion Corp.*,[168] a company stated that it recognized the "significance of newly emerging international markets and the vast potential for [its] products in these areas of the world."[169] The company failed to disclose, however, that it had discovered a component defect in some of its products that would significantly affect its international operations.[170] When the company finally disclosed the defect, the stock price fell,[171] and investors brought

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[166] *See* Schneider, *supra* note 57, at 258 (noting that "[i]nvestors assume, with a great deal of justification, that information appearing in SEC filings has been prepared with considerable care, tending to assure its accuracy").

[167] *See* Howard v. Haddad, 962 F.2d 328, 331 (4th Cir. 1992) (noting that because the statements were made while the company official and the investor were playing golf, it was less likely that the statements were material); Simon v. American Power Conversion Corp., 945 F. Supp. 416, 428 (D.R.I. 1996) (noting that because the statements were made in connection with a promotional press release, it was less likely that the statement was material).

[168] 945 F. Supp. at 428.

[169] *Id.*

[170] *See id.* at 423.

[171] *See id.* at 420.

suit, claiming that the company's statement was materially misleading.[172] The court first reviewed the language of the company's statement and held that it constituted puffery.[173] Then the court examined the context of the company's statement. Noting that the statement was made in a press release announcing the appointment of a new president for Worldwide Business Development, the court reasoned that the promotional context of the statement would lead a reasonable investor to discount its significance.[174] Thus, the context of the statement was further support for the court's holding that the company's statement was immaterial as a matter of law.

In addition to failing to recognize that *where* a company's statement was made might be important to a reasonable investor, the courts have failed to place any importance on *who* made the statement. Some courts have not drawn a distinction between statements made by brokers and statements made by non-brokers.[175] In *Voit v. Wonderware Corp.*,[176] for example, a company stated that its newly-hired president was "really looking forward to working with"[177] the company's existing Chief Executive Officer. Soon after, the company's CEO was replaced by the new president, and the company explained that the CEO's departure was part of a planned strategy.[178] Investors brought suit, contending that the company's original statement was a material misrepresentation.[179] In analyzing whether the company's statement constituted puffery, the court relied on several puffery cases involving statements made by brokers.[180] Thus, the court did not appear to attach any significance to the identity of the speaker.[181] The court looked only at the language of the statement and ignored the identity of the speaker.

The identity of the speaker would seem to be a factor that a reasonable investor would consider in determining whether the statement was important. Certainly, a reasonable investor would place greater significance on a statement made by a

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[172] *See id.* at 420–21.

[173] *See id.* at 428.

[174] *See id.*

[175] *See* Howard v. Haddad, 962 F.2d 328, 331 (4th Cir. 1992) (relying on puffery cases involving brokers in assessing whether a statement made by a director constituted puffery); Voit v. Wonderware Corp., 977 F. Supp. 363, 370 (E.D. Pa. 1997) (relying on puffery cases involving brokers in assessing whether a statement made by a company constituted puffery); *In re* Apple Computer Sec. Litig., 672 F. Supp. 1552, 1572 (N.D. Cal. 1987) (same).

[176] 977 F. Supp. at 363.

[177] *Id.* at 365.

[178] *See id.* at 366.

[179] *See id.* at 367.

[180] *See id.* at 370 (citing Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186 (3d Cir. 1990) and Newman v. L.F. Rothschild, 651 F. Supp. 160 (S.D.N.Y. 1986)).

[181] The *Voit* court ultimately determined that the company's statement did not constitute puffery because the company's statement was not an "exaggerated sales pitch[ ]." *Id.*

company than on a statement made by a broker. The investor is well aware that the company, through its officers and directors, owes fiduciary duties to its investors. On the other hand, a reasonable investor might be more likely to discount a statement made by a broker, who is trying to make a sale.[182]

Similarly, the courts have not drawn any distinction between statements made by a company through its officers or directors and statements made by an analyst[183] who purports to report statements made by the company.[184] Because there is a danger that an analyst may have misheard or misunderstood the company's statement, or that the analyst may have failed to communicate the company's statement properly, a statement reported by an analyst may be less reliable than a statement made directly by the company. Therefore, investors may attach less significance to such statements. Thus, by ignoring the significance of the speaker and focusing only on the vagueness of the company's statement, the courts have failed to conduct a materiality analysis.

