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# CLEANING THE MURKY SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS: AN INQUIRY INTO WHETHER ACTUAL KNOWLEDGE OF FALSITY PRECLUDES THE MEANINGFUL CAUTIONARY STATEMENT DEFENSE

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**CLEANING THE MURKY SAFE HARBOR FOR FORWARD-LOOKING  
STATEMENTS: AN INQUIRY INTO WHETHER ACTUAL KNOWLEDGE OF  
FALSITY PRECLUDES THE MEANINGFUL CAUTIONARY STATEMENT DEFENSE**

by Allan Horwich

Abstract

Congress included a safe harbor for forward-looking statements in the 1995 Private Securities Litigation Reform Act. This affords certain issuers and other specified persons limited protection from civil liability for damages under the Securities Act of 1933 and the Securities Exchange Act of 1934 when the projections or objectives in a forward-looking statement are not realized, *i.e.*, turn out to be false. The safe harbor contains two principal elements, in addition to protection for “immaterial” statements: one prong where projections are accompanied by “meaningful cautionary statements,” the second prong where the plaintiff fails to prove that the speaker made the statement with “actual knowledge” that it is false or misleading. This article reviews the legislative history of the safe harbor, the divergent lines of case law interpreting it and extensive commentary on how the safe harbor should be applied. The conclusion of this analysis is that the first prong is available as a complete defense without regard to the state of mind or intent of the speaker, so that (1) the second prong does not apply when the first prong is satisfied and (2) statements are not deemed not “meaningful” because a risk factor that rendered the forward-looking statement unlikely to be realized was knowingly omitted from the cautionary statements. Although there may be policy reasons why the safe harbor should have been different, this interpretation is compelled by the language of the statute and the legislative history, including the “bespeaks caution” line of cases on which the statutory safe harbor was based, and judicial and scholarly analyses to the contrary are flawed.

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STATEMENTS: AN INQUIRY INTO WHETHER ACTUAL KNOWLEDGE OF  
FALSITY PRECLUDES THE MEANINGFUL CAUTIONARY STATEMENT DEFENSE**

Allan Horwich\*

Many public companies disclose earnings projections and make other statements about their future. Those companies are sometimes sued when the projection is not borne out. This article addresses action by Congress to afford a safe harbor to public companies that make projections that are not accurate. Based on an analysis of the statute, its legislative history, judicial decisions and commentary regarding the interaction of the multiple prongs of the safe harbor this article proposes a definitive resolution of the extent to which the prongs overlap – that the prongs are independent and in particular actual knowledge of the weaknesses in a projection, including lack of a good faith belief in the projection, is not relevant to reliance on the meaningful cautionary statement safe harbor.

**I. INTRODUCTION AND BACKGROUND**

The Securities and Exchange Commission (“SEC”) once frowned upon – indeed, “generally prohibited” – public company<sup>1</sup> disclosure of earnings projections.<sup>2</sup> The SEC

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This article speaks as of January 1, 2010, unless otherwise noted. The views expressed are solely those of the author and should not be attributed to any client of Schiff Hardin LLP.

<sup>1</sup> In this article the phrase “public company” means an issuer that is subject to the public disclosure requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(a) and 78o(d) (2000) [hereinafter “Exchange Act”].

relented,<sup>3</sup> and in some cases now *mandates* disclosure of information with a forward looking element.<sup>4</sup> Making projections sometimes comes with a cost, however, as investors may seek

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<sup>2</sup> See Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, 38 FED. REG. 7220, 7220 (Mar. 19, 1973) (“It has been the Commission’s long-standing policy generally not to permit projections to be included in prospectuses and reports filed with the Commission”); 2 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 77-79 (4th ed. 2007) (describing earlier SEC prohibition on the inclusion of projections in documents filed with the SEC and SEC position that projections were *per se* misleading).

<sup>3</sup> See Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, 38 FED. REG. 7220, 7220 (Mar. 19, 1973); LOSS ET AL., *supra* note 2, at 80-95 (recounting evolution of the change in SEC policy). The current SEC policy is expressed in Item 10(b) of SEC Regulation S-K, 17 C.F.R. § 229.10(b) (2009):

*Commission Policy on Projections.* The Commission encourages the use in [certain documents filed with the SEC] of management’s projections of future economic performance that have a reasonable basis and are presented in an appropriate format. The guidelines set forth [in subsections (1), (2) and (3)] represent the Commission’s views on important factors to be considered in formulating and disclosing such projections.

(1) *Basis for Projections.* The Commission believes that management must have the option to present in Commission filings its good faith assessment of a registrant’s future performance. Management, however, must have a reasonable basis for such an assessment.

Subsections (2) and (3) of Item 10(b) provide guidance on preparing and presenting projections.

<sup>4</sup> For example, Item 7 of the annual report on Form 10-K required to be filed by public companies with the SEC requires that the company furnish the information required by Item 303 of Regulation S-K. See Form 10-K, Part II, Item 7, available at <http://www.sec.gov/about/forms/form10-k.pdf>. Management’s Discussion and Analysis of Financial Condition and Results of Operations must disclose, among other forward-looking elements, “any known trends or uncertainties that have had or that the registrant reasonably expects will have a favorable or unfavorable impact on net sales or revenues or income from continuing operations.” Regulation S-K, Item 303(a)(3)(ii), 17 C.F.R. § 229.303(a)(3)(ii) (2009).

damages when the projection does not come true, claiming that they were misled into buying or selling a security in reliance on an incorrect projection.<sup>5</sup>

In a private damage action based on a violation of Section 10(b) of the Exchange Act<sup>6</sup> and SEC Rule 10b-5,<sup>7</sup> the most common basis for a private damage claim under the federal securities laws,<sup>8</sup> there is liability for an incorrect projection only if the defendant stated the projection with scienter, an intent to deceive.<sup>9</sup> “Scienter” is generally understood to encompass reckless conduct, although the Supreme Court has not addressed that issue.<sup>10</sup> If a materially incorrect projection is made in an effective registration statement for a public offering of

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<sup>5</sup> See 5C ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 12.28 nn. 3-5 & 38 (2009) (collecting cases involving claims for misleading financial projections). For a discussion of Congressional concern about litigation based on incorrect projections, see *infra* text accompanying notes 21-23. This article sometimes uses the phrase “incorrect projection” to refer to a projection that does not come true, irrespective of whether it was believed to be accurate or had a reasonable basis when made.

<sup>6</sup> 15 U.S.C. § 78j(b) (2000).

<sup>7</sup> 17 C.F.R. § 240.10b-5 (2009).

<sup>8</sup> DONNA M. NAGY, ET AL., SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS 19 (2d ed. 2008) (“Rule 10b-5 is the leading anti-fraud weapon in the federal securities laws.”).

<sup>9</sup> See, e.g., *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 768 (2008) (“In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”). “Scienter” is a “mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

<sup>10</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 381 n.3 (2007) (“Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required.”).

securities, however, the issuer could be liable under Section 11 of the Securities Act of 1933<sup>11</sup> irrespective of any culpability.<sup>12</sup> Directors and officers of the issuer can defend a Section 11 claim by showing that after reasonable investigation the person had reasonable ground to believe that the projection was sound.<sup>13</sup>

In 1979 the SEC adopted two rules to provide safe harbors for certain forward-looking statements.<sup>14</sup> Under these rules if certain criteria are satisfied the statements are deemed not “fraudulent” and thus not the subject of any claim for wrongful conduct.<sup>15</sup> These rules proved to have limited utility in providing a defense, most notably because a court is able to determine that the criteria for protection are satisfied only after inquiring into the facts, including the good faith of the person who made the statement. Adding these safe harbors to a public company’s arsenal of defense tools thus did little to remove the litigation exposure for making an incorrect projection even in the utmost good faith.<sup>16</sup>

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<sup>11</sup> 15 U.S.C. § 77k (2000) [hereinafter “Securities Act”].

<sup>12</sup> See generally Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 10, 18-24 (2002) (discussing strict liability of the issuer in an action under Section 11). For a case where issuer liability under Section 11 was pursued based upon an alleged incorrect financial projection, see *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989) (affirming judgment for defendants on ground that projections were not material).

<sup>13</sup> Section 11(b)(3)(A) and (C), 15 U.S.C. § 77k(b)(3)(A) and (C) (2000).

<sup>14</sup> A “safe harbor” is “[a] provision (as in a statute or regulation) that affords protection from liability or penalty.” BLACK’S LAW DICTIONARY 1453 (9th ed. 2009).

<sup>15</sup> Rule 175 under the Securities Act (17 C.F.R. § 230.175 (2009)) and Rule 3b-6 under the Exchange Act (17 C.F.R. § 240.3b-6 (2009)) were adopted in Safe Harbor Rules for Projections, Securities Act Release No. 6084, 44 FED. REG. 38810 (July 2, 1979). For a discussion of the background of these rules, see LOSS ET AL., *supra* note 2, at 81-94.

<sup>16</sup> See Safe Harbor for Forward Looking Statements, Securities Act Release No. 7101, 59 FED. REG. 52723, 52728 (Oct. 19, 1994) [hereinafter *Concept Release*] (“The safe harbor is

Courts adopted the bespeaks caution doctrine as a means of winnowing non-meritorious incorrect projection claims under the federal securities laws. Under one line of bespeaks caution cases, a forward-looking statement that is sufficiently qualified by cautionary statements is not “material.”<sup>17</sup> Because materiality is an essential element of a claim of deception under the federal securities laws, this doctrine afforded a defense to claims based on an incorrect projection.<sup>18</sup> In appropriate cases the bespeaks doctrine is raised on a motion to dismiss the

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infrequently raised by defendants, perhaps because it compels judicial examination of reasonableness and good faith, which preclude early, pre-discovery dismissal. Thus, critics state that the safe harbor is ineffective in ensuring the quick and inexpensive dismissal of frivolous private lawsuits.”); *Hearings Before the Subcommittee on Telecommunications and Finance of the Committee on Commerce, House of Representatives*, 104th Cong., 1st Sess., Serial No. 104-2 at 233, 235 (1995) (statement of Cohen, Rosenman & Colin) (“determining whether a statement was made in good faith [under Rule 175] usually requires extensive discovery and can become the focus of protracted litigation”). Professor John Coffee described the existing SEC rule safe harbor as “very shallow” and “dysfunctional.” *Securities Litigation Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce*, 103rd Cong. 112, 181 (1994). *See also infra* note 22.

<sup>17</sup> *See* 4 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 642-48 (4th ed. 2009) (describing the bespeaks caution doctrine). *See also* Donald C. Langevoort, *Disclosures that “Bespeak Caution,”* 49 *BUS. LAW.* 481 (1994) (discussing multiple lines of cases under variations of the bespeaks caution doctrine).

<sup>18</sup> As reflected *supra* note 9, a “material” misrepresentation or omission is one of the elements of a private damage cause of action under Rule 10b-5 for deception. The same principle applies to actions under Section 11 of the Securities Act. Section 11(a), 15 U.S.C. § 77k(a) (2000) (imposing liability for an untrue statement of a material fact or omission to state a material fact required to be stated in the registration statement or necessary to make the statements made not misleading). Information is material if there is a substantial likelihood that a reasonable shareholder would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (applying materiality test of TSC *Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating materiality test under the proxy rules), to claim under Rule 10b-5). In other words, a fact is material if there is a substantial likelihood that the disclosure of the fact would be viewed by a reasonable investor as significantly altering the “total mix” of information. *Basic*, 485 U.S. at 231-32 (applying the concept to actions under Rule 10b-5). Information need not be outcome determinative in the investor’s decision – it need only be considered important in the decision-making process. *TSC Indus. Inc.*, 426 U.S. at 449.



complaint for failure to state a claim upon which relief can be granted under Rule 12(b)(6) of the Federal Rules of Civil Procedure.<sup>19</sup> In applying the bespeaks caution doctrine, courts may take into account an indisputably authentic disclosure document extant at the time of the alleged incorrect projection, whether or not the plaintiff included the cautionary disclosures in its complaint.<sup>20</sup>

In 1995 Congress enacted extensive reforms to securities litigation in the Private Securities Litigation Reform Act (“PSLRA”).<sup>21</sup> Reflecting a judgment that neither the bespeaks

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<sup>19</sup> *See, e.g., Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 373 (3d Cir. 1993) (affirming grant of motion to dismiss based on bespeaks caution doctrine, finding that the warnings and cautionary language that accompanied the challenged projections “served to negate any potentially misleading effect” created by the projections in an offering prospectus, so that “no reasonable jury could conclude that the subject projections materially influenced a reasonable investor”).

<sup>20</sup> *See, e.g., Trump*, 7 F.3d at 368 n. 9; *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122-223 (10th Cir. 1997) (taking into account contemporaneous disclosures and discussing legal basis for doing so).

<sup>21</sup> Pub. Law No. 104-67, 109 Stat. 737 (1995). For a general discussion of the background of the PSLRA, see MICHAEL A. PERINO, *SECURITIES LITIGATION AFTER THE REFORM ACT*, § 1.01, at 1012-23 (2009).

A major purpose of the PSLRA was to impose new or higher hurdles for plaintiffs to pursue private claims for damages under the Securities Act and Exchange Act, especially class actions. The Conference Report for the PSLRA stated:

This Conference Report seeks to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation. This legislation implements needed procedural protections to discourage frivolous litigation. It protects outside directors, and others who may be sued for non-knowing securities law violations, from liability for damage actually caused by others. It reforms discovery rules to minimize costs incurred during the pendency of a motion to dismiss or a motion for summary judgment. It protects investors who join class actions against lawyer-driven lawsuits by giving control of the litigation to lead plaintiffs with substantial holdings of the securities of the issuer. It gives victims of abusive securities lawsuits the opportunity to recover their attorneys’ fees at the conclusion of all action. And it establishes a safe harbor for

caution doctrine nor the SEC rule-based safe harbors afforded adequate protection for public companies that made forward-looking statements,<sup>22</sup> in the PSLRA Congress added safe harbors

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forward looking statements, to encourage issuers to disseminate relevant information to the market without fear of open-ended liability.

H. R. REP. NO. 104-369, at 32 (Nov. 28, 1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 731 [hereinafter “Conference Report” or *PSLRA Conf. Rep.*].

<sup>22</sup> The Conference Committee for the PSLRA stated:

The concept of a safe harbor for forward-looking statements made under certain conditions is not new. In 1979, the SEC promulgated Rule 175 to provide a safe harbor for certain forward looking statements made with a “reasonable basis” and in “good faith.” This safe harbor has not provided companies meaningful protection from litigation. In a February 1995 letter to the SEC, a major pension fund stated: “A major failing of the existing safe harbor is that while it may provide theoretical protection to issuers from liability when disclosing projections, it fails to prevent the threat of frivolous lawsuits that arises every time a legitimate projection is not realized.” See February 14, 1995 letter from the California Public Employees’ Retirement System to the SEC.

*PSLRA Conf. Rep.*, *supra* note 21, at 43 n. 29, 1995 U.S.C.C.A.N. at 742 n. 29. The Conference Committee also stated:

Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace. Former SEC Chairman Richard Breeden testified in a Senate Securities Subcommittee hearing on this subject: “Shareholders are also damaged due to the chilling effect of the current system on the robustness and candor of disclosure. . . . Understanding a company’s own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm.”

Fear that inaccurate projections will trigger the filing of securities class action lawsuit has muzzled corporate management. One study found that over two-thirds of venture capital firms were reluctant to discuss their performance with analysts or the public because of the threat of litigation. Anecdotal evidence similarly indicates corporate counsel advise clients to say as little as possible, because “legions of lawyers scrub required filings to ensure that disclosures are as milquetoast as possible, so as to provide no grist for the litigation mill.”

*Id.* at 42-43, 1995 U.S.C.C.A.N. at 741-42 (footnotes omitted).

for certain forward-looking statements to both the Securities Act (new Section 27A) and the Exchange Act (new Section 21E).<sup>23</sup> One aspect of these safe harbors is the focus of this article.

## II. THE PSLRA STATUTORY SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

What follows is an overview of the PSLRA safe harbor for forward-looking statements sufficient to provide a framework to address one aspect of the safe harbor that remains unsettled after fourteen years. This article does not include a comprehensive discussion of all aspects of the safe harbor.<sup>24</sup>

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<sup>23</sup> 15 U.S.C. §§ 77z-2 and 78u-5 (2000). Because there are many more significant private suits for damages under the Exchange Act than under the Securities Act (*see, e.g.*, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS 2008 REVIEW AND ANALYSIS at 10 (n.d.) (stating that “[o]nly a fraction” of the securities class actions settled in 1996 through 2008 did not involve a claim under Rule 10b-5), available at [http://securities.stanford.edu/Settlements/REVIEW\\_1995-2008/Settlements\\_Through\\_12\\_2008.pdf](http://securities.stanford.edu/Settlements/REVIEW_1995-2008/Settlements_Through_12_2008.pdf)), most of the discussion of the statutory safe-harbor for forward-looking statements in this article, and thus specific statutory citations, will address Section 21E.

