Developments in Disclosure: Special Problems in Public Offerings—Forward-Looking Information, Including the Private Securities Litigation Reform Act of 1995

HERBERT S. WANDER, JONATHAN I. COPE, AND JONATHAN DARIYANANI*

INTRODUCTION

Disclosure is one of the central cornerstones of federal securities law. For a number of years, the primary focus of disclosure was directed to the public offering process. More recently, however, disclosure to the trading markets has achieved equal prominence. There has also been a growing recognition that investors need the benefit of forward-looking information. Not only has there been historical reluctance—now fast disappearing—to the use of forwarding-looking information, but the explosion of securities fraud lawsuits has also materially inhibited the use of forecasts and projections. This Article will examine recent developments in disclosure including current practices involving analysts, T + 3, the "bespeaks caution" doctrine, and the use of forward-looking

---

* Herbert S. Wander is a senior partner at Katten Muchin & Zavis in Chicago. Jonathan I. Cope is an associate at Katten Muchin & Zavis in Chicago. Jonathan Dariyanani is a summer associate at Katten Muchin & Zavis in Chicago.

information, including the Private Securities Litigation Reform Act of 1995.

I. CURRENT PRACTICES OF INVOLVING ANALYSTS IN PUBLIC OFFERINGS

A. *Background*

Communication between issuer and analyst serves a significant market function in ensuring dissemination of information to the marketplace. As noted by the Supreme Court, "[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information and thus the analysts' work redounds to the benefit of all investors."[1]

The benefits of issuer-analyst dialogue do not accrue solely to the investing public. The benefits to an issuer of communication with analysts, particularly in the context of an offering, are many. Issuer-analyst interplay, however, has been described "as a fencing match conducted on a tightrope,"[2] and, unless, artfully managed can result in both civil and criminal sanctions. For example, selective disclosure of material information to an analyst may be viewed as unlawful tipping in violation of Rule 10b-5[3] and thereby create a duty to make disclosure of the information to the public generally. Additionally, information conveyed to analysts about fluid business situations can turn out to be misleading and the practice of reviewing or correcting analysts' reports might make issuers responsible for the accuracy of the entire report and establish a duty to keep the information current.

Current analysis of regulation of information stemming from nonpublic sources often centers around *Dirks v. SEC*,[4] wherein the Supreme Court attempted to craft a line between permissible and impermissible disclosure. In *Dirks*, Raymond Dirks, a well-known investment analyst, was informed by a former employee of Equity Financing Corporation that the company was involved in massive financial fraud. Dirks investigated the allegations and exposed the company's fraud, but not before revealing the company's wrongdoings to his own clientele. The SEC concluded that "[i]n tipping potential traders, Dirks breached a duty

---

1. Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983) (quoting 21 SEC Docket 1401, 1406 (1981)).
2. SEC v. Bausch & Lomb Inc., 565 F.2d 8, 9 (2d Cir. 1977).
3. 17 C.F.R. § 240.10b-5 (1996).
4. 463 U.S. 646 (1983).

which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders.'"[5] As noted by the Court, the SEC's theory of liability was "rooted in the idea that the antifraud provisions require equal information among all traders."[6]

The Court, however, rejected the notion that all traders must enjoy equal information before trading and ruled that those who receive material nonpublic information from insiders are not banned from trading unless (1) the insider breached a fiduciary duty for personal gain, and (2) the recipient knew or should have known of the breach.[7]

Despite the Court's efforts to establish a clear line between permissible and impermissible disclosure, the SEC has continued to push for equal information among all market participants and has continued to bring enforcement actions because of selective disclosure, relying on theory which substantially dilutes the potency of *Dirks*.[8] On the civil side, issuers have been sued by investors claiming entanglement between issuer and analyst and the failure of the issuer to update analysts' reports. Issuer and analyst have also faced a series of recent class action suits, wherein investors claim that issuer and analyst defraud investors by issuing overly optimistic research reports, thereby manipulating the issuer's stock price subsequent to an initial public offering (IPO).

In the face of an erosion of *Dirks* and continued SEC enforcement for selective disclosure, as well as new entanglement theory, it is difficult to offer precise guidance as to an appropriate level of discourse between issuer and analyst, and, indeed, it is tempting to suggest that analysts should take greater refuge behind a "Chinese wall." However, as argued below, the benefit from issuer-analyst dialogue in the context of an offering outweighs the risks inherent in such relationships, particularly for issuers making an initial public offering.