B. *The Unique Nature of Statements Characterizing Present Facts Should Affect the Materiality Determination*

In using the puffery defense to dismiss securities fraud actions, many courts have failed to attach any significance to the *type* of statement made by a company. Specifically, these courts see no difference between a vague forward-looking statement, such as a statement that the company expects to see "strong" earnings in the following quarter, and a vague statement characterizing present facts, such as a statement that demand for its product during the previous quarter was "strong."

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[182] A broker may also owe fiduciary duties to his client, although the law is far from clear. General agency principles impose fiduciary duties on a broker acting as an agent. In addition, under certain circumstances, the federal securities laws may impose certain fiduciary duties upon a broker acting as a principal (*i.e.*, as a dealer). For an overview of the fiduciary duties owed by brokers to their clients, see 8 LOSS & SELIGMAN, *supra* note 1, at 3816–39.

[183] A company may be liable for statements made by analysts if the company has "sufficiently entangled itself with the analysts' [statements] to render those [statements] attributable to it." Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980) (internal quotation marks omitted). For a discussion of the entanglement theory, see Robert Norman Sobol, Comment, *The Tangled Web of Issuer Liability for Analyst Statements: In re Cirrus Logic Securities Litigation*, 22 DEL. J. CORP. L. 1051, 1063–66 (1997).

[184] Although several puffery cases involved statements made by a company to analysts that were later reported to investors, none of these cases addressed whether the identity of the speaker was a factor in determining materiality. *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1428 (3d Cir. 1997) (statements made by company during conference with analysts were reported by Reuters); Schaffer v. Timberland Co., 924 F. Supp. 1298, 1310–12 (D.N.H. 1996) (statements made by company during conference calls with analysts reported to investors in analyst reports).

According to these courts,[185] a vague statement is a vague statement, and all vague statements constitute puffery.[186] These courts have failed to recognize that a reasonable investor might find a statement characterizing present facts to be significant, even if the statement is vague. Because the puffery defense focuses only on the language of the statement, courts applying the puffery defense have failed to attach any importance to the unique nature of statements characterizing present facts.

This faulty approach can be seen in *Grossman v. Novell, Inc.*[187] In *Grossman*, Novell, Inc. ("Novell") merged with WordPerfect Corp. ("WordPerfect").[188] Prior to the merger, there had been some concern that the integration of the two companies might be difficult.[189] Following the merger, Novell, the surviving corporation, stated that "Novell had experienced substantial success in the integration"[190] of the two sales forces, that the merger process had moved "faster than we thought it would,"[191] and that the Novell-WordPerfect merger had been "perhaps the smoothest of mergers in recent history."[192] Following these statements, Novell disclosed disappointing quarterly earnings, and investors brought suit, contending that these statements constituted material misrepresentations.[193]

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[185] *See* Grossman v. Novell, Inc., 120 F.3d 1112, 1121–22 (10th Cir. 1997) (holding that statement characterizing a prior merger as "success[ful]" was too vague to be material); Eisenstadt v. Centel Corp., 113 F.3d 738, 741, 745 (7th Cir. 1997) (finding that statement characterizing an on-going auction of the company as going "very well" and "very smoothly" was too general to be material); Gross v. Summa Four, Inc., 93 F.3d 987, 995 (1st Cir. 1996) (holding statement characterizing the company's receipt of orders for its product as "significant" to be too vague to be material); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1219 (1st Cir. 1996) (finding statements characterizing the company's prior transition to selling a new kind of product as "going reasonably well" and the company's financial status as "healthy" to be immaterial); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1118 (D. Nev. 1998) (holding statement characterizing the opening of the company's new hotel as going "very smoothly" to be too general to be material); *In re* Healthco Int'l, Inc. Sec. Litig., 777 F. Supp. 109, 115 (D. Mass. 1991) (finding statement characterizing the status of a merger too vague to be material); *In re* Apple Computer Sec. Litig., 672 F. Supp. 1552, 1572 (N.D. Cal. 1987) (holding statement characterizing the company's personal computer as "clearly being recognized as an important force in the office market" to be too emphatic to be material).

[186] For a criticism of this approach and an argument that a court should also consider the context of the statement, see *supra* Part V.A.

[187] 120 F.3d 1112 (10th Cir. 1997).

[188] *See id.* at 1116.

[189] *See id.*

[190] *Id.* at 1117.

[191] *Id.*

[192] *Id.*

[193] *See id.* at 1116.