<sup>24</sup> For extensive discussions of all aspects of the PSLRA safe harbor for forward-looking statements, see the following materials, which were invaluable sources of case law citations drawn upon in preparing this article: Marc H. Folladori, *Protecting Forward-Looking Statements: The Private Securities Litigation Reform Act of 1995 and Other Safeguards*, 1710 PLI/Corp 549 (Practising Law Institute Jan. 2009); Richard Rosen, *The Statutory Safe Harbor for Forward-Looking Statements: A Scorecard in the Courts from November 2004 through November 2006*, 39 SEC. REG. & L. REP. (BNA) 54 (Jan. 15, 2007); Richard Rosen, *The Safe Harbor for Forward-Looking Statements in the Courts, May 2003 through October 2004: Does Asher Change the Rules?*, 36 SEC. REG. & L. REP. (BNA) 2135 (Dec. 6, 2004); Richard Rosen, *The Statutory Safe Harbor for Forward-Looking Statements: A Scorecard in the Courts from January 2002 through April 2003*, 35 SEC. REG. & L. REP. (BNA) 1000 (June 16, 2003); Richard Rosen, *Safe Harbor for Forward-Looking Statements in the Courts: A Year 2001 Scorecard*, 34 SEC. REG. & L. REP. (BNA) 91 (Jan. 21, 2002); Richard Rosen, *The Statutory Safe Harbor for Forward-Looking Statements in the Courts: A Year 2000 Scorecard*, 1213 PLI/Corp 765 (Practising Law Institute Nov. 2000).

The PSLRA safe harbor applies to certain statements made by public companies and specified other persons, such as a person acting on behalf of the company.<sup>25</sup> The safe harbor does not apply to statements made by persons who are subject to specified disqualifications or to statements made in connection with certain transactions.<sup>26</sup> The safe harbor defines the term “forward-looking statement,” with the result that the safe harbor does not apply to all statements by public companies that speak to the future but it surely covers the preponderance of the significant ones.<sup>27</sup>

The provision that affords the safe harbors states as follows:<sup>28</sup>

[I]n any private action arising under [the Exchange Act] that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) of this section shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that –

(A) the forward-looking statement is –

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement; or

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<sup>25</sup> Section 21E(a) of the Exchange Act, 15 U.S.C. § 78u-5(a) (2000).

<sup>26</sup> Section 21E(b), 15 U.S.C. § 78u-5(b) (2000). For example, the safe harbor is not available for forward-looking statements made in “in connection with a tender offer” or “in connection with an initial public offering.” Section 21E(b)(2)(C)-(D). *See, e.g.,* In re Infonet Services Corp. Sec. Litig., 310 F. Supp. 2d 1080, 1088-93, 1103-04 (C.D. Cal. 2003) (analyzing forward-looking statements in initial public offering prospectus under bespeaks caution and analyzing subsequent forward-looking statements under the statutory safe harbor).

<sup>27</sup> Section 21E(i)(1), 15 U.S.C. § 78u-5(i)(1) (2000). Covered statements include “a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) . . . and other financial items.” Section 21E(i)(1)(A).

<sup>28</sup> Section 21E(c)(1), 15 U.S.C. § 78u-5(c)(1) (2000).

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement –

(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) if made by a business entity, was –

(I) made by or with the approval of an executive officer of that entity; and

(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

Before turning to an exegesis of this statutory language, several other aspects of the safe harbor should be noted. On any motion to dismiss based on the safe harbor, “the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement, which are not subject to material dispute, cited by the defendant.”<sup>29</sup> In other words, the defendant can move to dismiss based on cautionary statements in, most commonly, some document filed by the company with the SEC even if those statements are not contained in the complaint or even adverted to by the plaintiff.<sup>30</sup> If the defendant moves for summary judgment based on the safe harbor, any discovery not “specifically directed to the application” of the safe harbor is stayed.<sup>31</sup> The availability of the safe harbor does not in and of itself “impose upon any person a duty to update a forward-looking statement.”<sup>32</sup>

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<sup>29</sup> Section 21E(e), 15 U.S.C. § 78u-5(e) (2000).

<sup>30</sup> *See, e.g.*, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1278-80 (11th Cir. 1999) (holding error to refuse to consider, on motion to dismiss asserting protection of the statutory safe harbor, documents filed by the defendant with the SEC).

<sup>31</sup> Section 21E(f), 15 U.S.C. § 78u-5(f) (2000).

<sup>32</sup> Section 21E(d), 15 U.S.C. § 78u-5(d) (2000).

Returning to the core provision, the gist of the safe harbor is that in any private action<sup>33</sup> a person covered by the safe harbor is not liable for an incorrect projection if (I) the projection was identified as forward-looking and was accompanied by “meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those” in the projection, (Ia) the projection was “immaterial,” or (II) the plaintiff fails to prove that the projection was made with actual knowledge of its falsity or misleading character.<sup>34</sup> These few words raise myriad issues of interpretation.

For example, on a first reading the inclusion of alternative Ia may seem to be superfluous, inasmuch as an “immaterial” statement, forward-looking or otherwise, could never provide the basis for a claim that is predicated upon an alleged violation of Rule 10b-5 for making “an untrue statement of a material fact or omission of a material fact necessary in order to make the statement not misleading.” Congress included this alternative to underscore that a forward-looking statement might be immaterial for reasons other than its having been qualified by meaningful cautionary statements.<sup>35</sup> One example is a forward-looking statement – entirely unqualified by cautions – that is immaterial because it is mere puffery.<sup>36</sup>

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<sup>33</sup> See Section 21E(c)(1), 15 U.S.C. § 78u-5(c)(1) (2000). Thus, the statutory safe harbor does not apply in an enforcement action by the SEC or a criminal prosecution for securities fraud by the Department of Justice. NAGY, *supra* note 8, at 77-78.

<sup>34</sup> The statute also provides a subset of rules where the forward-looking statement is made orally, rather than in writing. Section 21E(c)(2), 15 U.S.C. § 78u-5(c)(2) (2000).

<sup>35</sup> The Conference Report states:

Courts may continue to find a forward-looking statement immaterial – and thus not actionable under the 1933 Act and the 1934 Act – on other grounds. To clarify this point, the Conference Committee includes language in the safe harbor provision that no liability attaches to forward-looking statements that are “immaterial.”

Other issues of interpretation include (1) when do meaningful cautionary statements “accompany” the forward-looking statement, (2) what is a “meaningful” cautionary statement, and (3) can a court determine whether the safe harbor has been satisfied merely by looking at

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*PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743. If, as concluded in this article, the first prong is itself a test of materiality, one might expect the word “otherwise” to appear before “immaterial” in Section 21E(c)(1)(A)(ii). Professor John Coffee has recounted the legislative history of the absence of the word “otherwise”:

[I]f subclause (i) of subsection (c)(1)(A) is read to require that the “meaningful cautionary statements” render the false statement immaterial, arguably subclause (ii) sounds superfluous. A closer look at the drafting history, however, explains this puzzle. The October 26, 1995 draft conference report shows that subsection (c)(1)(A)(ii) originally said “otherwise immaterial,” implying in effect that a properly qualified forward-looking statement was also immaterial as a matter of law. In the November 9, 1995 draft and in the final conference report, the word “otherwise” was dropped, probably as a simplifying language change. Given this evolution of the language, subclause (i) appears to be saying that a forward-looking statement that is properly qualified by “meaningful cautionary statements” becomes immaterial, but, even if not so qualified, it can be immaterial for other and independent reasons under subclause (ii). Indeed, the Statement of Managers virtually spells this out.

John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 991 (1996) (footnote omitted). The last reference to the Statement of Managers is to *PSLRA Conf. Rep.* at 44, 1995 U.S.C.C.A.N. at 743, quoted earlier in this footnote.

<sup>36</sup> See, e.g., *Indiana State Dist. Council of Laborers and Hod Carriers Pension and Welfare Fund v. Omnicare*, 583 F.3d 935, 944 (6th Cir. 2009) (holding immaterial puffing statements that “do nothing more than vaguely predict positive future results, a claim so banal and ubiquitous that it cannot engender reliance by reasonable investors”); *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir. 1997) (Posner, J.) (“[m]ere sales puffery is not actionable under Rule 10b-5”); *Raab v. General Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993) (“‘Soft,’ ‘puffing’ statements . . . generally lack materiality because the market price of a share is not inflated by vague statements predicting growth”). This doctrine was well-established at the time the PSLRA was enacted. See Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L. J. 1697, 1709 n.50, 1711 n.77, 1712 n.84. and 1713-14 n.95 (1998) (collecting cases, both before and after the PSLRA, applying the puffery concept) and *Langevoort*, *supra* note 17.

those accompanying cautionary statements or must there be evidence relating to what were, at the time of the statements, objectively the (more) important contingencies.<sup>37</sup>

The issues just identified, however, are not the focus here, with the exception of some discussion of the second of those points.<sup>38</sup> This article addresses whether proof that the forward-looking statement was made with actual knowledge of its falsity – element “II” in the third preceding paragraph (sometimes referred to here as the “second prong”) – can supersede, or at least must be taken into account in, the application of the meaningful cautionary language safe harbor – element “I” in the third preceding paragraph (sometimes referred to as the “first prong”). In the statute the word “or” appears after “immaterial.” One might thus quickly conclude that a person can escape liability under the safe harbor (“shall not be liable”) for the

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<sup>37</sup> See, e.g., *Asher v. Baxter Int’l, Inc.*, 377 F.3d 727, 734 (7th Cir. 2004) (Easterbrook, J.) (holding that on the pleadings, the court could not apply alternative I of the safe harbor because “there is no reason (on this record) to conclude that [the defendant] mentioned those sources of variance that (at the time of the projection) were the principal or important risks”). Some commenters, including this author, have been critical of *Asher* for taking an approach that effectively precluded disposition of cases at the motion to dismiss stage. See, e.g., Alfred Wang, Comment, *The Problem of Meaningful Language: Safe Harbor Protection in Securities Class Action Suits after Asher v. Baxter*, 100 NW. U. L. REV. 1907, 1928-32, 1936-37 (2006) (“Judge Easterbrook’s decision rejected the overwhelming goals that carried the PSLRA through its legislative battles until its enactment over the President’s veto. This decision is at odds with the Reform Act’s language, its legislative history, and with the precedents in the other circuits.”); Allan Horwich, *Is There a Breach in The Breakwater of the Statutory Safe Harbor for Forward-Looking Statements?*, 8 WALL ST. LAWYER, Sept. 2004, at 19, 22 (“the safe harbor will become a defense first usable at the summary judgment stage, after plaintiffs have had a full opportunity to rummage through defendants’ documents and take extensive depositions”)(footnote omitted). Others were, and remain, more sanguine. Richard Rosen, *The Statutory Safe Harbor for Forward-Looking Statements: A Scorecard in the Courts from November 2004 through November 2006*, 39 SEC. REG. & L. REP. (BNA) 54 (Jan. 15, 2007) (“Fears of the safe harbor’s demise [because of *Asher*] have not been realized”); Joseph De Simone et al., *Asher to Asher and Dust to Dust: The Demise of the PSLRA Safe Harbor?*, 1 N.Y.U.J. LAW & BUS. 799, 837 (2005) (“*Asher* is best viewed as a significant development in the normal ebb and flow of a resilient and influential defense theory, which has flourished since its enactment as part of the PSLRA in 1995”).

<sup>38</sup> See *infra* Parts IV.C and V.B.



incorrect projection if *either* the statement was accompanied by meaningful cautionary statements *or*, even if there were insufficient cautionary statements or the speaker failed to direct the audience to the cautionary statements, the plaintiff failed to prove (and thus failed to plead<sup>39</sup>) that the projection was made with actual knowledge of its falsity. That is, a covered defendant may prevail under either scenario, so that the question of whether the statement was made with actual knowledge of its falsity is moot if the projection was accompanied by meaningful cautionary statements. Notwithstanding the arguable clarity of the language, the courts have not uniformly interpreted the safe harbor so that “or” means “or,” or they have adopted a construction of the first prong that is influenced by allegations of the elements of the second prong. This article addresses which interpretation is correct.

The answer to these questions is of considerable significance. Congress (or at least many members of Congress) and the SEC have stated that dissemination of management’s own projections is a good thing.<sup>40</sup> While it is unclear whether the enactment of the PSLRA safe

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<sup>39</sup> The second prong of the safe harbor speaks only in terms of the consequences of plaintiff’s failure to prove certain facts. Presumably, in order to avoid dismissal of a claim based on an incorrect projection the plaintiff must also *plead* the defendant’s actual knowledge. *Cf.* *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (holding that because in a claim under Rule 10b-5 the PSLRA requires that the plaintiff prove the element of loss causation the plaintiff must also allege the requisite elements of loss causation). Cases addressing the second prong have uniformly so held at the motion to dismiss stage. *See, e.g.*, *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 259 (3d Cir. 2009) (ruling that second (actual knowledge) prong of the statutory safe harbor applies if the plaintiff fails to plead actual knowledge of the falsity of the statement); *Selbst v. McDonald’s Corp.*, 2005 WL 2319936, at \*19 (N.D. Ill. Sept. 21, 2005) (holding, and collecting cases so ruling, that second prong requires pleading of actual knowledge).

<sup>40</sup> *See, e.g.*, Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, 38 Fed. Reg. 7220, 7220 (Mar. 19, 1973):

[O]n the basis of the information obtained through the hearings and on the basis of staff recommendations and its experience in administering the securities laws, the Commission has now determined that changes in its present policies with

harbor actually led to increased disclosure of financial projections by public companies,<sup>41</sup> if protections thought to be afforded by the safe harbor have resulted in increased disclosure of forward-looking information, there could be retrenchment in the extent of disclosures if the safe harbor is interpreted more narrowly than public companies had anticipated.<sup>42</sup>

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regard to use of projections would assist in the protection of investors and would be in the public interest. The Commission recognizes that projections are currently widespread in the securities markets and are relied upon in the investment process. Persons invest with the future in mind and the market value of a security reflects the judgments of investors about the future economic performance of the issuer. Thus projections are sought by all investors, whether institutional or individual. . . .

Information gathered at the hearings reinforced the Commission's own observation that management's assessment of a company's future performance is information of significant importance to the investor, that such assessment should be able to be understood in light of the assumptions made, and that such information should be available, if at all, on an equitable basis to all investors.

*See also supra* note 22 and *infra* text accompanying notes 59-61.

<sup>41</sup> David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 46 (1998) (reporting that data collected suggest no more than a modest increase in the disclosure of forward-looking information rather than the anticipated "significant post-Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued"). The safe harbor does, however, appear to have reduced somewhat the amount of litigation based on allegedly faulty projections. Marilyn F. Johnson, Karen K. Nelson & A. C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J. L. ECON. & ORG. 627, 642 (2007):

Although earnings warnings continue to be an important trigger of lawsuits in the post-PSLRA period, firms are significantly less likely to be sued for such disclosures. In addition, issuing a forecast of positive earnings news is no longer a significant determinant of lawsuit filings, although the decrease in litigation risk associated with these disclosures is insignificant. Taken together, these results suggest that the PSLRA's safe harbor provides firms some protection from disclosure-related litigation . . . .

<sup>42</sup> Meaningful empirical evidence here may be hard to come by. Factors other than the effectiveness or absence of a liability shield may affect the prevalence of projections. For example, the 2008-2009 recession made foretelling a company's financial future more

### III. THE LEGISLATIVE HISTORY OF THE PSLRA SAFE HARBOR

The preceding discussion at the very least suggests that the language of the PSLRA safe harbor is unambiguous – the defendant prevails if either prong is satisfied. Nevertheless, before turning to an examination of the judicial interpretation of the safe harbor it is useful to try to ascertain what Congress intended by the specific statutory language.

#### A. Criteria for Considering Legislative History

When and whether it is appropriate to resort to legislative history is a matter of considerable debate, and for every maxim regarding reliance on legislative history there seems to be an equal and opposite principle.<sup>43</sup> Truly, this is a field where “the devil can cite Scripture for his purpose.”<sup>44</sup> One rule is that when a statute is unambiguous the court ought not to consider the legislative history.<sup>45</sup> Yet there are exceptions even when the statutory language seems clear.<sup>46</sup> Even if the statute is ambiguous, however, that is, if the words used do not appear to

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precarious, with the result that some companies that had been making projections suspended the practice. *See, e.g.,* Michael Barbaro, *Retailers Get Stingy with Data*, N.Y. TIMES, Apr. 17, 2008, at C1 (reporting that J. C. Penney and Starbucks, among other companies, had ceased disclosing annual profit estimates).

<sup>43</sup> *See* Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules of Canons about How Statutes Are to Be Construed*, 3 VAND. L. REV. 395, 401-06 (1950) (citing 28 pairs of opposing canons of statutory construction).