---

5. *Id.* at 655-56 (quoting Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974)).
6. *Id.* at 657.
7. *Id.* at 659.
8. *See* Donald C. Langevoort, *The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability*, INSIGHTS, June 1994, at 23.

B. Analysts Involved in Initial Public Offerings

1. Benefits of Analyst Involvement

In many ways the analyst is more indispensable to an issuer in the context of an IPO, as the public has no baseline from which informed investment decision-making can be made. Issuers generally recognize this and, indeed, often select an underwriter who has a known analyst. Moreover, the analyst is frequently involved in the offering process. Analysts, however, aside from getting a company's name in play, can also play a major role in an underwriter's due diligence process by identifying weaknesses in product, management, or business strategies because the analyst knows the industry and the competition. The analyst can also advise as to how a company's strengths and weaknesses should be disclosed in the company's prospectus.

More significant is the analyst's involvement in developing earnings projections. As one commentator has pointed out:

> [I]nstitutional customers, in particular, will not buy IPO shares without [earnings] estimates. . . . Estimates therefore are provided orally to investors, either at road shows or by the sales force on the telephone. The issuer typically will not take responsibility for these estimates, leaving it in many cases to the investment bankers working on the IPO to supply estimates based on discussions with the issuer and access to internal projections. Investment bankers, however, are not always experienced in coming up with earnings estimates, and salespersons and customers alike may regard such estimates as "tainted" . . . .
>
> The analyst, on the other hand, is experienced in coming up with earnings estimates and has a track record of credibility with salespeople and customers. The analyst also is more likely to identify unrealistic assumptions built into the issuer's internal projections. For this reason, analysts are increasingly permitted access to the issuer's internal projections . . . .[9]

Because of the importance of analysts to the offering process, underwriters are often selected to lead an offering based on the ability or reputation of the firm's analysts. Of course, this is a two-way street, and analysts may be more willing to cover a particular company if the analyst's firm is selected to manage the underwriting.

2. Costs of Analyst Involvement

Once the offering is completed, the analyst generally publishes a research report on the issuer subsequent to the "cooling down" period.

---

9. Joseph E. McLaughlin, *The Changing Role of the Securities Analyst in Initial Public Offerings*, INSIGHTS, Aug. 1994, at 6-7.

It is at this point that issuer and analyst alike generally are concerned that the analyst is "tainted" or possesses material nonpublic information, having participated in the due diligence process. It is also at this point that issuer and analyst risk enforcement by the SEC as well as civil suit.

The SEC, as discussed below, has expanded the "personal benefits" test established by the *Dirks* Court and has argued that even enhancement to reputation which does not result in pecuniary benefit is sufficient for a finding of insider trading. To our knowledge, the SEC has not prosecuted analysts on this theory.

Issuers also face exposure to claims based on entanglement. Traditionally, entanglement theory holds that if a company puts its imprimatur, expressly or impliedly, on an analyst's report, the company will be deemed to have adopted the report, will be responsible for its accuracy, and will have a duty to update. Recently, a new form of entanglement theory has emerged. Plaintiffs have brought class action suits alleging that analysts and their firms have defrauded investors by issuing reports containing overly optimistic earnings forecasts and other projections, called "booster shots," thereby manipulating the issuer's stock price immediately after an IPO. This entanglement theory has been described as a "devil's bargain" whereby weak companies are brought public and the company's stock price is inflated until issuers' directors can sell out their personal holdings.[10]

These cases name analysts as individual defendants and suggest a complex conspiracy between issuer, analyst, and underwriter to defraud investors. As noted in one recent complaint:

> Defendants accomplished their scheme and common course of conduct through the issuance of a series of interrelated and interdependent false and misleading reports to shareholders, filings with the SEC, financial statements and press releases to the public, as well as approving the issuance of (and reprinting) false and misleading analysts' reports which misrepresented the true facts regarding Coastcast's business, new products, manufacturing expertise, and future business prospects and created a false impression of continuing growth and future profitability. The Individual Defendants all benefitted from the illegal course of conduct by selling Coastcast stock owned by them at artificially inflated prices . . . .[11]

10. Jonathan C. Dickey, *The New "Entanglement" Theory: Securities Analysts are Sued in Class Action Complaints*, INSIGHTS, Mar. 1995, at 3.
11. Stark v. Present, No. 94-5712, at 17 (C.D. Cal., filed Aug. 22, 1994).