Novell argued that these statements were immaterial, and the district court agreed.[194] The Tenth Circuit affirmed.[195]

The Tenth Circuit first reviewed the puffery defense, noting that "[s]tatements classified as 'corporate optimism' or 'mere puffing' are typically forward-looking statements, or are generalized statements of optimism that are not capable of objective verification."[196] It emphasized that certain statements are immaterial as a matter of law because they are too vague to be found significant by a reasonable investor.[197] After examining Novell's statements, the court concluded that "[t]hese are the sort of soft, puffing statements, incapable of objective verification, that courts routinely dismiss as vague statements of corporate optimism."[198]

The *Novell* court, therefore, did not find it at all significant that Novell's statements were not forward-looking, but were rather statements characterizing present facts—the success of the merger. In other words, Novell was not predicting the effect of a *future* merger; it was evaluating the success of an *already completed* merger. According to the court, the distinction was not important. Because Novell's statements were too vague, no reasonable investor would consider them significant.

It is true that each of Novell's statements was vague. Nonetheless, a reasonable investor might have found the information to be important. A reasonable investor would place greater significance on a statement characterizing present facts than on a statement predicting future performance. Investors understand that forward-looking statements are inherently unreliable. Forward-looking statements almost always turn out to be wrong because they are based on estimates and assumptions. A statement characterizing present facts, on the other hand, is based on historical data. Therefore, it is more likely to be accurate.[199] Thus, even though a statement characterizing present facts may be vague, a reasonable investor would understand it to rest on historical information and might find it to be significant.

The *Novell* court failed to recognize this. Because it launched directly into a discussion of the puffery defense, the court was swayed by the vagueness of the company's statements. It did not attach any importance to the type of statement Novell made. If it had, it would have realized that a reasonable investor might attach significance to Novell's statements, despite their vagueness. By failing to draw a

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[194] *See id.* at 1117.

[195] *See id.* at 1126.

[196] *Id.* at 1119.

[197] *See id.* at 1119–20.

[198] *Id.* at 1121–22.

[199] As one commentator has pointed out: "The *reliability* of a statement of past events (*i.e.*, the correlation of the information contained in the statement with the events it describes) is apt to be greater than the reliability of a statement of future or contingent events." Victor Brudney, *A Note on Materiality and Soft Information under the Federal Securities Laws*, 75 VA. L. REV. 723, 729 (1989).

distinction between forward-looking statements and statements characterizing present facts, it impermissibly bypassed the materiality analysis. Rather than asking whether a reasonable investor might find the statement to be important, it simply asked whether the statement was too vague. This is not a proper materiality analysis.

Although most courts have overlooked the important distinction between forward-looking statements and characterizations of present facts, a few courts have recognized its relevance to the materiality analysis.[200] A good example is *McCarthy v. C-Cor Electronics, Inc.*[201] In *McCarthy*, a company stated that it was expecting "strong" quarterly revenues.[202] The company argued that this statement constituted puffery.[203] The court agreed that the company's statement was vague, but determined that vagueness alone was not dispositive to materiality.[204] Instead, the court emphasized the significance of the forward-looking nature of the company's statement to the materiality determination. The court drew a clear distinction between forward-looking statements and statements characterizing present facts, concluding that "[f]orward-looking statements are . . . less material than are statements of present fact."[205] According to the court, reasonable investors do not place as much significance on forward-looking statements because they "know that prediction is necessarily an inexact art, and so treat forward-looking statements as less reliable than statements about present facts."[206] The court noted that a similarly vague statement "that focused on the present, rather than the future, would certainly be material."[207]

As the above discussion demonstrates, many courts have failed to recognize that the special nature of statements characterizing present facts may lead reasonable investors to attach significance to them, despite their vagueness. There is another reason why courts should not automatically attach a puffery label to a vague statement characterizing present facts: Statements characterizing present facts

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[200] *See* Hillson Partners Ltd. Partnership v. Adage, Inc., 42 F.3d 204, 211 (4th Cir. 1994) (distinguishing between "expressions of belief or opinion 'concerning *current* facts,' that 'may be material'" and "opinions as to uncertain future events" that may not be material) (quoting Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1090–97 (1991)); Raab v. General Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993) (distinguishing between "expressions of belief or opinion concerning *current* facts" that may be material and "[p]redictions of future growth" that may not be material); McCarthy v. C-Cor Elec., Inc., 909 F. Supp. 970, 976–77 (E.D. Pa. 1995) (distinguishing between forward-looking statements and statements of present fact).

[201] 909 F. Supp. 970 (E.D. Pa. 1995).

[202] *See id.* at 974–75.

[203] *See id.* at 976.