<sup>44</sup> WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* act 1, sc. 3.

<sup>45</sup> *United States v. Gonzalez*, 520 U.S. 1, 6 (1997) (holding that when the language of a statute is plain, legislative history is irrelevant); *Connecticut Nat. Bank v. Germain*, 503 U.S. 249, 253-254 (1992) (“courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: the judicial inquiry is complete”) (citations and internal quotation marks omitted).

<sup>46</sup> *See, e.g., Public Citizen v. U.S. Dept. of Justice*, 491 U.S. 440, 455 (1989):

have an unmistakable meaning, there is some dispute about the propriety of resorting to legislative history to resolve the uncertainty.<sup>47</sup>

In most situations where resort to legislative history is appropriate, the primary source is the Conference Committee report.<sup>48</sup> Here that is particularly apt, because the final safe harbor provisions differed from both the House and Senate bills that went to conference.<sup>49</sup>

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Looking beyond the naked text for guidance is perfectly proper when the result it apparently decrees is difficult to fathom or where it seems inconsistent with Congress' intention, since the plain-meaning rule is "rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists." *Boston Sand & Gravel Co. v. United States*, 278 U.S. 41, 48 (1928) (Holmes, J.). See also *United States v. American Trucking Assns., Inc.*, 310 U.S. 534, 543-544 ("When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use, however clear the words may appear on 'superficial examination'") (citations omitted).

*See also* *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453, 458 (1974) ("even the most basic general principles of statutory construction must yield to clear contrary evidence of legislative intent").

<sup>47</sup> Compare *Blum v. Stenson*, 465 U.S. 886, 896 (1984) ("Where . . . the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear") *with* *Zedner v. United States*, 547 U.S. 489, 509-10 (2006) (Scalia, J., concurring) ("the only language that constitutes 'a Law' within the meaning of the Bicameralism and Presentment Clause of article I, § 7, and hence the only language adopted in a fashion that entitles it to our attention, is the text of the enacted statute"), and *United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 521 (1992) (Scalia, J., concurring) ("[legislative history is] that last hope of lost interpretive causes, that St. Jude of the hagiology of statutory construction"). An explanation of how Justice Scalia interprets statutes is beyond the scope of this article. For one analysis of his approach to statutory interpretation, see 3 NORMAN J. SINGER & J. D. SHAMBIE SINGER, *STATUTES AND STATUTORY CONSTRUCTION* § 65A:10 (7th ed. 2008).

<sup>48</sup> 2A NORMAN J. SINGER & J. D. SHAMBIE SINGER, *STATUTES AND STATUTORY CONSTRUCTION* § 48.8, at 580-81 (7th ed. 2007) ("Since the conference report represents the final statement of terms agreed to by both houses of Congress, next to the statute itself, it is the most persuasive evidence of congressional intent") (footnote omitted).

<sup>49</sup> *PSLRA Conf. Report*, *supra* note 21, at 43, 1995 U.S.C.C.A.N. at 742. *See also infra* text accompanying notes 62-103.

The following discussion also presents material from the floor debates as each house adopted a bill, the conference report was debated, the President vetoed the bill and his veto was overridden. It is doubtful that one should rely on statements of a single legislator, or even a group of them, who support a bill.<sup>50</sup> It is even more suspect to interpret statutory language based on the meaning given to the words by those who opposed it.<sup>51</sup> Nevertheless, because there was extensive floor debate on the safe harbor, in the interest of shedding as much light as possible from the legislative process, this article includes a narrative of each phase of that process.

### **B. The PSLRA Conference Report**

The two major prongs of the safe harbor are described as such in the Conference Report.<sup>52</sup> “The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.”<sup>53</sup> Because state of mind (“actual knowledge”) is the

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<sup>50</sup> See SINGER ET AL., *supra* note 48, at 600-607.

<sup>51</sup> See, e.g., *Gulf Offshore Co. v. Mobil Oil Corp.*, 453 U.S. 473, 483 (1981) (“[t]he fears and doubts of the opposition are no authoritative guide to the construction of legislation,” quoting *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 394 (1951)).

<sup>52</sup> *PSLRA Conf. Report*, *supra* note 21 at 43-44, 1995 U.S.C.C.A.N. at 742-43.

<sup>53</sup> *Id.* at 44, 1995 U.S.C.C.A.N. at 743. One court ruled, based on its analysis of the quoted text, that the preclusion of the examination of the speaker’s state of mind referred to is the state of mind when making the cautionary statement, not when making the forward-looking statement. *Desai v. General Growth Properties*, 654 F. Supp. 2d 836, 843 (N.D. Ill. 2009). While this grammatical construction is not implausible, it is not the only reasonable construction of the sentence, and numerous courts have understood the state of mind reference in the Conference Report to apply to the forward-looking statement itself. See, e.g., *Harris v. Ivax Corp.*, 182 F.3d 799, 803 (11th Cir. 1999); *In re Humana, Inc. Sec. Litig.*, 2009 WL 1767193, at \*15 (W.D. Ky. June 15, 2009); *Yellen v. Hake*, 437 F. Supp. 2d 941, 962 (S.D. Iowa July 7, 2006); *In re Gilat Satellite Networks Ltd. Sec. Litig.*, 2005 WL 2277476, at \*12 (E.D.N.Y. Sept. 19, 2005) (including extensive discussion of the legislative history); *In re BMC Software, Inc. Sec. Litig.*, 183 F. Supp. 2d 860, 881 n.28 (S.D. Tex. 2001); *In re Splash Technology Holdings, Inc. Sec. Litig.*, 2000 WL 1727377, at \*8 (N.D. Cal. Sept. 29, 2000). Nor is it apparent why the authors of

essence of the second prong, this statement strongly suggests that the first prong provides an *independent* ground of exoneration. According to the Conference Report, “Instead of examining the forward-looking and cautionary statements” the second prong requires a “focus[] on the state of mind of the person making the forward-looking statement,”<sup>54</sup> thus reinforcing the independence of the two prongs. The second prong is described as an “alternative,”<sup>55</sup> which, given the overall structure of the safe harbor – the first prong applies where the defendant satisfies the specified elements, the second prong applies if the plaintiff fails to make the requisite showing of knowledge – supports a conclusion that applicability of the first prong puts an end to the claim. Finally, the Conference Report states:

The applicability of the safe harbor provisions under subsection (c)(1)(B) shall be based on the “actual knowledge” of the defendant and *does not depend on the use of cautionary language*. The applicability of the safe harbor provisions under subsections (c)(1)(A)(I) and (c)(2) shall be based upon the sufficiency of the cautionary language under those provisions and *does not depend on the state of mind of the defendant*.<sup>56</sup>

Taken as a whole these remarks reflect Congressional intent that the two prongs are independent and either one, if satisfied, protects the covered speaker. Notwithstanding these seemingly clear statements in the primary source of legislative history, a deeper consideration of the legislative history may help to illuminate the meaning of the two prongs.

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the Conference Report would have focused on the good faith of the cautionary statements standing alone as distinguished from the forward-looking statements, on which the claim of liability is based. In the end, the *Desai* court determined that the plain language of the statute compels the conclusion that the defendant’s state of mind is irrelevant under the first prong. 654 F. Supp. 2d at 843-44.

<sup>54</sup> *PSLRA Conf. Report*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 47, 1995 U.S.C.C.A.N. at 746 (emphasis added).

### C. Legislative History of the PSLRA Prior to the Conference Report

Reform of securities litigation had been under consideration for several years before debate on the PSLRA.<sup>57</sup> By the time that proposed legislation came before the 104th Congress, there appears to have been widespread agreement that some improvement in the SEC safe harbor rules for forward-looking statements<sup>58</sup> was needed because of the effect the threat of litigation had on corporate willingness to make earnings projections and other forward-looking statements coupled with the recognition that disclosures of that type were desired by and valuable to investors.<sup>59</sup> A Congressional staff report had noted that statements that litigation may discourage disclosure

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<sup>57</sup> See, e.g., *Private Litigation under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong. (1993); and *Securities Litigation Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce*, 103rd Cong. (1994).

<sup>58</sup> See *supra* text accompanying notes 14-16.

<sup>59</sup> See, e.g., 141 CONG. REC. 7125 (Mar. 7, 1995) (statement of Rep. Cox) (“The threat of lawsuits over so-called forward-looking information . . . is so serious that many if not most CEO’s these days refuse to talk to the press at all about their company’s performance and yet that is exactly the kind of information the market needs to operate.”); and *id.* at 16936 (June 22, 1995) (statement of Sen. D’Amato) (“Abusive litigation also severely impacts the willingness of corporate managers to disclose information to the marketplace. . . . Understanding a company’s own assessment of its future potential would be amongst the most valuable information shareholders and potential investors could have.”). See also *Concept Release*, *supra* note 16, at 52728:

[C]ritics [of the SEC safe harbor rules] argue that, unless the courts vigorously apply a higher pleading threshold sufficient to sustain a motion to dismiss based on the allegations of a class-action complaint, the mere threat of litigation will continue both to discourage management from making forward-looking disclosure and cause those companies that nonetheless provide such disclosure to incur significant costs in defense of nonmeritorious litigation.

To be sure, there were contrary views. In hearings before a Senate subcommittee in 1993, Professor Joel Seligman expressed doubt that corporate behavior in making, or not

suggests [sic] that securities litigation may be working at cross-purposes to the fundamental objectives of the securities laws. The countervailing argument is also compelling that potential securities litigation has on balance reinforced the disclosure system, which in turn helped American securities markets to become the largest and most open in the world.<sup>60</sup>

The report concluded that there is no “clear answer” to “[w]hether private securities litigation has a net positive or negative effect on corporate disclosure.”<sup>61</sup>

Each of the principal bills that evolved into the PSLRA addressed a safe harbor for forward-looking statements. The initial Senate bill simply proposed directing the SEC to adopt or amend rules providing a safe harbor, with Congress specifying factors that the SEC should consider in doing so.<sup>62</sup> The House bill included a specific safe harbor.<sup>63</sup>

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making, projections would be significantly influenced by changes in the law. *Private Litigation under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong. 63 (1993). Members of the plaintiffs’ securities litigation bar also expressed doubt that litigation had a “chilling effect” on disclosures. *Common Sense Legal Reform Act: Hearings Before the Subcomm. on Securities on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong. 48 (1995) (statement of William Lerach on behalf of National Association of Securities and Commercial Law Lawyers); and *Securities Litigation Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce*, 103rd Cong. 276 (1994) (statement of Leonard B. Simon, Milberg Weiss Bershad Hynes & Lerach)

<sup>60</sup> STAFF OF S. SUBCOMM. ON SECURITIES OF THE S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS REPORT ON PRIVATE SECURITIES LITIGATION, ABANDONMENT OF THE PRIVATE RIGHT OF ACTION FOR AIDING AND ABETTING SECURITIES FRAUD at (1994), *as reprinted in Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong. (1994) 166, at 215.

<sup>61</sup> *Id.*

<sup>62</sup> S. 240, 104th Cong. § 201 (as introduced January 18, 1995), *reprinted in* 141 CONG. REC. 1531 (Jan. 18, 1995).

<sup>63</sup> H.R. 1058, 104th Cong., § 5 (as introduced March 6, 1995).



Debate occurred first in the House, where the bill was considered by the House in the Committee of the Whole.<sup>64</sup> The bill was amended on the floor to change the terms of the proposed safe harbor. The amendment provided that a person would not be liable with respect to any forward-looking statement in a private action under the Exchange Act “if and to the extent that” the statement was forward-looking and “refers clearly (or is understood by the recipient to refer) to” the forward-looking statement and “the risk that such projections, estimates or descriptions [of future events] may not be realized.”<sup>65</sup> As so amended the bill passed.<sup>66</sup>

Debate on the safe harbor in the Senate was vigorous. When S. 240 emerged from the Banking, Housing, and Urban Affairs Committee, it had changed from a directive that the SEC take action into a substantive safe harbor.<sup>67</sup> The safe harbor would not apply if the forward-looking statement was “knowingly made with the expectation, purpose, and actual intent of misleading investors.”<sup>68</sup> This was challenged on the ground that, “The safe harbor will for the first time protect fraudulent statements within the Federal securities laws” because of the high

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<sup>64</sup> 141 CONG. REC. 7122 (Mar. 7, 1995).

<sup>65</sup> 114 CONG. REC. 7267-68 (text of amendment), 7274 (passage of amendment) (Mar. 8, 1995).

<sup>66</sup> H.R. 1058, 104th Cong., § 5 (as passed by the House, Mar. 8, 1995).

<sup>67</sup> S. 240 § 105, as reprinted in 141 CONG. REC. 16929, at 16932-33 (June 22, 1995). See also S. REP. No. 104-98, at 40-42 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 718-21 (Additional Views of Senators Sarbanes, Bryan, and Boxer) (recounting changes to the safe harbor provisions of S. 240 as it had been introduced).

<sup>68</sup> S. 240 § 105, which would have added a new Section 13A(c)(1) to the Securities Act and a new Section 37(c)(1) to the Exchange Act, as reprinted in 141 CONG. REC. 16932-33 (June 22, 1995). “‘Expectation,’ ‘purpose,’ and ‘actual intent’ are independent elements of the exclusion, and plaintiffs have the burden of pleading and proving each of these elements.” S. REP. No. 104-98, at 18 (1995), as reprinted in 1995 U.S.C.C.A.N. at 697.

threshold of having to prove specific intent to invoke the exclusion.<sup>69</sup> The sponsors of the bill then proposed an amendment that removed the word “expectation” from the safe harbor.<sup>70</sup> This was adopted without opposition.<sup>71</sup>

The Senate proponents of the safe harbor as thus modified rejected an argument to narrow the safe harbor by eliminating the requirement that the plaintiff prove intent, explaining that using a standard of mere knowledge of falsity could deprive a company of the safe harbor where the speaker is aware of a view held somewhere within the company that is contrary to that reflected in the forward-looking statement.<sup>72</sup>

Opponents of the safe harbor mounted an aggressive challenge, contending that even as amended the safe harbor was too easily satisfied.<sup>73</sup> The opponents first sought to restore the original language of S. 240, which would have directed the SEC to take action.<sup>74</sup> The proponents of the safe harbor countered by expressing their frustration that the SEC had failed to

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<sup>69</sup> 141 CONG. REC. 16944-45 (June 22, 1995) (statement of Sen. Sarbanes); *see also* Letter from Arthur Levitt, Chairman, SEC, to Senator D’Amato (May 25, 1995), *as reprinted in* 141 CONG. REC. 16949 (June 22, 1995) (“I continue to have serious concerns about the safe harbor fraud exclusion as it relates to the stringent standard of proof that must be satisfied before a private plaintiff can prevail. . . . The scienter standard in [S. 240 as reported out of committee] may be so high as to preclude all but the most obvious fraud.”).

<sup>70</sup> 141 CONG. REC. 17231 (June 27, 1995) (amendment proposed by Sen. D’Amato).

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 17236 (June 27, 1995) (statement of Sen. Bennett).

<sup>73</sup> *Id.* at 17231-45, 17248-56 and 17258-60 (June 27, 1995).

<sup>74</sup> *Id.* at 17231-32 (June 27, 1995) (amendment proposed by Sen. Sarbanes). The final legislation expressly provided that the SEC could grant additional safe harbors for forward-looking statements. *See, e.g.*, Section 21E(g) of the Exchange Act, 15 U.S.C. § 78u-5(g) (2000).

propose a new regulatory safe harbor<sup>75</sup> even though the SEC had issued a release in October 1994 with a view toward doing so.<sup>76</sup> The amendment was defeated 56 to 43.<sup>77</sup>

The opponents of the safe harbor in S. 240, led by Senator Sarbanes, then advocated an amendment that would eliminate the protection of the safe harbor if the speaker had “actual knowledge that [the forward-looking statement] was false or misleading.”<sup>78</sup> This failed when that motion to amend was tabled by a vote of 50 to 48.<sup>79</sup> The full bill passed the Senate 70 to 29<sup>80</sup> with an exclusion from the safe harbor when the forward-looking statement was “knowingly made with the purpose and actual intent of misleading investors.”<sup>81</sup>

#### D. Legislative History of the PSLRA After the Conference Report

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<sup>75</sup> *Id.* at 17238, 17244 (June 27, 1995) (statements of Sen. Dodd), 17243 (June 27, 1995) (statement of Sen. Domenici).

<sup>76</sup> *Concept Release*, *supra* note 16. In the *Concept Release*, the SEC recounted the development of the SEC safe harbor rules for forward-looking statements, identified the perceived benefits of forward-looking disclosures and the perceived failures of the existing safe harbor rules, discussed judicial approaches toward liability for forward-looking statements, identified several proposals for regulatory revisions to the safe harbors, solicited public comment on nine general topics and many subsidiary questions and scheduled public hearings.

<sup>77</sup> 141 CONG. REC. 17245 (June 27, 1995).