As the above complaint illustrates, the "devil's bargain" suggests an intricate level of market manipulation over a sustained period of time. Several of the suits alleging this new form of entanglement have been voluntarily dismissed. It is unclear, however, how the trial courts will respond to these class action suits, especially in light of the fact that analysts apparently issue more favorable earnings forecasts and recommendations for their firm's underwriting clients than for issuers with whom they have no preexisting relationship.[12]

3. Cost Benefit Analysis

Issuers should involve analysts in the due diligence phase of an IPO. While there is a risk of selective disclosure, there are sound business reasons for involving analysts in the IPO process which counterbalance these risks and which make an SEC argument of "personal benefit" less likely. As one author has noted:

> [T]he IPO issuer has eminently reasonable corporate business purposes in permitting an analyst full access to its internal information. These include permitting the underwriters to conduct more effective due diligence . . . increasing the underwriters' confidence level in the issuer's business plan and projections, and assuring that the analyst's earnings estimates . . . are in turn based on all available information about the issuer. Indeed, these business purposes are in full accord with the public policy of the Securities Act, which is to assure full disclosure to investors in securities distributed in the course of *registered public offerings.*
>
> By contrast, the corporate officers working on the IPO derive no personal benefit from the disclosure to the analyst. Even taking the SEC's broad views of "personal benefit" into consideration, this may be one of the few examples of a "completely business-justified disclosure" that should therefore be "immunized from liability."[13]

With respect to liability on the basis of entanglement, as discussed below, entanglement claims are becoming increasingly difficult to sustain as the courts have recently required plaintiffs to plead specific facts such as time, place, and statements made, in order to withstand a motion to dismiss.

Finally, an issuer can take additional measures to further guard against selective disclosure or entanglement law suits. For example, an issuer can designate a handful of corporate officers who can monitor written

---

12. *See* H. Lin & M. McNichols, Underwriting Relationships in Analysts' Research Reports (Mar. 1993) (unpublished manuscript, on file with authors). *See also* Roni Michaely & Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations (Apr. 1996) (unpublished manuscript, on file with *San Diego Law Review*).

13. *See* McLaughlin, *supra* note 9, at 11.

or oral information supplied to the analyst. An issuer can also adopt a written policy statement indicating how far they will participate with the analyst in the due diligence process and that the company will not review the analyst's projections. If the company does elect to review the analyst's report, it can provide a disclaimer describing the purpose of the review. Such a disclaimer may include the following:

> Our review of the report has been limited to the accuracy of the factual information contained therein as of the date of our review. As a matter of corporate policy, we do not comment on analysts' projections or earnings estimates and our review of the report should not in any manner be viewed as agreement or acquiescence on our part with the projections, predictions or opinions set forth therein.
>
> In addition, we assume no responsibility to provide you with any material information which may not be included in the report or to update any information which may become inaccurate following our review.[14]

C. *Analyst Participation in Public Offerings of Already-Public Companies*

Analysts in the majority of offerings involving already-public issuers generally participate in the due diligence process and contribute the same insights to the process as discussed above. However, analysts generally do not participate in obtaining projections from the company and the need for a "Chinese wall" between analysts and investment banking firm is even greater than in the IPO setting because the analyst is already in communication with the company's stockholders.

Some commentators have noted that analysts refrain from publishing detailed reports about a company if a company is making a public offering. While there are limitations imposed on analysts circulating reports during an offering, analysts should probably avail themselves of Rules 138 and 139 of the Securities Exchange Act of 1934 (1934 Act),[15] defining the circumstances under which a report is not deemed to be an offer for the sale of securities.

---

14. James J. Junewicz, *Handling Wall Street Analysts*, INSIGHTS, Jan. 1995, at 9, 14. One author has suggested that underwriters, in order to minimize their exposure, should obtain issuer consent where an analyst will participate in all facets of the due diligence process and then publish a post-offering analysis. *See* McLaughlin, *supra* note 9. We are not aware of any underwriting firms which deliver such a letter other than Goldman Sachs.

15. 17 C.F.R. §§ 230.138, 230.139 (1996); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-*ll* (1994 & West Supp. 1996).