[204] *See id.* at 977.

[205] *Id.* at 976.

[206] *Id.*

[207] *Id.*

are necessarily vague. When a company evaluates an on-going transaction or its past financial performance, it will examine the relevant facts, analyze them, and then distill them into a general statement. For example, when a company is asked to describe its present financial health, it could respond with a simple dollars and cents statement of earnings, allowing its audience to draw their own conclusions. However, the information the market really wants to know is the company's own assessment of its health (*i.e.*, Is the company's condition "strong?" "Fair?" "Improving?"). Similarly, when a company is asked to comment on the status of its attempt to acquire another company, for example, its response may be that the transaction is proceeding "very well," "well," or perhaps "not so well." All of these evaluative words are sufficiently vague to be labeled puffery. However, such a result would mean that a company's statement characterizing present facts would *always* be immaterial and therefore non-actionable. Courts should recognize, then, that the vagueness of a statement characterizing present facts should not be dispositive to a materiality determination.

The Supreme Court has buttressed the conclusion that a company's statement characterizing present facts, though vague, may nonetheless be material. In *Virginia Bankshares, Inc. v. Sandberg*,[208] the board of directors of a bank stated that they approved a merger because it presented the minority shareholders with an opportunity to receive a "high" value for their stock.[209] The board also stated that the proposed price for the minority shareholders's stock was "fair."[210] The bank argued that these statements were too "indefinite" and too "unverifiable" to be actionable under the federal securities laws.[211] The Supreme Court disagreed.[212]

The Supreme Court began its analysis with a discussion of whether statements of opinion or belief can ever be material.[213] The Court simply stated that "no serious question"[214] could be raised that such statements could be material. In the section of its opinion addressing materiality,[215] the Court did not directly discuss the effect of vagueness on the materiality determination. Instead, it merely agreed that the jury hearing the *Virginia Bankshares* case could have found that the bank's statements were material.[216] Therefore, the Court indicated that the vagueness of the bank's

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[208] 501 U.S. 1083 (1991).

[209] *See id.* at 1088.

[210] *See id.*

[211] *See id.* at 1090.

[212] *See id.* at 1093.

[213] *See id.* at 1090.

[214] *Id.*

[215] Part II-A of the *Virginia Bankshares* opinion addresses materiality. *See id.*

[216] The Supreme Court noted that "the shareowner faced with a proxy request will think it important to know the directors' beliefs about the course they recommend and their specific reasons for urging the stockholders to embrace it." *Id.* at 1091.

statements did not lead automatically to a conclusion that the statements were immaterial. In other words, the Supreme Court appears to have rejected the argument that vague statements characterizing present facts are always immaterial as a matter of law.[217]

The Supreme Court *did* directly address the significance of vagueness in another section of the *Virginia Bankshares* opinion. After discussing whether the bank's statements were material, the Court turned to the question of whether the bank's statements were factual.[218] The bank had argued that the statements were too vague to constitute facts. The Supreme Court disagreed, stating:

> It is no answer to argue... that the quoted statement on which liability was predicated did not express a reason in dollars and cents, but focused instead on the "indefinite and unverifiable" term, "high" value, much like the similar claim that the merger's terms were "fair" to shareholders. The objection ignores the fact that such conclusory terms in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate....[219]

Because this discussion focused on whether vague statements constituted facts, as opposed to whether such statements were material, this portion of the opinion did not directly stand for the proposition that a vague statement characterizing present facts is material. However, the opinion clearly demonstrates that the Supreme Court *does* recognize that vague statements may be important to investors.

VI. A PROPOSED FRAMEWORK FOR ADDRESSING THE MATERIALITY OF VAGUE STATEMENTS OF CORPORATE OPTIMISM

So what should a court do when it is confronted with a vague statement of corporate optimism? As I demonstrated in the previous sections of this Article, the

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[217] Several courts have read *Virginia Bankshares* as standing for the proposition that vague statements characterizing present facts can be material. *See* Shapiro v. UJB Fin. Corp., 964 F.2d 272, 282 (3d Cir. 1992) (stating that *Virginia Bankshares* supported the court's holding that a company's characterizations of management practices as "adequate," "conservative," and "cautious" were actionable); McCarthy v. C-Cor Elec., Inc., 909 F. Supp. 970, 976 (E.D. Pa. 1995) (stating that the "adjective 'strong' is no less specific than the adjectives at issue in *Virginia Bankshares*, in which the [Supreme] Court found that statements that a merger offered a 'high' value at a 'fair' price were material").