<sup>78</sup> *Id.* at 17250 (June 27, 1995).

<sup>79</sup> *Id.* at 17259-60 (June 27, 1995). Those who opposed the amendment wanted to preserve the standard of intent to deceive, requiring more proof than actual knowledge of falsity. *See, e.g., id.* at 17249-50 (statement of Sen. D’Amato). As explained by Senator Brown, “Well, ‘knowingly made’ and ‘actual knowledge’ sound similar and have some similarities. I believe, in reading the legislation, the big difference is this: It is in the words of ‘purpose’ and “actual intent.”” *Id.* at 17258.

<sup>80</sup> *Id.* at 17443-44 (June 28, 1995).

<sup>81</sup> S. 240 § 105 (as passed by the Senate June 28, 1995), *as reprinted in* 141 CONG. REC. 17444, at 17447-48 (June 28, 1995).

The bills of the House and Senate then went to conference, with the final form of the safe harbor emerging as described earlier.<sup>82</sup> There was considerable debate on the Conference Report, as those who were concerned about the safe harbor *before* it went to conference reflected outrage at the safe harbor reported by the Conference Committee. Much of the colloquy focused on whether the inclusion of cautionary statements would immunize from liability a person who made the forward-looking statement with knowledge of its falsity. These statements may shed some light on whether the two prongs operate independently, whether satisfaction of the first prong renders the issue of actual knowledge *vel non* irrelevant. Many statements made on the floor, principally from *opponents* of the safe harbor in the Conference Report who were concerned that the safe harbor immunized knowingly false statements, reflect that understanding. For example, Senator Sarbanes, the leading spokesperson for the group opposing the earlier form of the safe harbor that worked its way through the Senate, stated:

I remain concerned that the safe harbor provision before us today will, for the first time, provide protection for fraudulent statements under the Federal securities laws. For the first time, fraudulent statements will receive protection under the Federal securities laws.

The American Bar Association wrote the President last week that the safe harbor “has been transformed not simply into a shelter for the reckless, but for the intentional wrongdoer as well.” Projections by corporate insiders will be protected no matter how unreasonable, no matter how misleading, no matter how fraudulent, if accompanied by boilerplate, cautionary language.

. . . .

[F]raud artists will be able to shield themselves from liability simply by accompanying their fraudulent statements with general cautions that actual results may differ.<sup>83</sup>

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<sup>82</sup> See *supra* text accompanying notes 24-37.

<sup>83</sup> 141 CONG. REC. 35243 (Dec. 5, 1995)

Senator Bryan stated, “[E]ven statements that are false, totally false – we are not talking about misleading or inaccurate; we are talking about totally false statements – are protected. That is, those who offer those statements now enjoy no liability if they simply add cautionary language.”<sup>84</sup>

At other times, principally in statements from supporters of the bill, there are denials that the safe harbor would permit knowingly false statements, arguably implying that the second prong could supersede the first. For example, Senator D’Amato stated, “The safe harbor does not give a license to lie. The second prong does not give safe harbor protection when forward-looking statements are made with actual knowledge that the statement is false or misleading.”<sup>85</sup> Senator Bennett added, “The comment was made that the safe harbor will now allow people to lie. No, it will not.”<sup>86</sup> Senator Dodd, a leader of the forces in favor of the safe harbor, stated that the safe harbor has two parts to it.

The first is that any forward-looking statement may be accompanied by “meaningful cautionary statements that identify important factors that could cause” the prediction not to come true, or *if a company officer fails to meet that test*, all that a plaintiff must do is prove that the person actually knew that the statement was false or misleading.<sup>87</sup>

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<sup>84</sup> *Id.* at 35256. Among other speakers, Senator Spector stated that “there is no liability for forward-looking statements with cautionary statements no matter what the intent.” *Id.* at 35267. Senator Feingold added, “The language of this bill protects forward-looking statements by insulating the maker of those statements from liability even if they are deliberately false, provided the statement is accompanied by what is termed ‘cautionary’ language.” *Id.* at 35267. Senator Biden stated that “deliberately fraudulent statements, written or oral, as long as they are accompanied by cautionary language, will be immunized from private liability.” *Id.* at 35299. Senator Cohen added, “The immunity is absolute, so long as the predictions are accompanied with cautionary language.” *Id.* at 35300.

<sup>85</sup> *Id.* at 35239.

<sup>86</sup> *Id.* at 35257.

<sup>87</sup> *Id.* at 35264 (emphasis added).

Senator Dodd continued, however, “[I]t is hard for this Member to envision how anyone could lie in their predictive statements and still be covered by this safe harbor . . . .”<sup>88</sup> Senator Moseley-Braun, a supporter of the legislation, offered this summary:

The conference report essentially codified the bespeaks caution doctrine. Moreover, in response to concerns raised by the distinguished ranking Democratic member of the Banking Committee, Senator Sarbanes, the conference report does not provide protection for statements *not covered under the bespeaks caution provisions* made with actual knowledge that they are false.<sup>89</sup>

The pattern was much the same in the floor debate on the conference report in the House: opponents of the safe harbor expressed concern that cautionary statements would render intent irrelevant, proponents not so clearly accepting that interpretation. Representative Markey, an opponent, stated that forward-looking statements “may be entirely immunized from liability as long as they are accompanied by meaningful cautionary language.”<sup>90</sup> Senator Eschoo, a proponent, responded that the conference report protects the “rights of investors to sue in cases of actual fraud.”<sup>91</sup> He then added, however, that there is no liability for forward-looking statements “as long as those statements are accompanied by specific warnings that their predictions may not come true.”<sup>92</sup>

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<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 35292 (emphasis added).

<sup>90</sup> *Id.* at 35566 (Dec. 6, 1995). To the same effect, Representative Dingell characterized the conference report safe harbor as “immuniz[ing] deliberate fraud.” *Id.* at 35556. Representative Conyers called the safe harbor a “license to lie.” *Id.* at 35564.

<sup>91</sup> *Id.* at 35567.

<sup>92</sup> *Id.*

In the end, both houses passed the legislation.<sup>93</sup>

#### E. The President's Veto and the Override

President Clinton vetoed the bill.<sup>94</sup> He objected to the safe harbor, among other provisions:

[W]hile I support the language in the Conference Report providing a “safe harbor” for companies that include meaningful cautionary statements in their projections of earnings, the Statement of Managers – which will be used by courts as a guide to the intent of the Congress with regard to the meaning of the bill – attempts to weaken the cautionary language that the bill itself requires. Once again, the end result may be that investors find that their legitimate claims are unfairly dismissed.<sup>95</sup>

Debate regarding overriding the veto quickly ensued.

In the House the safe harbor was again contested, with opponents reflecting their interpretation that the second prong comes into play only if the first prong is not dispositive. Representative Markey claimed that the safe harbor “would give blanket immunity to those who would commit intentional fraud. . . . The state of mind of the company’s executives, meaning whether or not they intended to deceive or to mislead investors, is supposed to be irrelevant, even if the executive of the company, of the financial firm, intentionally lies to the investing public.”<sup>96</sup> Representative Collins stated, in extended remarks, “[A]ny statements made by a defendant in a

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<sup>93</sup> In the Senate the vote on the conference report was 65 to 30. *Id.* at 35304 (Dec. 5, 1995). In the House the vote was 320 to 102. *Id.* at 35571 (Dec. 6, 1995).

<sup>94</sup> *Id.* at 37797-98 (Dec. 20, 1995).

<sup>95</sup> *Id.* at 37798. The reference to language in the Conference Report appears to be that which reflects that the first prong of the safe harbor controls if it has been satisfied. *See supra* text accompanying notes 52-55. *See* 141 CONG. REC. 37799 (Dec. 20, 1995) (statement of Rep. Markey elucidating the basis for the veto).

<sup>96</sup> 141 CONG. REC. 37799 (Dec. 20, 1995). This statement was relied on in *Gilat*, 2005 WL 2277476, at \*12 n.9, in finding that the defendant’s state of mind is irrelevant to the application of the first prong of the safe harbor.

securities fraud case would be exempt from liability – even if the statement is deliberately false – as long as it is accompanied by vaguely defined ‘cautionary’ language.”<sup>97</sup> The veto was overridden by a vote of 319 to 100,<sup>98</sup> satisfying the Constitutional requirement of a two-thirds vote of each house.<sup>99</sup>

In the Senate Senator Sarbanes again led the attack. “Projections by corporate insiders will be protected, even though they may be unreasonable, misleading, and fraudulent, if accompanied by boilerplate cautionary language.”<sup>100</sup> Senator Boxer, another opponent, added, “Fraudulent future predictions and estimates would be permitted under the bill if those defrauding attach ‘some’ possible reasons why the prediction might not come true. Those defrauding can hide the real reason that their fraudulent prediction will not come true and they cannot be sued.”<sup>101</sup> An exchange between Senator Feinstein and Senator Dodd, a principal sponsor of the PSLRA, included the following colloquy:

Mrs. Feinstein: Or, as a separate test [from the first prong], as I am led to believe, the safe harbor does not apply if the statement is made with “actual knowledge” that the statement was “an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading.”

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<sup>97</sup> *Id.* at 37804.

<sup>98</sup> *Id.* at 37807.

<sup>99</sup> U.S. CONST. art. I, § 7.

<sup>100</sup> 141 CONG. REC. 38198 (Dec. 21, 1995). Senator Sarbanes was supported in his concern by Professor John Coffee, who wrote the President a letter asserting that the conference report safe harbor was “a license to lie” and that “even if [a] knowingly false statement is made, the defendant escapes liability if ‘meaningful cautionary statement[s]’ are added to the forward-looking statement.” *Id.* at 38201.

<sup>101</sup> *Id.* at 38211 (Dec. 21, 1995).



Mr. Dodd: Mr. President, the Senator from California is correct as well on that.<sup>102</sup>

The Senate then also overrode the veto, 68 to 30.<sup>103</sup> Accordingly, the PSLRA became law with the version of the safe harbor included in the Conference Report.

**F. Conclusion – The Reliance by Congress on Bespeaks Caution in Fashioning the First Prong of the Statutory Safe Harbor**

It is generally understood that the statutory safe harbor was derived from the bespeaks caution doctrine. The Conference Report reflects that bespeaks caution was a model for, but did not necessarily set the outer limits of, the first prong, as it described the safe harbor as “based on aspects of SEC Rule 175 and the judicially created ‘bespeaks caution’ doctrine.”<sup>104</sup> The version of the doctrine applied in *Trump* was used as a model by Congress.<sup>105</sup> This is most clearly established by the fact that the actual words used in the first prong of the statutory safe harbor – “meaningful cautionary statements” – were used in *Trump* in articulating the bespeaks caution doctrine.<sup>106</sup>

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<sup>102</sup> *Id.* at 38222. This exchange was relied upon in one case in support of the conclusion that state of mind is irrelevant to the first prong of the safe harbor. *Gilat*, 2005 WL 2277476, at \*12 n.9.

<sup>103</sup> *Id.* at 38354 (Dec. 22, 1995).

<sup>104</sup> *PSLRA Conf. Rep.*, *supra* note 21, at 43, 1995 U.S.C.C.A.N. at 742. *See also supra* text accompanying note 89 (statement of Sen. Moseley-Braun).

<sup>105</sup> In addition to the analysis in the text that follows, 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, 641 (1997) (reading Conference Report to “impl[y] that the statutory safe harbor was based on a materiality analysis,” with earlier legislative action even more clear in that respect, with specific reference to *Trump*); Beck, *The Substantive Limits of Liability for Inaccurate Predictions*, 44 AM. BUS. L. J. 161, 195-96 (2007) (acknowledging that in formulating the safe harbor Congress was guided in large measure by the *Trump* materiality line of bespeaks caution cases).

<sup>106</sup> 7 F.3d at 371. Other bespeaks caution cases decided before enactment of the PSLRA used that phrase. *See, e.g.*, *Saltzberg v. TM Sterling/Austin Associates, Ltd.*, 45 F.3d 399, 399 (11th Cir. 1995) (citing *Trump*); *In re Quarterdeck Office Systems, Inc., Sec. Litig.*, 854 F. Supp.

Bespeaks caution, like much of the jurisprudence in the development of the implied private cause of action under Rule 10b-5, was judge-made law akin to common law in that the courts have had to fill in the gaps to an unusual extent where the legislature or, in the case of Rule 10b-5 the regulator (the SEC), was silent.<sup>107</sup> The leading securities law treatise describes the process as follows:<sup>108</sup>

[The law under Rule 10b-5], of course, is federal law: the “federal common law” of which Judge Friendly and others have spoken as forming a penumbra around every federal statute. In theory the courts are merely construing a statute and a rule. But when the statute and rule are, like § 10(b) and Rule 10b-5, virtually as vague as the Due Process Clause, the law is surely as much judge made as in the classic common law of the states.

This strongly suggests a parallel to when a statute uses terms with a settled meaning at common law. When a statute uses a term that was applied at common law, in the absence of evidence to the contrary the statute is to be interpreted using the common law meaning of the

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1466, 1471 (C.D. Cal. 1994) (quoting *Trump*). The bespeaks caution doctrine has been applied after the PSLRA using the same formulation. *See, e.g.*, *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 548 (8th Cir. 1997) (quoting *Trump*).

<sup>107</sup> *See* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975):

When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it [citation omitted], but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

<sup>108</sup> 7 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 3479-80 (3d ed. rev. 2003) (footnote omitted).

term.<sup>109</sup> Indeed, some courts have referred to bespeaks caution as a common law doctrine.<sup>110</sup> Thus, the phrase “meaningful cautionary statements” should be interpreted in the statute as it was in the case – *Trump* – from which it was undeniably drawn.

From this reliance on the express language in *Trump* it is reasonable to infer that the other elements of *Trump* were imported into the statutory safe harbor, most notably that the speaker’s state of mind is not relevant in assessing whether the first prong has been satisfied.<sup>111</sup> To be

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<sup>109</sup> See *Neder v. U.S.*, 527 U.S. 1, 21-23 (1999) (“Congress intends to incorporate the well-settled meaning of the common-law terms it uses” unless the “statute otherwise dictates”); *Gilbert v. U.S.*, 370 U.S. 650, 655 (1962) (“in the absence of anything to the contrary it is fair to assume that Congress used that word in the statute in its common-law sense”).

<sup>110</sup> See, e.g., *Western Washington Laborers Employers Pension Trust v. Panera Bread Co.*, 2009 WL 3756619, at \*3 (E.D. Mo. Nov. 6, 2009); *In re XM Satellite Radio Holdings Sec. Litig.*, 479 F. Supp. 2d 165, 187 (D.D.C. 2007); and *In re Nokia Oyj (Nokia Corp.) Sec. Litig.*, 423 F. Supp. 2d 364, 392 (S.D.N.Y. 2006).

<sup>111</sup> 7 F.3d at 368 (applying bespeaks caution doctrine to dismiss claim even though plaintiffs alleged that defendants “had neither an honest nor a reasonable belief” in the challenged forward-looking statement).

Professor Langevoort, writing on the bespeaks caution doctrine in the year before the PSLRA was adopted, observed that under *Trump* “even deliberate misrepresentation by the promoters apparently will be insulated from liability. This is important, for if a plaintiff can defeat a motion by charging deceptive intent or gross unreasonableness, much of the prophylactic power of the bespeaks caution doctrine is lost.” Langevoort, *supra* note 18, 49 BUS. LAW. at 488 (footnote omitted). Professor Langevoort also observed:

While it is impossible to completely reconcile the desire to eliminate misleading disclosures with the desire to control weak claims as a matter of law, the goals are not always mutually exclusive. A balanced approach is to hold that a case properly may be dismissed as a matter of law if the cautionary language or other disclosures make it highly unlikely that a typical investor would be misled even if the makers had no genuine, good faith belief in the reasonableness of the projection. Such reasoning applies in cases like *Trump*, where the risk disclosure was so specific and detailed that whatever small measure of optimism otherwise might be present was diluted effectively by the cautionary language.

*Id.* at 500. While Professor Langevoort does not dismiss entirely the relevance of the speaker’s state of mind when the bespeaks caution doctrine is applied (see, e.g., *id.* (“it well might make

sure, the bespeaks caution cases were not consistent on the relevance of the defendant's state of mind,<sup>112</sup> but the statements in the Conference Report on the irrelevance of state of mind under the first prong are in accord with *Trump* on this point.<sup>113</sup> Scholarly criticisms of this conclusion are addressed later in this article.<sup>114</sup>

#### IV. JUDICIAL INTERPRETATIONS OF THE SAFE HARBOR

Judicial interpretations of the statutory safe harbor for forward-looking statements vary widely. Some cases treat the second (actual knowledge) prong as irrelevant if the first prong is satisfied. A contrary line of cases treats the second prong as pertinent even if the first prong has been – or may be – satisfied, that is, an allegation of actual knowledge precludes dismissal even if there were meaningful cautionary statements. There is yet a third perspective, that if actual

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sense to hold that forecasts and projections (forms of opinion, plainly) are actionable in private actions only if they are objectively unreasonable and not genuinely believed by the maker (unless something in the way they are disclosed is specifically misleading)” (footnote omitted)), the thrust of his analysis of the bespeaks caution doctrine was that the speaker's state of mind was not relevant.