Rule 139 provides that with respect to an issuer who proposes to file or who has filed a registration statement, a publication by a broker or dealer of an opinion with respect to the registrant will not be deemed to be an offer to sell securities even though such broker or dealer is a participant in the distribution of such securities if:

> (a) (1) The registrant meets the registrant requirements of Form S-3 . . . and such information, opinion or recommendation is contained in a publication which is distributed with reasonable regularity in the normal course of business; or . . .
>
> (b) (1) [For non-Form S-3 issuers,] [s]uch information, opinion or recommendation is contained in a publication which:
>
> (i) Is distributed with reasonable regularity in the normal course of business and
>
> (ii) Includes similar information, opinions or recommendations with respect to a substantial number of companies in the registrant's industry, or sub-industry, or contains a comprehensive list of securities currently recommended by such broker or dealer.
>
> (2) Such information, opinion or recommendation is given no materially greater space or prominence in such publication than that given to other securities or registrants; and
>
> (3) an opinion or recommendation as favorable or more favorable as to the registrant or any class of its securities was published by the broker or dealer in the last publication of such broker or dealer addressing the registrant or its securities prior to the commencement of participation in the distribution.[16]

D. *What Do the Cases Say?*

1. *Selective Disclosure*

In the aftermath of the Supreme Court's decisions in *Chiarella v. United States*[17] and *Dirks v. SEC*,[18] a duty to disclose or refrain from trading on the basis of material nonpublic information arises only when such trading constitutes a breach of fiduciary duty. In *Dirks*, the Court ruled that "[w]hether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure. . . . Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure."[19] The Court defined personal benefit as a "pecuniary gain or a reputational benefit that will translate into future earnings."[20]

In March 1991, the SEC applied the *Dirks* "personal benefits" test in *SEC v. Stevens*.[21] In *Stevens*, the SEC charged a corporate executive

---

16. 17 C.F.R. § 230.139 (1996).
17. 445 U.S. 222 (1980).
18. 463 U.S. 646 (1983).
19. *Id.* at 662.
20. *Id.* at 663.
21. SEC v. Stevens, 48 S.E.C. Docket 739, 1991 WL 296537 (S.D.N.Y. Mar. 19, 1991); *see also* SEC v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977).

of Ultrasystems, Inc., with unlawful tipping when he called a few analysts who provided research coverage of the company to let them know of an anticipated earnings decline. The SEC alleged that Stevens placed these calls "to protect and enhance his reputation" as a corporate manager, and therefore the calls had "direct, tangible benefit to his status as a corporate manager."[22]

After Stevens' calls, two of the analysts called their clients, who then sold Ultrasystems' stock prior to Ultrasystems' issuance of a press release announcing its lower-than-expected revenues and earnings. The SEC alleged that the loss avoided by these clients was "of at least $126,455."[23] Stevens agreed to pay the $126,455 as well as to be permanently enjoined from violating section 17(a) of the Securities Act of 1933 (1933 Act)[24] and section 10(b) of the 1934 Act.

Stevens stretches the "reputational benefit" test of *Dirks* to its limit. There was no allegation that Stevens received any type of substantial reputational benefit that "translates into future earnings."[25] The danger of the Commission's rationale in *Stevens* is that virtually all selective disclosures are likely to have been made on some element of personal motivation.[26] Thus, any executive, even one who is driven by a desire to serve the corporation, may be charged with deriving a "reputational benefit" when he or she communicates with analysts. Steven's monetary liability, representing the trading profits of remote tippees, further serves as a significant *in terroram* deterrent for executives who deal with analysts.

2. *Entanglement Cases*

Entanglement theory presents two distinct problems for an issuer involved in dialogue with an analyst. First, an issuer may become responsible for what is contained in an analyst's report, including the

---

22. *Stevens*, 1991 WL 296537, at *1.
23. *Id.* at *2.
24. 15 U.S.C. §§ 77a-bbbb (1994 & West Supp. 1996).
25. *Stevens*, 1991 WL 296537, at *1.
26. *See* Edward H. Fleischman, Ferreting in the Interstices of S.E.C. Attitudes to Securities Analysts, Address to the Eighteenth Annual Securities Regulation Institute, University of California, San Diego (Jan. 24, 1991) (transcript available at *San Diego Law Review*). Former SEC commissioner Fleischman suggested that every corporate officer who communicates with analysts could be viewed as seeking to build, preserve, redeem or maintain his or her reputation with analysts. *Id.* at 8.

analyst's own projections, even where the company does not want to comment on some of the findings included in the analyst's report. Second, as a result of an analyst's report being attributable to the company, the company may have a duty to update and correct material errors or omissions contained in the analyst's report.