[218] Part II.B.1 of the *Virginia Bankshares* opinion addresses whether vague statements can be factual. *See id.* at 1091. Because it begins with the Supreme Court assuming the materiality of the bank's statements, the Supreme Court makes clear that it is not addressing materiality in this section of its opinion. *See id.*

[219] *Id.* at 1093.

court should not simply review the language of the statement, label the statement as puffery, and dismiss the action as a matter of law.[220] Instead, the courts should conduct a full materiality analysis by examining both the statement itself and the context in which the statement was made. This section of the Article attempts to provide the courts with a framework for addressing the materiality of vague company statements.

When a court is asked to determine the materiality of a vague statement of corporate optimism, it should consider the following factors: (1) the vagueness of the statement; (2) whether the statement is a forward-looking statement or a statement characterizing present facts; and (3) the presence or absence of any other factors that may lead a reasonable investor to find the company's statement to be significant to an investment decision.

Vagueness of the Statement: As shown above,[221] the courts should not limit their analysis to the language of the statement. Nonetheless, the vagueness of a statement is a significant factor in determining materiality. The more vague the statement, the less likely it is that a reasonable investor would find it important. Therefore, it is less likely to be material. However, vagueness is not dispositive. Instead, it is merely one of several factors that a court needs to consider in its materiality determination.[222]

Type of Statement: In addition to the vagueness of the statement, the court should consider whether the statement of corporate optimism is a forward-looking statement or a statement characterizing present facts. As discussed above,[223] there is an important distinction between the two types of statements. Because forward-looking statements are understood to be somewhat unreliable, reasonable investors are less likely to find such statements to be significant.[224] However, courts should not always hold that vague forward-looking statements are immaterial as a matter of law. Rather, the courts should scrutinize the forward-looking statement to determine how unreliable it is. Certain forward-looking statements are more reliable than others. For example, the court should consider the timeframe of the prediction.[225] A prediction of company earnings expected at the end of the next quarter is more reliable than a prediction of company earnings expected at the end of the next year. Thus, a reasonable investor might attach more significance to the first prediction than the second. In assessing the materiality of a vague forward-looking statement, then, a court should examine the statement to determine if a

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[220] *See supra* Part V.

[221] *See supra* Part V.

[222] *See supra* Part V.A.

[223] *See supra* Part V.B.

[224] *See supra* notes 205–06 and accompanying text.

[225] *See* McCarthy v. C-Cor Elec., Inc., 909 F. Supp. 970, 977 (E.D. Pa. 1995).

reasonable investor would find the forward-looking statement to be reliable and therefore significant to an investment decision.

A statement characterizing present facts should be held immaterial as a matter of law only in very rare circumstances. Because statements characterizing present facts are based on historical facts, they are more likely to be reliable, and reasonable investors are more likely to attach significance to such statements.[226] Moreover, when a court is asked to consider the materiality of a statement characterizing present facts, it should recognize that assessments and evaluations of present facts are necessarily vague.[227] Therefore, in assessing the materiality of a statement characterizing present facts, the courts should place much less emphasis on the statement's vagueness.

Identifying the company's vague statement as a statement characterizing present facts will not always lead to a determination that the statement is not immaterial as a matter of law. However, it would seem that courts should normally allow the determination to be made by a jury. Only if the surrounding circumstances undeniably lead to a conclusion that a reasonable investor would attach no importance to the statement should a court find the statement to be immaterial as a matter of law.

Other Factors Affecting Significance to Investor: Finally, the court should consider the presence or absence of any other factors that might lead a reasonable investor to attach significance to the company's vague statement of corporate optimism. An important factor to consider is *where* the statement was made. If the statement was made in a document filed with the SEC, a reasonable investor might find a vague statement to be significant, despite its vagueness.[228] On the other hand, if the statement was made orally, in a casual setting, a reasonable investor would probably not attach much significance to a vague statement of corporate optimism.[229]

The court should also consider if the statement was made in a promotional setting. If so, investors would be more likely to understand that the company's statement may be somewhat exaggerated and may therefore place less importance on it. For example, if a company's vague statement is connected with the launch of a new product, a reasonable investor is likely to discount the company's statement as product "hype."[230] Similarly, if the company's vague statement of corporate optimism is made in the "Chairman's Letter" to investors that appears in the

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[226] *See supra* note 199 and accompanying text.

[227] *See supra* Part V.B.

[228] *See supra* notes 165–66 and accompanying text.