<sup>112</sup> In addition to *Trump*, compare *Moorehead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245 (8th Cir. 1991) (applying bespeaks caution doctrine where there were “risk statements, detailed cautionary language and disclosures about the underlying economic assumptions” even though “plaintiff alleged defendant recklessly prepared the feasibility study” and that “defendant made misrepresentations, omitted material facts and made economic predictions with reckless disregard for their validity”), with *Rubinstein v. Collins*, 20 F.3d 160, 171 (5th Cir. 1994) (“the inclusion of general cautionary language regarding a prediction would not excuse the alleged failure to reveal known material, adverse facts”), and *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 858 (N.D. Cal. 1993) (“the bespeaks caution doctrine does not apply to immunize false statements if the defendants knew the statements were false when made”), *aff'd in part, rev'd in part*, 35 F.3d 1407, 1415 (9th Cir. 1994) (“we adopt the district court's formulation of the [bespeaks caution] doctrine”). See also *infra* text accompanying note 152 (summarizing commentary that bespeaks caution doctrine ignores whether the speaker acted in good faith)

<sup>113</sup> See *supra* text accompanying notes 53-56.

<sup>114</sup> See *infra* text accompanying notes 160-178.

knowledge of falsity is alleged the cautionary statements cannot be “meaningful” so that the first prong cannot be satisfied. The following subsections address the principal cases adopting these interpretations.

A. Many Cases Treat the Second (Actual Knowledge) Prong as Irrelevant if the First Prong Is Satisfied

At the motion to dismiss or summary judgment stage many decisions ignore allegations or even proof of actual knowledge that the projection was incorrect if the defendant’s conduct satisfied the first prong of the safe harbor, that is, the defendant identified the forward-looking statements as such and accompanied them with what the court found to be meaningful cautionary statements. For example, in *Miller v. Champion Enterprises, Inc.* the court stated, “[I]f the statement qualifies as ‘forward-looking’ and is accompanied by sufficient cautionary language, a defendant’s statement is protected regardless of the actual state of mind.”<sup>115</sup> Calling the result

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<sup>115</sup> 346 F.3d 660, 672 (6th Cir. 2003). The court followed *Ivax*, 182 F.3d at 803 (“if a statement is accompanied by ‘meaningful cautionary language,’ the defendants’ state of mind is irrelevant”). After finding that the challenged forward-looking statements were accompanied by meaningful cautionary language, the court in *Miller* found that “the statements are subject to the safe harbor provisions of the PSLRA and are therefore not actionable. No investigation of defendant’s state of mind is required.” 346 F.3d at 678. This remains the approach within the Sixth Circuit. See, e.g., *Humana*, 2009 WL 1767193, at \*10, \*15. The Court of Appeals for the Eleventh Circuit recently reaffirmed its adherence to the approach taken in *Ivax*. *Howard J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 2010 WL 154519, at \*9-10 (11th Cir. Jan. 19, 2010) (emphasizing the disjunctive nature of the subclauses of the safe harbor and holding that “an allegation of actual knowledge of falsity will not deprive a defendant of protection by the statutory safe harbor if his forward-looking statements are accompanied by meaningful cautionary language” and stating that “the plaintiff’s inability to show knowledge of falsity is only relevant if the defendant is unable to produce meaningful cautionary statements or evidence of immateriality.”). *But see* within the Eleventh Circuit *Primavera v. Liquidmetal Technologies, Inc.*, 403 F. Supp. 2d 1151, 1159 (M.D. Fla. 2005) (ruling that allegations of actual knowledge preclude application of the safe harbor, apparently notwithstanding the presence of meaningful cautionary statements).

“surprising,” the First Circuit adopted the same interpretation.<sup>116</sup> A district court within the Seventh Circuit described the conclusion “counterintuitive” but was “compelled” to apply it under the plain meaning of the statute.<sup>117</sup> These cases essentially rely on an explicit rigid application of the disjunctive wording of the safe harbor.<sup>118</sup>

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<sup>116</sup> *In re Stone & Webster, Inc. Sec. Litig.*, 414 F.3d 187, 212 (1st Cir. 2005) (“The statute thus seems to provide a surprising rule that the maker of knowingly false and wilfully fraudulent forward-looking statements, designed to deceive investors, escapes liability for the fraud if the statement is ‘identified as a forward-looking statement and [was] accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.’ [quoting statute]”). This court elaborated on its analysis by observing that a lie about a *present* fact that relates to the accuracy of a projection would not be protected by the safe harbor for *forward-looking* statements. The court gave the example of an issuer of securities in a business with an obvious risk of liability that states it has procured liability insurance in amounts sufficient to cover the maximum anticipated liability. If the aspect of the statement alleged to be fraudulent “lies not in the estimate of likely liabilities, but in the fact that the issuer was lying in stating that it had obtained insurance,” the safe harbor would not protect the false statement of present fact. *Id.* at 213. A district court in the Eighth Circuit recently followed *Stone & Webster*:

The Court finds that application of the first safe harbor does not involve an inquiry into the speaker’s state of mind, but instead is limited to whether the cautionary language is adequate and whether the challenged statement is solely forward-looking and predictive, as opposed to an arguably forward-looking statement that also contains representations as to present facts.

*Western Washington Laborers*, 2009 WL 3756619, at \*2 (footnote omitted).

<sup>117</sup> *Desai*, 654 F. Supp. 2d at 843-44:

[A]re we really to believe that Congress, in the course of tightening the standards of pleading and proof in private lawsuits claiming securities violations, intended to immunize deliberate liars from liability to those who invested in securities on the strength of such lies and suffered major losses? That would appear to subvert the long-established principles of fraud-based liability.

Yet this Court also finds itself compelled to answer “Yes” to what should have seemed a rhetorical question calling for a “No” response. . . . [T]he unambiguous language of [Section 21E(c)(1)(A) of the Exchange Act] itself dictates that outcome – it requires only a forward-looking statement (whether true or false) plus an accompanying meaningful cautionary statement.

B. Some Cases Treat the Second Prong as Pertinent Even if the First Prong Has Been – or May Be – Satisfied

In contrast to the cases described in Part IV.A, a number of cases deem the second prong of the safe harbor – that the defendant acted with actual knowledge of the falsity of the forward-looking statement – pertinent even if the first prong was, or might be, established. In dictum in *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.* the court stated that a “strong inference of actual knowledge” will “except[] [purportedly forward-looking] statements from the safe harbor rule altogether.”<sup>119</sup> Other courts have come to

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The holding in *Desai* is consistent with prior decisions within the Seventh Circuit. See *In re Midway Games, Inc. Sec. Litig.*, 332 F. Supp. 2d 1152, 1167 (N.D. Ill. 2004) (holding that state of mind is irrelevant if the first prong is satisfied); *Sandmire v. Alliant Energy Corp.*, 296 F. Supp. 2d 950, 958 (W.D. Wis. 2003) (“Proof of knowledge that a forward-looking statement was false relates to a separate and distinct safe harbor provision, § 78u-5(c)(1)(B). Such knowledge and the state of mind of the defendants at the time the statement was made are irrelevant to a safe harbor defense based on cautionary language.”).

<sup>118</sup> See also *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 371 (5th Cir. 2004) (“The safe harbor has two independent prongs: one focusing on the defendant’s cautionary statements and the other on the defendant’s state of mind”) (dictum); *In re Williams Sec. Litig.*, 339 F. Supp. 2d 1206, (N.D. Okl. 2003) (“The safe harbor of the PSLRA provides two primary paths by which a defendant may avoid liability. [Citing *PSLRA Conf. Rep.*, *supra* note 21, at 43] The application of the safe harbor under the “actual knowledge” prong does not depend on the use of cautionary language, and the application under the “cautionary language” prong does not depend upon a defendant’s state of mind. [Citing *PSLRA Conf. Rep.*, *supra* note 21, at 47].”) (dictum); *Yellen v. Hake*, 437 F. Supp. 2d 941, 961 (S.D. Ia. 2006) (“the statute is worded in the disjunctive”).

<sup>119</sup> 320 F.3d 920, 937 n.15 (9th Cir. 2003). Cases applying this dictum include *In re Dura Pharmaceuticals, Inc. Sec. Litig.*, 548 F. Supp. 2d 1126, 1143 (S.D. Cal. 2008) (noting that while some courts have declined to follow *America West* as dicta, “The parties have not cited, nor has the Court found, any subsequent Ninth Circuit authority contradicting the statutory interpretation in *America West*”); *In re LDK Solar Sec. Litig.*, 584 F. Supp. 2d 1230, 1250 (N.D. Cal. 2008) (holding that where plaintiff alleges that the statements were made with actual knowledge of their falsity “it does not matter whether or not the statements were forward-looking or were accompanied by meaningful cautionary statements”). An unpublished decision of the Ninth Circuit Court of Appeals, however, held, without citation to *America West*, that a forward-looking statement that satisfies the first prong cannot give rise to liability “regardless of

a similar conclusion.<sup>120</sup> These courts treat the two prongs to operate so that the claim may proceed if *either* the forward-looking statement identified as such was not accompanied by meaningful cautionary statements *or* the plaintiff alleges actual knowledge of the falsity of the statement. These courts do not directly address the disjunctive grammatical structure of the statute.

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Defendants' state of mind." *Winick v. Pac. Gateway Exchange*, 73 Fed. Appx. 250, 253 (9th Cir. 2003), *withdrawn pursuant to settlement*, 80 Fed. Appx. 1 (9th Cir. 2003).

<sup>120</sup> *See, e.g., Lormand v. US Unwired, Inc.*, 565 F.3d 228, 244 (5th Cir. 2009) (stating in dictum that allegation of actual knowledge would preclude reliance on the safe harbor even if there were meaningful cautionary statements). Though that court cited *Southland*, *supra* note 118, that court did not address the different perspective on the interpretation of the interrelationship of the prongs of the safe harbor in the two decisions.

*See also Gargiulo v. Isolagen, Inc.*, 527 F. Supp. 2d 384, 389 (E.D. Pa. 2007) ("though some of the statements are forward-looking and contain cautionary language, they are still not protected by the PSLRA safe harbor because Plaintiffs allege that Defendants had actual knowledge of falsity"); *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 676 (D. Colo. 2007) (stating in dictum that even a forward-looking statement made with meaningful cautionary statements may be actionable if there are sufficient allegations of actual knowledge of the falsity of the statement); *In re Alliance Pharm. Corp. Sec. Litig.*, 279 F. Supp. 2d 171, 192 (S.D.N.Y. 2003) (stating in dictum that the safe harbor provision of the PSLRA does not protect a defendant from liability if a statement was knowingly false when made even if there were adequate cautionary statements); *Schaffer v. Evolving Systems, Inc.*, 29 F. Supp. 2d 1213, 1224 (D. Colo. 1998) ("Plaintiffs correctly argue that the safe harbor provision provides no refuge for Defendants who make statements with 'actual knowledge' of their falsity," even though the court decided the statement was "accompanied by sufficiently specific cautionary language"). *See also In re Cambrex Corp. Sec. Litig.*, 2005 WL 2840336, at \*8 (D. N.J. Oct. 27, 2005) ("Even if the warnings were sufficient, the safe harbor is not available when the forward-looking statements are made by or with the approval of an executive officer of that entity who had actual knowledge that the statement was false or misleading, as is alleged to be the case here"), relying upon *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999), which had stated that the safe harbor would not apply if the statement was made with actual knowledge of its falsity. Insofar as the Court of Appeals for the Third Circuit is concerned, however, at the appellate level the issue of the relationship between the two prongs is undecided. *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 259 (3d Cir. 2009) (distinguishing *Advanta* on the ground that in *Advanta* there was no cautionary language to consider).



C. Some Cases Find that Actual Knowledge of the Falsity of the Forward-Looking Statement Precludes a Finding that Meaningful Cautionary Statements were Made within the Meaning of the First Prong of the Safe Harbor

There is a third perspective, which essentially seeks to meld the two prongs by ruling that an allegation of undisclosed actual knowledge of falsity of the forward-looking statement means, *ipso facto*, that the cautionary statements were not meaningful. The principal case adopting this approach is *In re SeeBeyond Technologies Corp. Sec. Litig.*<sup>121</sup> After rejecting the statement in *America West* as dictum<sup>122</sup> and noting that the two prongs of the safe harbor operate independently, the court went on to state:<sup>123</sup>

[S]ubsection [Section 21E(c)(1)](A)'s requirement that meaningful cautionary language accompany the forward-looking statement severely limits the possibility that false or misleading statements could be made with actual knowledge and yet be protected under the safe harbor provision. If the forward-looking statement is made with actual knowledge that it is false or misleading, the accompanying cautionary language can only be meaningful if it either states the belief of the speaker that it is false or misleading or, at the very least, clearly articulates the reasons why it is false or misleading. These are undeniably "important factors that could cause actual results to differ materially from those in the forward-looking statement . . . ." [Citing Section 21E(c)(1)(A)(i)] Only if such information is included can the cautionary language be "meaningful."

In a footnote to this passage, the court addressed a criticism that this analysis "improperly imports a state of mind element into subsection (A),"<sup>124</sup> stating:<sup>125</sup>

Whether cautionary language is meaningful, in that it identifies important factors, can only be understood with reference to the defendant's knowledge of relevant factors. This result follows from the fact that courts and Congress have made clear

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<sup>121</sup> 266 F. Supp. 2d 1150 (C.D. Cal. May 28, 2003).

<sup>122</sup> *See supra* text accompanying note 119.

<sup>123</sup> 266 F. Supp. 2d at 1165-66 (footnote omitted).

<sup>124</sup> *Id.* at 1165 n.8.

<sup>125</sup> *Id.* at 1166 n.8 (emphasis in original)

that mere boilerplate cautionary language will not do. [Citations omitted] Moreover, whether a specific factor is “important” and therefore should be listed, likely should not be evaluated by an objective standard (i.e. what the defendant should have known). If an objective standard is adopted for determining whether a factor is “important,” then it seems this would *heighten* the bar of the first prong of the safe harbor provision, making it more difficult for defendants to take advantage of its grant of immunity. This result seems contrary to congressional intent.<sup>126</sup> Instead, it appears as though a determination of whether “important” factors have been identified should be made with reference to those factors of which the speaker is aware – things that the speaker believes may cause actual results to vary. Therefore, it appears as though the cautionary statement cannot be evaluated without reference to the defendant’s knowledge.

While it is undisputed that a speaker need not identify all of the factors that may cause actual results to differ from a prediction, a speaker with actual knowledge that a prediction is false or misleading must identify the basis for the misleading or false nature of the prediction, as surely this is an important factor that could - perhaps undoubtedly will - make actual results differ materially from those in the forward-looking statement.

It may also be argued that this reading of [Section 21E(c)(1)] obliterates the distinction between subsections (A) and (B), as the key element under both prongs seems to simply be whether the plaintiff alleges that the defendant had actual knowledge. The Court disagrees. Subsection (B) sets the standard the plaintiff must meet when no cautionary language is present. Subsection (A) may still provide safe harbor where cautionary language is used, even if the defendant has actual knowledge that the statement is false or misleading. The idea that sufficient cautionary language may be used when the defendant has actual knowledge that a statement is somehow misleading (for instance, where the company is engaging in “puffery” of some sort) is not so far-fetched. On a related note, the two-prong construction of the safe harbor provision may be explained by the fact that Congress was perhaps looking to the existing “bespeaks caution” doctrine when enacting subsection (A), while seeking to place a heightened burden on plaintiffs when enacting subsection (B).

In assessing the accuracy of the statement that Congress may have been “looking to” the bespeaks doctrine when enacting the first prong of the safe harbor, one must take into account that at least one line of bespeaks caution cases rejects the relevance of the alleged actual

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<sup>126</sup> The preceding language in this quotation is in effect a rejection of the approach applied by the Seventh Circuit in *Asher*, which reflected that discovery would be necessary, at least in some cases, to determine objectively what the important factors were at the time the statements were made. *See supra* note 37.

knowledge of the falsity of the forward-looking statement.<sup>127</sup> The fact that Congress modeled the first prong after *Trump*<sup>128</sup> strongly suggests that it accepted the approach of that case that state of mind is not relevant to the application of the bespeaks caution doctrine.<sup>129</sup>

*See Beyond* is simply not reconcilable with the cases discussed in Part IV.A, and the case cannot be criticized for failure to take into account the statements in the Conference Report on which those cases rely.<sup>130</sup> One respect in which the decision seems to have applied a policy rationale that may be at odds with expressed Congressional intent, however, is the court's interpretation, to use the court's own words, of the principle that to satisfy the first prong "a speaker need not identify all of the factors that may cause actual results to differ from a prediction."<sup>131</sup> This is a reference to the statement in the Conference Report that the speaker need not identify "all factors" that "could cause results to differ materially" from the projection.<sup>132</sup> The Conference Report continued, "Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor,"<sup>133</sup> and, "The Conference Committee specifies that the cautionary statements identify 'important' factors to provide guidance to issuers and *not to*

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<sup>127</sup> *See supra* text accompanying notes 111-112.