In the leading case of *Elkind v. Liggett & Myers, Inc.*,[27] the Second Circuit Court of Appeals addressed the issue of whether an issuer has a continuing duty to correct analyst reports where the defendant company instituted a policy of regularly meeting with analysts and reviewing their reports. The court held that management did not assume a continuing duty to correct the analysts' projections because, while company personnel would correct factual errors in the reports, it had generally not commented on earnings projections. The court explained that:

> [T]he controversy before us is whether Liggett sufficiently entangled itself with the analysts' forecasts to render those predictions "attributable to it" . . . . We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views.[28]

After reviewing the facts, the court of appeals affirmed the district court's finding that Liggett "did not place its imprimatur, expressly or impliedly, on the analysts' projections."[29] The court warned, however, that:

> [C]orporate pre-release review of the reports of analysts is a risky activity, fraught with danger. . . . A company which undertakes to correct errors in reports presented to it for review may find itself forced to choose between raising no objection to a statement which, because it is contradicted by internal information, may be misleading and making that information public at a time when corporate interests would best be served by confidentiality.[30]

One difficulty plaintiffs encounter in pleading entanglement is that the courts increasingly have required specific facts which definitively link an analyst's statements to insiders of the company. In *Raab v. Gen. Physics Corp.*,[31] stockholders of General Physics sued the corporation, claiming it had misled investors through false statements to analysts and the media.[32] The district court dismissed the plaintiffs' complaint for failure to plead specific facts supporting their allegations of fraud, and

27. 635 F.2d 156 (2d Cir. 1980).
28. *Id.* at 163.
29. *Id.*
30. *Id.*
31. 4 F.3d 286 (4th Cir. 1993).
32. *Id.* at 288.

the Court of Appeals for the Fourth Circuit affirmed the dismissal, holding that plaintiffs had not pled specific facts from which the analyst's report could be attributed to the company.[33] The court concluded that "soft" or "puffing" statements are generally not material because the market price is not driven by such vague declarations.[34] The court also concluded that the company's statement that profits should be in line with analysts' current projections did not constitute a guarantee that earnings would be forthcoming in particular amounts. The court considered this forecast not to be material.[35]

Recent case law, particularly in California, has also been very favorable, making it difficult for plaintiffs to plead entanglement. In *In re Time Warner Sec. Litig.*,[36] plaintiffs alleged that statements made by unidentified Time Warner insiders in discussions with analysts and newspaper reporters misled the public by suggesting that Time Warner would reduce certain outstanding debt.[37] The court, in upholding the district court's dismissal pursuant to Rule 9(b), ruled that the circumstances constituting fraud must be stated with particularity and noted that "at a minimum . . . the plaintiff [must] identify the speaker of the allegedly fraudulent statements."[38]

Following *Time Warner*, a number of California district courts have required plaintiffs to plead specific facts to withstand a motion to dismiss and have articulated which facts plaintiffs must set forth in their complaint. In *Fisher v. Acuson Corp.*, the court, citing *Time Warner*, noted that:

> [T]he heightened pleading requirements of Rule 9(b) require plaintiffs who are claiming that insiders are liable for third party financial analysts' statements to show adoption by alleging the following: (1) specific reports and the name of the insider who adopted them; (2) specific interactions between the insider and the analyst; and (3) dates on which the interactions occurred.[39]

---

33. *Id.*
34. *Id.* at 289.
35. *Id.* at 291.
36. 9 F.3d 259 (2d Cir. 1993).
37. *Id.* at 262.
38. *Id.* at 265. Echoing the *Dirks* court, the Second Circuit noted that "the function of financial reporters and security analysts is to determine the truth about the affairs of publicly traded companies." *Id.*
39. Fisher v. Acuson Corp., No. C93-20477RMW(EAI), 1995 WL 261439, at *7 (N.D. Cal. Apr. 26, 1995); *see also* Stack v. Lobo, 903 F. Supp. 1361 (N.D. Cal. 1995); *In re* Cypress Semiconductor, 891 F. Supp. 1369 (N.D. Cal. 1995). *But see In re* RasterOps Corp. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶

The heightened pleading requirements of *Fisher* appear to be the current trend in entanglement cases, though it is unclear whether the courts will continue to move in this direction.[40]