[229] *See supra* note 167 and accompanying text.

[230] For a discussion of the promotion that ordinarily accompanies an introduction of a new product, see Robert A. Prentice & John H. Langmore, *Beware of Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies*, 8 HARV. J.L. & TECH. 1, 4–16 (1994).

company's annual report that is sent to shareholders,[231] then a reasonable investor may place less importance on it. The annual report that is sent to shareholders is a glossy, promotional document, and investors understand that statements made in the Chairman's Letter are often exaggerated.[232] For example, following an extensive review of annual reports, a business journalist observed:

> Sameness is apparent from the outset, as most opening statements employ superlatives: "We're the leading provider of..." or "... the dominant force in..." Every one of the annual reports from long-distance companies said "we're" the leader in the field. And one chairman after another reported the completion of yet another "record year"—including heads of two companies whose major financial indicators, depicted later in the report, had all declined from the previous year.[233]

The courts should also consider the identity of the speaker.[234] Investors would most likely attach greater significance to statements made by a company's officer or director than to statements made by other representatives of the company, such as spokespersons, or to statements made indirectly by the company through

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[231] The annual report that is sent to shareholders is distinguishable from a company's "Annual Report on Form 10-K" that must be filed with the SEC. The annual report that is sent to shareholders contains a summary of the information required to be disclosed in the company's 10-K. *See* Securities Exchange Act of 1934 Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1998) (listing the information that must be disclosed in an annual report to security holders). It is also "glossier" than the more formal document that is filed with the SEC. For a discussion of the annual report, see HAZEN, *supra* note 32, § 11.6, at 588–89.

[232] The promotional nature of the Chairman's Letter to investors is well recognized. *See* David Robinson, *From the Desk Of: Annual Reports, R.I.P.*, N.Y. TIMES, June 28, 1998, at C13 (recognizing the Chairman's Letter as "usually full of self-congratulation"); Sana Siwolop, *Investing It: Annual Report Mantra: New! Improved!*, N.Y. TIMES, Apr. 26, 1998, at C4 (noting that "the glossy missives that companies send shareholders each year have long tended to play up efforts to become sleeker, more cost-conscious and more profitable"); Sana Siwolop, *Investing It: Painting the Year That Was, or Will Be*, N.Y. TIMES, Apr. 27, 1997, at C4 (characterizing the Chairman's Letter to investors as "breezy"); David Stauffer, *Manager's Journal: What Annual Reports Won't Say*, WALL ST. J., Apr. 7, 1997, at A14 (noting that annual reports "try[ ] to give a rosy glow to lackluster corporate performance").

[233] Stauffer, *supra* note 232, at A14. In a humorous article, Mr. Stauffer "translates" a typical annual report, distinguishing between what actually happened to the company and how it is presented in the annual report. For example:

> —[What happened:] By just about every measure of corporate performance, the company now ranks at or near the bottom for its industry.
> How it's described: "We are well-positioned for future growth."

Id.

[234] *See supra* notes 175–84 and accompanying text.

analysts.[235] In addition, investors might find certain types of speakers to be more important than others. For example, a statement made by a company officer who does not ordinarily make public statements may be considered to be quite important to investors, simply because of its rarity.[236]

This proposed framework will assist courts in making a reasoned materiality determination. If courts continue to apply the puffery defense, which focuses simply on the language of the company's vague statement of corporate optimism, courts risk dismissing meritorious actions as a matter of law. However, if courts apply the proposed framework, they may well determine that a reasonable investor *could* find the company's statement of corporate optimism to be material, despite its vagueness, and therefore allow the claim to proceed to the jury. The jury will then be able to capitalize on its particular strengths to determine whether the company's statement was material or not.

The proposed framework will allow potentially meritorious actions to continue without creating a risk of increased strike suits. Courts applying the proposed framework can, and should, continue to dismiss clearly immaterial actions as a matter of law. The proposed framework simply refocuses the court's attention on its true task—assessing the materiality of a company's statement. It reminds the court that it must examine all circumstances that might lead an investor to attach significance to a company's statement. Only when courts apply the proposed framework will the puffery defense be relegated back to its proper extinct status.

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235 *See supra* notes 183–84 and accompanying text.

236 *See, e.g.*, Gretchen Morgenson, *The Markets: Value of Spin on Wall Street Is $15 Billion to 2 Companies*, N.Y. TIMES, May 15, 1998, at D1 (noting that the chairman of IBM only speaks to analysts once a year).