<sup>128</sup> *See supra* text accompanying notes 105-106.

<sup>129</sup> *See supra* text accompanying notes 105-113 and *infra* text accompanying notes 159-163 and 203-209.

<sup>130</sup> *See* 266 F. Supp. 2d at 1165-66 n.8 (discussing legislative history and selected commentary).

<sup>131</sup> *See supra* text accompanying note 125.

<sup>132</sup> *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743.

<sup>133</sup> *Id.*

provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.”<sup>134</sup> *SeeBeyond* concludes, however, “[A] speaker with actual knowledge that a prediction is false or misleading *must* identify the basis for the misleading or false nature of the prediction, as surely this *is an important factor*.”<sup>135</sup> *SeeBeyond* thus expressly imposes a requirement that one type of factor can *never* be omitted and thus that, before a claim is dismissed, the plaintiff should be allowed to inquire into what the speaker knew at the time the statement was made, concepts that are at odds with statements of Congressional intent in the Conference Report just quoted.

*SeeBeyond* has been followed within the Ninth Circuit<sup>136</sup> and elsewhere.<sup>137</sup> No case has been found directly rebutting its analysis. One court expressed an inclination to follow the ruling in *SeeBeyond* but concluded that it was constrained by the “statutory language.”<sup>138</sup>

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<sup>134</sup> *Id.* (emphasis added).

<sup>135</sup> *See supra* text accompanying note 125, 266 F. Supp. 2d at 1166 n.8 (emphasis added).

<sup>136</sup> *See, e.g.,* Rosenbaum Capital LLC v. McNulty, 549 F. Supp. 2d 1185, 1190-91 (N.D. Cal. 2008).

<sup>137</sup> *In re Nash Finch Co.* 502 F. Supp. 2d 861, 873 (D. Minn. 2007) (“This Court concludes that cautionary language can not be ‘meaningful’ when defendants know that the potential risks they have identified have in fact already occurred, and that the positive statements they are making are false,” citing *SeeBeyond*); *Freeland v. Iridium World Communications, Ltd.*, 545 F. Supp. 2d 59, 74 (D.D.C. 2008) (following *SeeBeyond* in denying summary judgment because of issues of fact regarding defendants’ intent that bear on whether cautionary statements were “meaningful”). A decision in the latter court in the period between *SeeBeyond* and *Iridium* had held, however, without any discussion of *SeeBeyond*, that state of mind is irrelevant if there are meaningful cautionary statements. *XM Satellite*, 479 F. Supp. 2d at 186 n.14. *Iridium* rejected the conclusion in *XM*. 545 F. Supp. 2d at 72 (noting that there was no controlling decision from the Court of Appeals for the District of Columbia).

<sup>138</sup> *In re Broadcom Corp. Sec. Litig.*, 2004 WL 3390052, at \*3 n.4. (C.D. Cal. Nov. 23, 2004) (stating that the analysis in *SeeBeyond* “is sound and should be adopted by the Ninth Circuit. However, in light of the statutory language and the present state of the case law, the Court cannot adopt this argument”).

One decision of dubious merit, within the Second Circuit, has expressed a view somewhat similar to that developed more fully in *See Beyond*, stating that “no degree of cautionary language will protect material misrepresentations or omissions where defendants knew their statements were false when made.”<sup>139</sup> The flaw in that case is that the decision on which it relied dealt with the bespeaks caution doctrine, not the statutory safe harbor.<sup>140</sup>

Other courts appear to conclude that when there is a close question whether the cautionary statements satisfy the first prong, allegations of actual knowledge of the falsity tilt the balance against applying the first prong. Thus, one court stated, “Taken together, the facts of the complaint suggest the Defendants had actual knowledge of the problems [undermining the forward-looking statement]. In such a situation, vague and insipid cautionary language is insufficient to afford the statements protection under PSLRA’s safe harbor provision.”<sup>141</sup> Cases

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<sup>139</sup> *In re AOL Time Warner, Inc. Sec. and “ERISA” Litig.*, 381 F. Supp. 2d 192, 223 (S.D.N.Y. 2004), quoting *Milman v. Box Hill Systems Corp.*, 72 F. Supp. 2d 220, 231 (S.D.N.Y. 1999).

<sup>140</sup> *See Milman*, 72 F. Supp. 2d at 230-31. The case involved claims under the Securities Act apparently involving an initial public offering, which is not subject to the statutory safe harbor. Section 27A(b)(2)(D) of the Securities Act, 15 U.S.C. § 77z-2(b)(2)(D) (2000).

<sup>141</sup> *In re FirstEnergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 596 (N.D. Ohio 2004). The cited authority for this statement (*In re Prudential Securities Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996)), however, is mischaracterized as presenting an interpretation of the statutory safe harbor, when in fact it was applying the bespeaks caution doctrine. A later case in a neighboring district made a similar comment, relying on *FirstEnergy* and *Prudential*. *In re Cardinal Health Inc. Sec. Litig.*, 426 F. Supp. 2d 688, 750 (S.D. Ohio 2006). The result reached in *FirstEnergy* may be difficult to square with the holding by the Sixth Circuit Court of Appeals in *Miller* (*see supra* text accompanying note 115), which *FirstEnergy* cited. 316 F. Supp. 2d at 596.

that apply the first prong independently, however, always require more than “vague and insipid language,” so that such language is insufficient irrespective of actual knowledge of falsity.<sup>142</sup>

#### D. Summary of the Case Law

Many courts, some with express reservations, apply the first prong as literally written, without addressing what “meaningful” may mean with reference to the defendant’s state of mind. Other courts, perhaps acting on the revulsion expressed by some courts in the first cohort, apply the second prong to supersede the first, without directly articulating why that is the correct analysis. *See Beyond* offers a reasoned attempt to address both the plain meaning of the two prongs and the revulsion factor by holding that cautionary statements cannot ever be “meaningful” if the statement was known to be false and the speaker did not include that revelation as part of the cautionary statements. As discussed above, however, thoughtful though *See Beyond* is, it is at least in some respects inconsistent with the expression of Congressional intent in the Conference Report.<sup>143</sup>

#### V. THE VIEWS OF COMMENTATORS AND THE SEC

Part IV of this article demonstrates that there is a three-way split among the cases regarding whether satisfaction of the first prong of the safe harbor moots the second prong or whether, on the contrary, allegations (or proof) of actual knowledge of the falsity of the projection preclude application of the first prong of the safe harbor as a complete defense (on one of two different approaches). Commentators likewise have expressed divergent views, and the

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<sup>142</sup> *See, e.g., US Unwired*, 565 F.3d at 244 (“the language urged here is boilerplate and does not qualify as meaningful cautionary language. Congress clearly intended that boilerplate cautionary language not constitute “meaningful cautionary” language for the purpose of the safe harbor analysis.”)

<sup>143</sup> *See supra* text accompanying notes 131-135.

SEC recently filed an amicus brief addressing the safe harbor. The following subsections present the perspectives of a number of authors who have addressed the relevance of the defendant's state of mind to the application of the first prong of the safe harbor and the view of the SEC.

A. Many Commentators Treat the Second (Actual Knowledge) Prong as Irrelevant if the First Prong Is Satisfied

In an early assessment of the PSLRA safe harbor, one commentator followed the plain meaning of the statute, concluding, "Even deliberate omission of one or more important factors appears not to subject the issuer to private liability, since some important factors would still be identified, just not all of them. Apparently, an issuer could even omit the most likely factors and still be protected, provided that the factors which the issuer does state are important."<sup>144</sup>

Another commentator offered the following assessment:<sup>145</sup>

Many opponents of the bill repeatedly argued that under this prong of the safe harbor, even if an issuer makes a knowingly false prediction of future success

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<sup>144</sup> Steven J. Spencer, Note, *Has Congress Learned Its Lesson? A Plain Meaning Analysis of the Private Securities Litigation Reform Act of 1995*, 71 ST. JOHN'S L. REV. 99, 118 (1997) (footnotes omitted). The author is, however, critical that there is no "textual basis" for the statement in the *PSLRA Conf. Rep.*, on which that author relies, for the statement that state of mind is irrelevant under the first prong. *Id.* at 119. Nevertheless, he states:

Strict interpretation of the safe harbor provision shows its two prongs to be set forth in the disjunctive. A forward-looking statement is protected either if it is accompanied by meaningful cautionary statements or if the plaintiff fails to prove that the statement was made with actual knowledge that it was false or misleading. Consequently, a forward-looking statement that is known to be untrue can be protected under the safe harbor by the presence of cautionary language. This does little to encourage public investment in a company, for any statement accompanied by statutorily sufficient cautionary language might be a blatant lie, and yet remain protected by the safe harbor.

*Id.* at 121-22 (footnote omitted).

<sup>145</sup> Richard A. Rosen, *The Statutory Safe Harbor for Forward-Looking Statements After Two and a Half Years: Has it Changed the Law? Has It Achieved What Congress Intended*, 76 WASH. U. L. Q. 645, 657-58 (1998).

– that is, false because the defendant actually knew at the time that the projection would be impossible to achieve – the forward-looking statement is nevertheless immunized from the liability. The Act does indeed provide that a forward-looking statement can be immune from suit irrespective of the state of mind of the defendant (which need not even be investigated by the court) if appropriate cautionary language is present. That much is perfectly consistent with existing law. In *Trump* and most other cases, the courts make clear that if a forward-looking statement is qualified with concrete, specific risk disclosures that address the factors that may cause results to differ, the forward-looking statement is immaterial as a matter of law. It simply does not matter whether the defendants made the projections in good faith.

I would submit that, however anomalous the result may seem on the facts of a particular case, this result is correct as a matter of policy as well. The theory of the Act – like that of much prior case law<sup>146</sup> – is that no reasonable investor could rely on a forward-looking statement in light of specific attendant risk disclosures, so a prediction that is adequately hedged with concrete cautionary language simply is not material.

In succeeding years, that commentator has closely followed case law developments under the statutory safe harbor and maintained his view that state of mind has no bearing on the application of the first prong.<sup>147</sup>

Another commentator has concluded:<sup>148</sup>

Because these three Safe Harbor provisions work independently of one another, the corporation’s state of mind is irrelevant under the first two provisions. In other

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<sup>146</sup> As noted earlier, some cases differed from *Trump* by taking the defendant’s state of mind into account when applying the bespeaks caution doctrine. *See supra* text accompanying notes 111-112.

<sup>147</sup> *See, e.g.,* Richard A. Rosen, *The Statutory Safe Harbor for Forward-Looking Statements: A Scorecard in the Courts from November 2004 through November 2006*, 39 SEC. REG. & L. REP. (BNA) 54 (Jan. 15, 2007) (“Under a plain reading of the PSLRA, the safe harbor can apply to forward-looking statements even if the defendant knew the forward-looking statements were false. . . . Despite the statute’s plain language, there is a rather surprising ongoing circuit split over whether a defendant who is alleged to have had actual knowledge that a statement was false when made may still obtain safe harbor protection.”) (footnote omitted).

<sup>148</sup> Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. Ill. L. Rev. 929, 933 (2005).



words, corporate executives can knowingly lie to the market by making a forward-looking statement they are fully aware will never materialize, so long as they attach meaningful cautionary language to warn the market of the potential risks of the investment.

Thus, the plain meaning approach that maintains an impenetrable separation between the two prongs has strong adherents among the commentators as well as the courts.

B. Some Commentators Urge that Actual Knowledge of the Falsity of the Forward-Looking Statement Be Taken into Account in Determining Whether the First Prong of the Safe Harbor Applies

In an article published shortly after the passage of the PSLRA, Professor John Coffee rejected as “unseemly” an interpretation of the first prong that would protect “knowing falsehoods.”<sup>149</sup> He would “read ‘meaningful’ to require that the cautionary statements provide corrective disclosure that offset or at least significantly dilute the false statement. That is,

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<sup>149</sup> Coffee, *supra* note 35, 51 BUS. LAW. at 989. Professor Coffee was an immediate critic of the final legislation, urging that the President veto it, claiming that under the safe harbor set forth in the Conference Report “even if a knowingly false statement is made, the defendant escapes liability if ‘meaningful cautionary statements’ are added to the forward-looking statement. This is bad enough, but under the proposed legislative history there now appears to be no obligation to disclose the most important reasons why the forward-looking statement may prove false (so long as some ‘important factors’ are indicated.)” Letter from John C. Coffee, Jr. to President Clinton (Dec. 6, 1995), *reprinted in* 141 CONG. REC. 38201-02 (Dec. 21, 1995). *See also supra* note 100 (referring to Professor Coffee’s position during Senate debate). Professor Coffee’s proposed reading of the statute published in 1996 thus seems at odds with his interpretation of the language when it was before Congress less than a year earlier.

Professor Coffee had been an advocate of a safe harbor that would protect a forward-looking statement that “contains or is closely accompanied by clear and specific cautionary language that explains in detail sufficient to inform a reasonable person of the level of risk associated with, or inherent in, the statement and that identifies the specific basis for such statement and for such level of risk.” *See Concept Release, supra* note 16, 59 FED. REG. 52723, 52734-75 (reproducing proposal made by Professor Coffee). Professor Coffee’s proposed safe harbor would not by its terms have been dependent upon the speaker’s state of mind. In particular, as the SEC explained, that proposed safe harbor “would not require that the forward-looking statement have a ‘reasonable basis’ (as under existing Rules 175 and 3b-6) because, according to Professor Coffee, this requirement often raises factual issues that cannot easily be resolved at the pre-trial state.” *Id.* at 52730.

statements that did not correct or minimize the lie are arguably not ‘meaningful.’”<sup>150</sup> He acknowledged, however, that if the first prong does not protect knowingly false statements, some non-redundant interpretation must be given to the second prong. This would result in interpreting the first prong so that a knowingly false statement would be protected only when it had been rendered immaterial or incapable of reasonable reliance, essentially by disclosing the false nature of the projection, and a recklessly (but not knowingly) false forward-looking statement would be protected by the second prong, even if it was not qualified by “meaningful” cautionary statements.<sup>151</sup> Professor Coffee acknowledged that the stated purpose of the statutory safe harbor was “likely” to “go well beyond the ‘bespeaks caution’ case law” but claimed it would not to go so far as protect a defendant from liability for a “knowingly false statement unaccompanied by a special qualification.”<sup>152</sup>

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<sup>150</sup> Coffee, *supra* note 35, 51 BUS. LAW. at 989.

<sup>151</sup> Coffee, *supra* note 35, 51 BUS. LAW. at 989-90. Professor Coffee would give independent meaning to the “immaterial” test in Section 21E(c)(1)(A)(ii) by interpreting the first prong to render the statement immaterial because it is qualified by meaningful cautionary statements, with the separate “immaterial” test applying where the statement is not material for some independent reason. *Id.* at 990-91. *See supra* text accompanying note 35 (quoting Conference Report on inclusion of the separate “immaterial” test and quoting Professor Coffee’s recount of one aspect of the history of the drafting of that subclause).

<sup>152</sup> Coffee, *supra* note 35, 51 BUS. LAW. at 990. In this discussion, Professor Coffee asserted that the bespeaks caution cases did not protect knowingly false statements. *Id.* & n.75. (The reference there is to note 55 earlier in the cited text, an apparent miscitation for note 64.) As discussed earlier in this article, however, the bespeaks caution case law as of the time of enactment of the PSLRA was not so clear as Professor Coffee suggests, and some cases rejected any state of mind component in the bespeaks caution doctrine. *See supra* notes 111-112. Professor Coffee cited (*id.* at 987 n.64) only *Isquith v. Middle S. Util., Inc.*, 847 F.2d 186, 203 (5th Cir. 1988), and *Kline v. First W. Gov’t Sec., Inc.*, 24 F.3d 480, 489 (3d Cir. 1994), neither of which was discussed by Professor Langevoort in his 1994 article on bespeaks caution discussed *supra* note 111. *Isquith* at least suggests that a statement that bespoke caution is not actionable whether or not it was made in good faith:

Urging a comparable approach, one author states in the current edition of his treatise:<sup>153</sup>

A quick reading of the statute might lead one to conclude that a defendant can make a forward looking statement with actual knowledge of its falsity and escape liability by identifying the statement as forward looking and adding “*meaningful* cautionary statements.” Courts should avoid this bizarre result by classifying any cautionary statement as not “meaningful” – and thus denying access to the safe harbor – when the statement’s maker has actual knowledge of the falsity. Such a result is within the literal wording of Section [21E](c)(1)(B).