A Second Circuit opinion recently adopted a similar line of reasoning. In *San Leandro Emerg. Medical Group Profit Sharing Plan v. Phillip Morris Cos.*,[41] plaintiffs alleged that the cigarette maker failed to disclose plans to lower prices on its flagship Marlboro brand.[42] Plaintiffs alleged that failure to disclose this information rendered several statements made in analyst meetings and press releases misleading, including statements that the company would deliver consistent income growth. The Court of Appeals for the Second Circuit affirmed the dismissal of the complaint, stating that Philip Morris' announcement that it expected Marlboro to perform well and that the company was "optimistic about its earnings" was mere puffery.[43]

E. Conclusion

Analysts should continue to work with issuers in both initial public offerings and offerings for publicly held companies. Issuers should, however, adopt policy statements indicating their level of involvement with analysts and their stance on reviewing analysts' reports. Issuers should also adopt internal guidelines which clearly articulate who is responsible for communication with analysts and who will review any materials supplied to analysts.

II. T + 3

Effective June 7, 1995, Rule 15c6-1[44] establishes that the standard settlement time for most broker-dealer trades is three business days after the trade, or "T + 3."[45] When Rule 15c6-1 was first proposed,

---

98,467 (Oct. 31, 1994) (ruling that plaintiffs need only allege insiders provided false information, approved drafts of analysts' reports, and circulated reports to investors).

40. *See also In re* Seagate Techn. II Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,530 (Feb. 8, 1995) (citing *Elkind*, 635 F.2d 156, to support ruling that guidance alone does not make a company liable for analyst's forecast); Gross v. Summa Four, Inc., [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,999 (Nov. 8, 1995) (ruling that a company's predictive statements which lacked specificity failed to meet the materiality requirement under Rule 10b-5).

41. 75 F.3d 801 (2d Cir. 1996).

42. *Id.*

43. *Id.* at 811.

44. 17 C.F.R. § 240.15c6-1 (1993).

45. *See* Prospectus Delivery; Securities Transactions Settlement, Exchange Act Release No. 33-7168, Release No. 34-35705, 59 S.E.C. Docket 550 (May 11, 1995)

commentators expressed concern that settlement within T + 3 would not be feasible because of the amount of time it would take to print and deliver prospectuses.[46] Two proposals to simplify prospectus delivery were submitted to the commission: The "Four Firms" proposal and the Securities Industry Association (SIA) approach.[47]

A. *The Four Firms Proposal*

The Four Firms proposal was based on the view that most of the prospectus could be printed before pricing to facilitate delivery within T + 3, if certain modifications were made to existing SEC rules.[48] Six of the key modifications are summarized below.

1. *Re-Ordering of Prospectuses*

The SEC's rule revisions allow issuers to present information that becomes available or is likely to change at the time of pricing to be included together either in the beginning of the prospectus after the front cover page in a "pricing-related information" section or wrapped around the prospectus inside the front and back cover pages.[49] The pricing-related information section may include use of proceeds, capitalization, pro forma financial information, dilution, selling shareholder information, and shares eligible for future sale, among others. If the pricing-related information is included after the front cover page, the prospectus summary and risk factors sections may appear immediately following the pricing-related section. Additionally, disclosure regarding availability of 1934 Act information, nature of reports to be given to security holders, undertakings with respect to information incorporated by reference, and enforceability of civil liabilities against foreign persons, required on the prospectus cover page, may be placed elsewhere in the prospectus.

[hereinafter *Adopting Release*].

46. The SEC noted that prospectus delivery concerns should be alleviated as electronic delivery becomes more prevalent. *Id.* § I.

47. *Id.* The Four Firms include CS First Boston Corporation, Goldman Sachs & Co., Lehman Brothers, Inc., and Morgan Stanley & Co. *Id.*

48. *Id.* § II(A).

49. *Id.* § I(A)(1). To ensure that investors continue to easily locate the "risk factors" section of the prospectus, the SEC also requires that the cover page of the prospectus identify the page number at which that section appears in the prospectus and that the risk factors section be labeled as "Risk Factors."

2. *Changes in Offering, Size, or Price*

An issuer is permitted to register securities by specifying only the title of the class being registered and the proposed maximum offering price.[50] However, the issuer is still required to specify in the prospectus the amount of securities being offered and, if the issuer is not a reporting company, a bona fide estimate of the range of the maximum offering price. The aggregate dollar amount associated with each class of securities must be disclosed in the registration fee table. If the issuer registers more shares than required in the offering, the excess securities may be carried forward to subsequent registrations of the same class of securities.

Where the size of an offering increases subsequent to pricing, the issuer is eligible to use an abbreviated registration statement to register additional securities, provided that the additional shares represent no more than a twenty percent increase over the shares previously registered.[51] This abbreviated registration statement includes the facing page, a statement incorporating by reference the contents of the prior filing, all required consents and opinions, and the signature page. It may also include any price-related information with respect to the offering that was omitted from the earlier registration statement pursuant to Rule 430A. The abbreviated registration statement must be filed prior to the time sales are made and confirmation is given, and is effective upon filing.[52]

Where the size or the price of an offering declared effective under Rule 430A do not in the aggregate deviate more than twenty percent from the price set forth in the registration fee table of the effective filing, a post-effective amendment is not required. Additionally, where there is a change in offering size or deviation from the price range beyond the twenty percent threshold, a post-effective amendment is required only if such change materially changes the previous disclosure.[53] The release does, however, indicate that "issuers continue to be responsible for evaluating the effect of a volume change or price

---

50. *Id.* § II(A)(2)(a).
51. *Id.* § II(A)(2)(b).
52. *Id.* Abbreviated filing is allowed even where pricing occurs after the SEC offices have closed. Electronic filers may file via Edgar and others may file by fax, between 5:30 and 10:00 p.m. Eastern time. Payment may be made after banking hours by instructing a bank to wire no later than the close of the next business day after filing and providing certain certifications to the SEC with the filing. *Id.*
53. *Id.* § II(A)(2)(c).

deviation on the accuracy and completeness of disclosure made to investors."[54]

3. *Manual Signatures and Incorporating by Reference Opinions and Consents*

The SEC now permits duplicate or facsimile signature to be used in lieu of manual signatures for any registration filed under the 1934 Act.[55] If facsimile or duplicate signatures are used, the registrant must maintain the manually signed version for five years and provide it to the SEC upon request.

4. *Rule 430A Pricing Period*

Rule 430A previously provided that a registration could be declared effective without pricing information if the missing information was contained in a supplemental prospectus filed five days after the effective date of the registration statement.[56] The SEC extended the pricing period to fifteen days, principally to reduce the likelihood that a post-effective amendment would have to be filed.

5. *Acceleration Request*

The SEC now permits requests for acceleration of effectiveness to be transmitted either via facsimile or orally.[57] A letter indicating that the registrant and managing underwriter intend to request oral acceleration must be submitted to the Commission prior to the oral acceleration request.[58]

6. *T + 4 For Firm Commitment Offerings Priced After the Close of the Market*

Firm commitment offerings priced after 4:30 p.m. Eastern Standard Time, where the securities are sold by an issuer to an underwriter or a

---

54. *See id.* at n.32.
55. *Id.* § II(A)(3).
56. *Id.* § II(A)(4).
57. *Id.* § II(A)(6).
58. The letter should also indicate that the registrant and the managing underwriter are aware of their obligations under the 1933 Act. *Id.*

broker-dealer participating in an offering, are governed by a T + 4 settlement time frame.[59] The T + 4 period also applies to a secondary offering where the issuer and managing underwriter agree in writing that such a settlement period will apply. In addition, the Commission has provided an "override" provision to T + 3 for the sale of all securities subject to a firm commitment offering upon agreement by the managing underwriter and the issuer. The Commission has stressed, however, "that the override provision is not intended to dilute the presumption in favor of application of the T + 3 settlement cycle in connection with firm commitment offerings."[60] Instead, the override provision is intended to be used only in those circumstances when T + 3 settlement is not feasible.

B. SIA Proposal

As adopted by the Commission, the SIA approach provides for incremental prospectus delivery.[61] For offerings registered on forms other than S-3 or F-3, prospectus delivery is accomplished by delivery of a preliminary prospectus, a term sheet, if necessary, and a confirmation.[62] The term sheet provides all information material to investors that is not disclosed in the preliminary prospectus. The preliminary prospectus and term sheet, taken together, may not materially differ from the disclosure included in the effective registration statement. The term sheet must be filed with the Commission within two business days after the earlier of the pricing date or first use.[63]