Speaking with reference to the bespeaks caution doctrine, another leading securities law commentator stated:<sup>154</sup>

A cautionary statement found in a risk factor or disclaimer should be given no weight if the defendants were aware (or should have been aware) of a prospective negative material fact and chose not to disclose it. The bespeaks caution doctrine,

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Most often, whether liability is imposed depends on whether the predictive statement was “false” when it was made. The answer to this inquiry, however, does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction – with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, *or* had a sound factual or historical basis.

847 F.2d at 203-204 (emphasis added). *Kline* (which purported to follow, though in this respect may not be consistent with, *Trump*, also in the Third Circuit) does support Professor Coffee’s interpretation of the bespeaks caution doctrine.

It is also notable that the leading general treatise on the federal securities laws interprets the bespeaks caution doctrine as inapplicable where the speaker knows the projection is false but views the question to be open whether actual knowledge of falsity of the projection would preclude reliance on the first prong of the statutory safe harbor. 4 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 644 (4th ed. 2009) (stating that under the bespeaks caution doctrine “[a] cautionary statement found in a risk factor or disclaimer should be given no weight if the defendants were aware (or should have been aware) of a prospective negative material fact and chose not to disclose it”) and 2 *id.* at 100 (4th ed. 2007) (observing, with express reservations, that under the statutory safe harbor “appropriate cautionary language may render even a knowing misstatement or omission immaterial”).

<sup>153</sup> 5 ARNOLD S. JACOBS, *DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS* § 3:31, at 3-152 to -153 (2009) (emphasis in original; footnote omitted).

<sup>154</sup> Joel Seligman, *The SEC’s Unfinished Soft Information Revolution*, 63 *FORDHAM L. REV.* 1953, 1978 (1995).

in other words, should not be a device by which defendants can obscure or misrepresent prospective bad news.

After the statutory safe harbor was adopted, that author observed that the first prong “may immunize a deliberately false forward looking statement if the court concludes it was accompanied ‘by meaningful cautionary statements.’ . . . . If courts narrowly construe the term ‘meaningful cautionary statement’ language when confronted with deliberate fraud, much mischief can be avoided.”<sup>155</sup>

An early commentator on the PSLRA observed that the first prong “[r]ead literally . . . would protect forward-looking statements that were known to be false and misleading when made.”<sup>156</sup> He continued, however:<sup>157</sup>

As a practical matter, while the presence of cautionary statements may serve to avoid lengthy discovery on the issue of knowledge, if the plaintiff can adequately plead that the forward-looking statement was known to be false when made, it may be difficult for the defendant to win a dismissal on the grounds that the cautionary statements were “meaningful.”<sup>158</sup>

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<sup>155</sup> Joel Seligman, *The Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 717, 733 (1996).

<sup>156</sup> John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act*, 51 BUS. LAW. 335, 355-56 (1996).

<sup>157</sup> *Id.* at 356.

<sup>158</sup> Another commentator seems to urge simultaneous conflicting positions. After observing that “forward-looking statements surrounded by ‘meaningful cautionary statements’ will be insulated from challenge even if knowingly false,” he continues, “A false projection lacks a reasonable basis. To the extent that a company knows that the projection lacks a reasonable basis, the meaningful cautionary statements would have to indicate the ‘unreasonable’ assumptions.” J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 6A.04[3], at 6A-20.2 to -20.3 (3d ed. 2010) (footnotes omitted).

A more recent extensive exegesis of the statutory safe harbor by Hugh Beck<sup>159</sup> focuses on an analysis of *Trump*<sup>160</sup> and argues that *Trump* departed from earlier formulations of the bespeaks caution doctrine in determining that cautionary statements may render a false projection immaterial.<sup>161</sup> Beck contends that prior to *Trump* the courts that applied a bespeaks caution doctrine did so with a focus on falsity, not materiality.<sup>162</sup> At the same time, he concedes

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<sup>159</sup> At the time Beck was a member of the staff of the SEC and his discussion was accompanied by the appropriate disclaimer that his views do not necessarily reflect those of the SEC. Beck, *supra* note 105, 44 AM. BUS. L. J. at 161 n.1

<sup>160</sup> See *supra* notes 19-20.

<sup>161</sup> Beck, *supra* note 104, 44 AM. BUS. L. J. at 190-95. Beck states that *Trump* “[f]ail[ed] to perceive the common doctrinal framework underlying the holdings in the previous bespeaks caution cases . . . .” *Id.* at 191. (Beck’s understanding of the “common doctrinal framework” is set forth *infra* note 162.) An article published ten years earlier, which Beck does not cite, also concluded that Congress adopted a materiality-based approach to the safe harbor. O’Hare, *supra* note 105, 58 U. PITT. L. REV. at 641. O’Hare concluded that the statutory “safe harbor protects an issuer who did not believe its forward-looking statement because it was aware of important risks, but failed to disclose them to the public.” *Id.* at 665.

<sup>162</sup> *Id.* at 175-81. Beck states:

The [traditional] framework’s underlying assumption is that disclosures of forward-looking information tend to influence investor behavior. Accordingly, the finder of fact preliminarily assumes the materiality of the forward-looking statement in question and focuses on determining whether the statement was false or misleading. This determination is made by evaluating whether a “reasonable” investor would have drawn from the publication of the forward-looking statement the incorrect inferences that allegedly misled the plaintiff. To the extent a reasonable investor would have drawn those inferences they constitute implied misrepresentations, which render the forward-looking statement itself false or misleading. Any definitive evaluation of the materiality of the forward-looking statement prior to this falsity analysis is premature because the materiality (or immateriality) of any aspects of the statement other than such implied misrepresentations has no impact on the statement’s actionability. In other words, under this traditional framework, until the finder of fact determines how a forward-looking statement was false, it cannot determine whether that falsity was material and therefore actionable.

*Id.* at 165-66.

that in formulating the safe harbor Congress was guided in large measure by *Trump* and its progeny, not what he refers to as the “traditional” cases.<sup>163</sup> He concludes, nevertheless, that application of the PSLRA safe harbor “does not clearly require a materiality-driven approach to evaluating whether an issuer should be liable if a published prediction turns out to be wrong.”<sup>164</sup> From a policy perspective, “The most obvious problem with reading the first safe harbor provision as a formula for rendering predictive information immaterial is the inability of this

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<sup>163</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 196. Beck acknowledges that the *Trump* (materiality) formulation of the bespeaks caution doctrine “was quickly absorbed into the case law of other circuits” reflecting “widespread judicial acceptance of the Third Circuit’s materiality-driven bespeaks caution doctrine [which] gradually spilled over into ongoing congressional deliberations” regarding securities litigation reform. *Id.* at 195. He continues:

[T]here is no indication that any of the legislators considered that the legal relevance of accompanying statements could be conceptualized in any terms other than materiality. Rather, it appears that members of Congress took as granted *Trump’s* assertion that the primary relevance of accompanying cautionary language is its impact on a projection’s materiality because none of the cases subsequent to *Trump* questioned this assertion.

*Id.* at 196. Indeed, in explaining the inclusion of the separate “immaterial” safe harbor, the Conference Report states that this allows protection for a statement that is immaterial “on *other* grounds.” *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743 (emphasis added). This can only mean that the first prong sets forth a test of immateriality.

For a recent expression of the bespeaks caution doctrine as both a foundation for the first prong of the statutory safe harbor and with origins in a materiality-based approach, see *Goodman Life*, 2010 WL 154519, at \*11:

Our conclusion [that state of mind is irrelevant to the meaningful cautionary statement element of the safe harbor] is further informed by this circuit’s judicially created bespeaks caution doctrine, whose “statutory equivalent” is the PSLRA safe harbor provision. [Citation omitted]; see also [*PSLRA Conf. Rep.* at 43, 1995 U.S.C.C.A.N. at 742] (noting that the safe harbor provision “is based on aspects of . . . the judicial created ‘bespeaks caution’ doctrine”). Under the bespeaks caution doctrine, a forward-looking statement is rendered immaterial as a matter of law when accompanied by meaningful cautionary language.

<sup>164</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 197.

approach to connect the provision to the safe harbor's stated policy goal of enhancing allocative efficiency."<sup>165</sup> By this Beck means "the allocation of capital to its best use [which] requires securities prices that reflect available information regarding companies' business prospects. Accordingly, an increase in forward-looking information disclosures enhances allocative efficiency only to the extent that the disclosures influence the investor decisions that determine security prices."<sup>166</sup> He finds the first prong of the safe harbor lacking to the extent that – if by hypothesis the meaningful cautionary statements render the projection immaterial – companies will simply increase the disclosure of "immaterial information [that] will have little impact on the accuracy of equity prices on which allocative efficiency depends."<sup>167</sup> As a prescriptive matter, that may bear consideration, but it flies in the face of the balance of the legislative history.

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<sup>165</sup> *Id.* at 198 (footnote omitted).

<sup>166</sup> *Id.* at 164 n.11. The safe harbor is intended to achieve this goal by increasing the disclosure of forward-looking disclosures. *Id.* at 165, citing *PSLRA Conf. Rep.*, *supra* note 21, at 43, 1995 U.S.C.C.A.N. at 742. The Conference Report stated that the safe harbor is intended "to enhance market efficiency by encouraging companies to disclose forward-looking information." *Id.*

<sup>167</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 198. It is tautological that if the cautionary statements render the forward-looking statements immaterial then the statement as a whole is, under the definition of materiality, one that lacks a substantial likelihood that a reasonable shareholder would consider the information important in making an investment decision. *See supra* note 18. At the same time, the safe harbor was intended to encourage public companies to make forward-looking statements (*see supra* note 21), presumably ones of meaningful content to investors. If there is a tension between encouraging issuers to make informative statements that are, at the same time, sufficiently qualified to be immaterial, that is simply a legislative judgment that courts should not second-guess. Investors can decide for themselves how much reliance to place on projections, choosing to ignore the cautions if they wish, but they must recognize that adequately qualified projections will not provide the basis for a claim of material deception.

Beck sought to develop an interpretation of the three safe harbors (including the one that the statement is “immaterial”<sup>168</sup>) that does not render any one of the safe harbors superfluous.<sup>169</sup> He recognizes that a *Trump*-based interpretation of the first prong would preserve independent significance for the actual knowledge prong because adequately qualified forward-looking statements would be protected even if the speaker had knowledge of the falsity.<sup>170</sup> He finds this approach wanting, however, because a conclusion under the first prong that the forward-looking statement is “immaterial” would, he asserts, render the separately stated “immaterial” safe harbor superfluous.<sup>171</sup> This article has already shown, however, that the “immaterial” safe harbor in Section 21E(c)(1)(A)(ii) has independent significance from the first prong.<sup>172</sup>

Beck argues that a *Trump*-based framework would not be a “reasonable construction[] of the statutory language” because it would permit “meaningful cautionary statements” to exclude “contingencies management knows are more likely to cause departure from projected results.”<sup>173</sup> This criticism, however, is somewhat undermined by the statement in the *PSLRA Conference*

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<sup>168</sup> See, e.g., Section 21E(c)(1)(A)(ii) of the Exchange Act, 15 U.S.C. § 78u-5(c)(1)(A)(ii).

<sup>169</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 199-204.

<sup>170</sup> *Id.* at 199.

<sup>171</sup> *Id.* at 200 n. 131. Beck quibbles that if the *Trump* approach was the guidepost for Congress, Congress should have included only two components to the safe harbor, one being immateriality and the other lack of actual knowledge. *Id.* The fact that Congress chose to include alternative approaches leading to a conclusion of immateriality, as discussed *infra* text accompanying note 172, is not a basis for rejecting the conclusion that the first prong presents an unqualified test for immateriality.

<sup>172</sup> See *supra* text accompanying notes 35-36 and note 151. Beck’s article does not contain any mention of the puffery doctrine of immateriality.

<sup>173</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 199.



*Report* that the safe harbor *is* available even if the contingency that ultimately undermines the projection was not disclosed.<sup>174</sup> Read literally, this explanation by the Conference Committee means that omitting from the meaningful cautionary statements a “factor known to the issuer” would not preclude successful reliance on the safe harbor. While this part of Beck’s analysis may be in accord with *Asher*, which requires disclosure of the “principal” contingencies in order to rely on the safe harbor<sup>175</sup> – a criterion that would surely include known falsity – the *Asher* approach has not become the dominant one for applying the first prong of the safe harbor.<sup>176</sup>

Beck draws a distinction between lack of belief in the statement in determining whether the statement is misleading and actual knowledge that it is false. Lack of belief in the statement would *not* render the statement misleading, so that it could still be protected by the first prong of the safe harbor, whereas lack of belief *would* leave the statement vulnerable under the “actual

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<sup>174</sup> *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743:

Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor. The Conference Committee specifies that the cautionary statements identify “important” factors to provide guidance to issuers and *not* to provide an opportunity for plaintiff counsel to conduct discovery on *what factors were known to the issuer at the time the forward-looking statement was made*.

(Emphasis added)

<sup>175</sup> *See supra* note 37, and *Asher*, 377 F.3d at 734.

<sup>176</sup> *See supra* note 37. Beck asserts that under his interpretation of the safe harbor “the omission of an important factor or even of the most important factor would not automatically render the remaining disclosures meaningless, particularly where disclosure of such information would substantially undermine the company’s competitive position. On the other hand, an omission of one of the most important factors that can only be explained by management’s intent to mislead investors ought to render the remaining statements meaningless.” Beck, *supra* note 105, 44 AM. BUS. L. J. at 201 n. 132.

knowledge” prong.<sup>177</sup> In the end, however, Beck acknowledges that proof that a forward-looking statement lacked meaningful cautionary statements will substantially overlap proof of actual knowledge of falsity.<sup>178</sup> This strongly suggests, to him, that in practice there should be very little distinction between the two (principal) prongs of the safe harbor.

Beck’s analysis is based on several faulty premises, not the least of which is that he criticizes the materiality-driven approach to the bespeaks caution doctrine in *Trump* yet, as he acknowledges, that *is* the foundation for Congress’s adoption of the first prong of the statutory safe harbor.<sup>179</sup> That is, irrespective of whether Beck’s criticism of *Trump* itself is well-founded, or whether Beck’s policy analysis is in accord with Congressional intent, it is *Trump* on which Congress undeniably based its approach. The interpretation and application of the statutory safe harbor must be based on the words Congress chose in the statute and, secondarily, its intent in

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<sup>177</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 202-203, relying upon *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991) (holding that a misstatement of one’s belief in a statement, a psychological fact, would not be a “misleading” statement that could provide the basis for a claim under Rule 10b-5).

<sup>178</sup> Beck states:

[I]n most cases where evidence adduced demonstrates management’s “actual knowledge” that a prediction was false, the same evidence will also demonstrate that statements accompanying the prediction were not “meaningful” because they failed to prevent important incorrect inferences a reasonable investor would have drawn about the probability of a departure of actual results from the predicted outcome. Accordingly, as managers perpetrating a fraud through the use of baseless predictions leave a trail of “actual knowledge” evidence they will generally be unable to avoid creating evidence of the “meaninglessness” of the statements accompanying the predictions at the same time.

*Id.* at 204 (footnote omitted).

<sup>179</sup> *See supra* Part III.F

choosing those words. Congress having enacted the words of *Trump*, what *Trump* meant is what the statute means.<sup>180</sup>

C. The SEC Urges that Application of the First Prong Take into Account Knowledge of Historical Facts Bearing on the Forward-Looking Statement

In response to a request from the Court of Appeals for the Second Circuit, the SEC recently filed a brief *amicus curiae* in an appeal from the dismissal of a private claim for damages under Rule 10b-5 in which that court may address the safe harbor.<sup>181</sup> The SEC addressed the relevance of the defendant's state of mind to a determination whether the "meaningful cautionary statement" test has been satisfied. The crux of the SEC's position is that a caution is not meaningful if it warns of a "potentiality that [the defendant] is aware currently exists."<sup>182</sup> The SEC sees this as consistent with the statement in the Conference Report that "[a] cautionary statement that misstates historical facts is not covered by the Safe [sic] harbor."<sup>183</sup> The SEC argued that consideration of the defendant's state of mind in this regard is not inconsistent with the emphasis in the Conference Report that the first prong of the safe harbor does not permit examining the defendant's state of mind.<sup>184</sup> The SEC urged that the Conference

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<sup>180</sup> See *supra* text accompanying notes 106-109.

<sup>181</sup> Brief for Securities and Exchange Commission as Amicus Curiae, *Slayton v. Am. Express Co.*, No. 08-5442-cv (2d Cir.), filed on January 21, 2010, <http://www.sec.gov/litigation/briefs/2010/slayton0110.pdf> [hereinafter *SEC Amicus Brief*]. The decision appealed from is *In re American Express Co. Sec. Litig.*, 2008 WL 4501928 (S.D.N.Y. Sept. 26, 2008). The court of appeals' questions are set forth in the docket entry for the case on October 23, 2009.

<sup>182</sup> *Id.* at 10.

<sup>183</sup> *Id.*, quoting *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743.

<sup>184</sup> *SEC Amicus Brief*, *supra* note 181, at 11. See, e.g., *supra* text accompanying notes 53 and 56 (discussing Conference Report comments on irrelevance of the defendant's state of mind under the first prong).

Committee’s statements regarding the prohibition on inquiring into the defendant’s state of mind were intended to emphasize that the application of the first prong of the safe harbor was not conditioned on the defendant’s disclosure of *all known* risks “where the issuer’s cautionary statements are otherwise adequate under the safe harbor . . . .”<sup>185</sup>

The SEC’s interpretation of the language in the Conference Report is subject to serious question. The Conference Report states that the requirement to identify “‘important’ factors” was not intended to “provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made” and the “use of the words ‘meaningful’ and ‘important factors’ are intended [to permit deciding a motion to dismiss] without examining the state of mind of the defendant.”<sup>186</sup> Moreover, in a passage that the SEC did not address, the Conference Committee concluded its explanation of the safe harbor with a general statement that state of mind is irrelevant to the first prong.<sup>187</sup> The SEC thus has conflated, on the one hand, what *historical* facts may have been misrepresented with, on the other, the defendant’s state of mind with regard to those facts. There is no question that a cautionary statement with an historical (or current) component may, to that extent, be a material misstatement that may itself give rise to a claim, apart from the forward-looking character of other parts of the statement.<sup>188</sup> It is a very fine distinction indeed, implicitly made by the SEC, to assert that state of mind is not relevant in determining whether some known cautionary statement

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<sup>185</sup> *SEC Amicus Brief*, *supra* note 181, at 11.

<sup>186</sup> *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743.

<sup>187</sup> *See supra* text accompanying note 56.

<sup>188</sup> *See, e.g., supra* note 116. Of course, in order to prevail in a claim under Rule 10b-5 the plaintiff must establish that the statement was made with scienter. State of mind *is* relevant in any Rule 10b-5 claim. *See supra* text accompanying notes 9-10.

was omitted altogether but state of mind is relevant in determining whether some cautionary statement was false. Either inquiry would collide with the Conference Committee’s concern about allowing discovery “on what factors were known to the issuer at the time the forward-looking statement was made.”<sup>189</sup>

An anomaly produced by the SEC’s position is that the plaintiff may not take discovery, including inquiring into the defendant’s state of mind, if the plaintiff alleges that some important cautionary factor was omitted altogether, but the plaintiff can take discovery if one of the cautionary factors relates to a present or historical state of affairs. This distinction would tend to encourage issuers to limit their cautionary factors to prospective ones and exclude altogether any reference to current trends, thus arguably resulting in the disclosure of fewer cautionary factors – so long as the issuer believed that it had disclosed sufficient important ones to satisfy the test of “meaningful cautionary statements.” If, on the other hand, a plaintiff can recast any cautionary statement into an implication about the past or the present and thereby circumvent the prohibition on inquiring into what the speaker knew when the forward-looking statement was made, very little may remain of the first prong of the safe harbor.

The issue addressed in this article is whether state of mind is relevant to determine the sufficiency of the cautionary statements. In its brief the SEC did not directly address whether the defendant’s state of mind with respect to the non-historical elements of the cautionary statements is in any way germane to application of the first prong of the safe harbor.<sup>190</sup>

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<sup>189</sup> *PSLRA Conf. Rep.*, *supra* note 21, at 44, 1995 U.S.C.C.A.N. at 743.

<sup>190</sup> The SEC did not address this issue because the SEC directed its analysis to what it understood to be the limited question presented by the pending case, where the pivotal allegation was that the defendant cautioned about “potential deterioration in the high yield sector” when it was alleged that deterioration was actually occurring when the statement was made. *SEC Amicus*

The SEC also addressed the nature of “actual knowledge” necessary to satisfy the second prong of the safe harbor:<sup>191</sup>

A statement of prediction or expectation . . . contains at least three implicit factual assertions, including (i) that the statement is genuinely believed; (ii) that there is a reasonable basis for that belief; and (iii) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. . . . It follows, then, that a speaker has “actual knowledge” that a forward-looking statement is misleading if the speaker actually knows that one or more of these implicit factual representations is not true.

That is, the defendant must be “subjectively aware that one of the implicit factual assertions underlying its forward-looking statement was false when the statement was made.”<sup>192</sup> The SEC did not argue that this actual knowledge test, *e.g.*, whether the forward-looking statement is “genuinely believed” or “that the speaker is . . . aware of . . . undisclosed facts tending to seriously undermine the accuracy of the statement,” has any application to the “meaningful cautionary statement” prong of the safe harbor, nor did the SEC state that an allegation of the second prong precludes reliance on the first prong – issues that were not posed to it by the court of appeals.

**VI. THE FIRST PRONG OF THE SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS PROVIDES A COMPLETE DEFENSE THAT CANNOT BE OVERRIDDEN BY ALLEGATIONS OF ACTUAL KNOWLEDGE OF THE FALSITY OF A PROJECTION**

Many courts and commentators perceive the plain meaning of the statutory safe harbor for forward-looking statements to be that each of the two principal prongs of the safe harbor

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*Brief, supra* note 181, at 9. *See also* 2008 WL 4501928, at \*2 (summarizing allegations of the complaint).

<sup>191</sup> *SEC Amicus Brief, supra* note 181, at 11-12. Whether this is an accurate statement of the actual knowledge criterion is beyond the scope of this article.

<sup>192</sup> *Id.* at 13.

operates independently, so that satisfaction of the first prong (inclusion of meaningful cautionary statements) renders plaintiff's reliance on the second prong (defendant's actual knowledge that the statement was false) irrelevant.<sup>193</sup> This interpretation is grounded in the disjunctive "or" that separates subclauses (A) and (B) of Section 21E(c)(1).<sup>194</sup> The legislative history, most notably the primary source,<sup>195</sup> the Conference Report, also supports this interpretation of the statutory language by making an unqualified statement that the defendant's state of mind is altogether irrelevant to the first prong.<sup>196</sup> The major arguable weakness in this analysis is the disclaimer by Congressional proponents of the safe harbor that it was *not* a license to lie – in answer to the opponents who expressed the fear that that is exactly what the safe harbor, in its final form, would allow.<sup>197</sup> The statutory language, especially as reinforced by the Conference Report, controls over statements by individual legislators under the conventional approach to relying on legislative history as a tool for statutory interpretation.<sup>198</sup>

There are two other strains of judicial decisions and commentary – one that seems to ignore the disjunctive language of the statute altogether, without comment,<sup>199</sup> and another that, on several different approaches, precludes finding cautions to be meaningful when the speaker

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<sup>193</sup> See *supra* text accompanying notes 115-118 (cases) and 144-148 (commentators).

<sup>194</sup> The word "or" also separates subclauses (i) ("meaningful cautionary statements") and (ii) ("immaterial") of subclause (A). See, e.g., *Goodman Life*, 2010 WL 154519, at \*10 ("The statute offers several ways for a defendant to avoid liability, all written in the disjunctive.").

<sup>195</sup> See *supra* text accompanying note 48.

<sup>196</sup> See *supra* text accompanying notes 53-56.

<sup>197</sup> See, e.g., *supra* text accompanying notes 86 and 88.

<sup>198</sup> See *supra* text accompanying note 50.

<sup>199</sup> See *supra* text accompanying notes 119-120.

knows but does not disclose that the projection is false.<sup>200</sup> If non-disclosure of actual knowledge that the projection is false precludes reliance on the first prong, then there is no real difference between the two prongs – a result that courts abhor.<sup>201</sup>

Several commentators have mounted a vigorous assault on the plain meaning approach to interpreting the safe harbor. Beck’s proposed interpretation – which he acknowledges would largely obliterate the distinction between these two prongs<sup>202</sup> – is flawed to the extent that it purports to be an interpretation of the statute as adopted as distinguished from what (he urges) Congress should have done. Beck recognizes that Congress relied on the *Trump* approach to bespeaks caution but he argues that it erred in so doing because *Trump* departed from the earlier bespeaks caution cases.<sup>203</sup> The evidence that Congress accepted the *Trump* materiality-focused version of the doctrine, however, is very strong.<sup>204</sup> Beck also misperceives the independence of the separate “immaterial” element of the safe harbor.<sup>205</sup>

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<sup>200</sup> See *supra* text accompanying notes 121-141 (cases) and 149-178 (commentators).

<sup>201</sup> SINGER ET AL., *supra* note 48, § 46.6, at 230-44 (“A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of obvious mistake or error.”) (footnote omitted).

<sup>202</sup> See *supra* text accompanying note 178.

<sup>203</sup> See *supra* text accompanying notes 160-164.

<sup>204</sup> See *supra* text accompanying note 106 (demonstrating that the safe harbor uses the formulation “meaningful cautionary statements” from *Trump*); *supra* note 163; O’Hare, *supra* note 105, 58 U. PITT. L. REV. at 641; Beck, *supra* note 105, 44 AM. BUS. L. J. at 195-96.

<sup>205</sup> See *supra* text accompanying notes 171-172.



Professor Coffee’s objections are unpersuasive. After the statute was enacted he urged an interpretation different from the plain meaning,<sup>206</sup> notwithstanding that when the statute was under consideration he opposed it because of the import of its plain meaning,<sup>207</sup> and had himself urged a cautionary statement safe harbor from which he deliberately omitted any state of mind test.<sup>208</sup> He may change his mind about what Congress *should have done*, but the issue under consideration here is what Congress in fact *did*. In addition, his more recent analysis relies on an assessment that the pre-PSLRA bespeaks caution doctrine did not apply where the speaker knew the projection was false, which overstates the uniformity of the law on that point – especially insofar as the *Trump* ruling is concerned.<sup>209</sup>

The language of the statute should be applied as the disjunctive phrases read, with “meaningful” interpreted without reference to the speaker’s knowledge (much less belief) in the truth or falsity of the projection. The defendant “shall not be liable” *either* if the defendant satisfies the first prong “or” the plaintiff is unable to prove (and first plead) that the defendant acted with actual knowledge that the projection was false. This gives each prong independent significance: the first principal prong applies if there are meaningful cautionary statements, irrespective of the state of mind of the speaker; the “immaterial” prong applies if for some *other* reason (most likely puffery) the forward-looking statement is not material; and the “actual knowledge” prong is available if there were not meaningful cautionary statements *and* the statement was not otherwise immaterial.

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<sup>206</sup> See *supra* text accompanying notes 149-152.

<sup>207</sup> See *supra* notes 100 and 149.

<sup>208</sup> See *supra* note 149.

<sup>209</sup> See *supra* text accompanying note 152.

Beck acknowledges this harmonious construction of the alternatives, but objects to it because it “invites managers to intentionally deceive investors.”<sup>210</sup> This objection, like the concerns expressed by some members of Congress that the safe harbor would be a “license to lie,”<sup>211</sup> raises a policy issue about the wisdom of adopting the provision. This, of course, is for Congress, not the courts, to resolve.<sup>212</sup> In the absence of any demonstration that prior to the PSLRA the availability of the bespeaks caution doctrine provided any increased inducement for managers of public companies to engage in deception, or even that the SEC’s relaxation of the prohibition on projections in documents filed with the SEC<sup>213</sup> led to deliberate deception, there is no basis to believe that Congress intentionally tilted the balance in a way that was expected to increase deceptive conduct. Indeed, Congress arguably allowed *more* opportunity for deception by requiring proof of “actual knowledge” in order to sustain a claim where an inadequately qualified material forward-looking statement was unfulfilled, thereby imposing a standard of

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<sup>210</sup> Beck, *supra* note 105, 44 AM. BUS. L. J. at 199 n.129. Beck also correctly notes that if the first prong does nothing more than identify a form of immateriality, it would have been enough for Congress to have adopted two prongs – an immateriality prong and an actual knowledge prong. *Id.* at 200 n.131. Any arguable overlap would be eliminated by adding the word “otherwise” before “immaterial” in Section 21E(c)(1)(A)(ii), and Professor Coffee – an advocate of a narrow interpretation of the first prong (*see supra* text accompanying notes 149-152) – reads the statute as if the word “otherwise” were there, its omission being no more than “a simplifying language change.” *See supra* note 35.

<sup>211</sup> *See supra* text accompanying notes 83-84, 90, 96-97, and 101.

<sup>212</sup> *See, e.g.,* Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 2339 (2008) (stating, in response to contention that challenged application of a statute would reflect an “absurd” policy, that it is not for a court to substitute its view of policy for legislation which has been passed by Congress).

<sup>213</sup> *See supra* text accompanying notes 3-4.

greater culpability than is otherwise necessary to sustain a claim under Rule 10b-5.<sup>214</sup> The task here is not to second guess what Congress decided, but to ascertain what in fact the adopted statutory language means. Because it was the manifest intent of Congress to *enhance* the protection for public companies that made forward-looking statements,<sup>215</sup> it would be inconsistent with Congressional intent to interpret the statutory safe harbor so that it would be narrower than the bespeaks caution doctrine.<sup>216</sup>

The thrust of the argument of the SEC in its recent amicus brief, addressing the specific facts alleged in the case on which it was asked by the court to express its views, is that a false historical statement that is implied by the cautionary statements is not protected by the safe

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<sup>214</sup> There is no doubt that “actual knowledge” is something more than the minimum scienter required to sustain a claim under Rule 10b-5. *See, e.g.*, Institutional Investors Group v. Avaya, Inc., 564 F.3d 242, 274 (3d Cir. 2009) (“the scienter requirement for forward-looking statements is stricter than that for statements of current fact. Whereas liability for the latter requires a showing of either knowing falsity or recklessness, liability for the former attaches only upon proof of knowing falsity”); *Gilat*, 2005 WL 2277476, at \*12 (noting that the second prong “imposes a heightened scienter requirement for forward-looking statements not accompanied by cautionary language”). For example, it is generally held that reckless conduct satisfies the scienter requirement under Rule 10b-5. *See supra* text accompanying note 10. For the SEC’s interpretation of this term, see *supra* text accompanying note 191 (asserting that the speaker must “actually know[]” that at least one of certain representations implicit in the forward-looking statement “is not true”). *See also SEC Amicus Brief, supra* note 181, at 12 (footnote omitted):

[T]his standard is distinct from, and requires more than, a showing that a speaker acted recklessly in making a misleading forward-looking statement. Although the PSLRA’s legislative history is unilluminating on the matter, the plain language of the provision requiring “actual knowledge” indicates that, to avoid the safe harbor, a plaintiff needs to show more than that a defendant acted recklessly.

<sup>215</sup> *See supra* note 21 and text accompanying notes 58-61.

<sup>216</sup> The Conference Report stated that the statutory safe harbor was not intended to replace the bespeaks caution doctrine. *PSLRA Conf. Rep., supra* note 21, at 46, 1995 U.S.C.C.A.N. at 745. It would be odd to attribute to Congress an intention to adopt a statutory safe harbor that was *narrower* than the prevailing application of the bespeaks caution doctrine. To do only that would have been to do no more than protect defendants if courts abandoned or narrowed the bespeaks caution doctrine.

harbor.<sup>217</sup> The SEC’s analysis does not present a cogent basis for taking into account, under the first prong of the safe harbor, the defendant’s state of mind – actual knowledge or otherwise – with regard to whether it believes the prediction will come true.

## VII. CONCLUSION

What seems to underlie the judicial and scholarly reluctance to give the first prong independent significance as urged in this article is an antipathy to exonerate a person who spoke falsely knowing that his words were false.<sup>218</sup> This ignores the underlying thrust of the first prong – that which is meaningfully qualified is simply not material, as under the *Trump* formulation of the bespeaks caution doctrine. A necessary element of a claim of deception under the securities laws is that the statement that is the subject of the cause of action is material.<sup>219</sup> If the statement is not material it thus does not matter whether it was uttered with a vile intent to deceive, with actual knowledge of the falsity, recklessly or entirely innocently. “The anti-fraud provisions of the securities laws are plainly disinterested with immaterial statements, no matter the state of mind of the speaker.”<sup>220</sup>

The first prong of the statutory safe harbor for forward-looking statements should be dispositive where it is satisfied, without requiring that any doubt or lack of belief about the projection be disclosed in order for the cautionary statements to be “meaningful” as that term is

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<sup>217</sup> See *supra* text accompanying notes 181-190.

<sup>218</sup> See *supra* text accompanying notes 116-117 (citing cases in which the court reluctantly found the first prong applied even where actual knowledge was alleged).

<sup>219</sup> See *supra* note 9 and text accompanying note 12.

<sup>220</sup> *Goodman Life*, 2010 WL 154519, at \*11.

used in the first prong. The defendant's state of mind with regard to unmatured contingencies or the likelihood of the projection being realized is not a factor in applying the first prong.

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