For registrants using short-form registration, delivery may be accomplished by delivery of a preliminary prospectus, an abbreviated term sheet, and a confirmation.[64] The abbreviated term sheet must include, unless described in the preliminary prospectus or incorporated by reference, a description of the securities (as required by Item 202 of Regulation S-K) and information regarding material changes (as required by Item 11 of Form S-3). Offering-specific information usually contained in the final prospectus, such as use of proceeds and plan of

---

59. *Id.* § II(A)(7).
60. *Id.* § III.
61. *Id.* § II(B).
62. *Id.* § II(B)(1).
63. *Id.* One author has noted that while a term sheet may be effective to quickly update pricing information it may be the less attractive alternative where the form of prospectus included in the registration statement at the time of effectiveness has been significantly modified compared to the preliminary prospectus delivered to investors. Memorandum from Nicholas Grabar, Compliance with Prospectus Delivery Requirements in a T + 3 Settlement Environment (May 17, 1995) (on file with authors).
64. *Adopting Release, supra* note 45, § II(B)(2).

distribution, may not be physically delivered to investors and, instead, is required only in the prospectus supplement filed with the Commission.

It is unclear how comfortable underwriters will be in delivering abbreviated prospectuses or term sheets to investors or in deviating significantly from the current ordering of information contained in a prospectus. Our own experience has been that few issuers have availed themselves of abbreviated prospectus delivery.[65]

III. RISK FACTORS

Risk factors have become a common section in many prospectuses even for seasoned companies. The risk factors section is helpful in establishing the "bespeaks caution" doctrine. It is also a useful section to ensure the issuer's disclosure is complete. There is generally some discussion as to whether the risk factors section should be drafted prior to the rest of the prospectus or only after all other items in the prospectus have been drafted. We generally try to write the risk factors section after everything else is complete, to ensure that we have identified the specific risks associated with a particular issuer.[66]

IV. "BESPEAKS CAUTION" DOCTRINE

A recurrent theme of cases dealing with forward-looking information is that the issuer reaffirmed prior projections through general expressions of optimism or by confirming its goals at a time when the issuer knew or should have known that identified problems with products or operations threatened its ability to achieve the earlier projections. These allegations often are commingled with sundry other counts constituting a Rule 10b-5 action. Defendants have a difficult burden dismissing these claims where internal memoranda, statements to third parties, or other "smoking guns" contradict the issuer's public statements. Issuers should beware that virtually any public expression of optimism could be construed as a reaffirmation of prior forward-looking statements.

---

65. Financial printers whom we contacted have indicated that they have not had any problems meeting a T + 3 deadline. Additionally, they have indicated that issuers and underwriters alike have not wanted to be "first on the block" to deliver term sheets or abbreviated prospectuses.

66. For an account of recent changes brought about by the Private Securities Litigation Reform Act of 1995, *see infra* Part V.B.

Certain other cases suggest that issuers may avoid liability for projections and other predictive information when such information is accompanied by certain risk disclosure. This bespeaks caution doctrine holds that when precise cautionary language that directly addresses itself to future projections, estimates, or forecasts is used, such projections, estimates, or forecasts cannot be misleading as a matter of law.[67] This doctrine does not apply, however, when the speaker knows he is making untrue statements.[68] Regardless of the "matter of law" rhetoric used when speaking of this doctrine, as illustrated by the cases below, and in light of certain statements made by the Supreme Court in *Virginia Bankshares Inc. v. Sandberg*,[69] the application of the bespeaks caution doctrine is, indeed, a case-by-case factual analysis.

The following cases demonstrate that, regardless of any safe harbor or disclosure of risk factors and underlying factual assumptions, forward-looking statements will be subject to a plaintiff's 20/20 hindsight and may be actionable under the federal securities laws. On the brighter side, the Ninth Circuit's recent adoption of the bespeaks caution doctrine in *In re Worlds of Wonder Sec. Litig.*[70] shows that issuers may indeed find protection when cautionary language is specific and not generic—but, as recently emphasized by the Ninth Circuit in *Fecht v. Price Co.*,[71] the cautionary language must be specific.

---

67. The rationale for some courts in applying this doctrine is that where there is enough cautionary language attached to optimistic statements, investors have no right to rely on only the optimistic statements. For a more detailed discussion of the bespeaks caution doctrine, see Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994). It has been argued, however, that "even caution-laden disclosures may have the propensity to mislead" because "the presence of cautionary language actually may make the projections more influential." *Id.* at 497-98. Thus, it can be argued that courts which assume that cautionary language automatically negates optimistic statements would be erroneously applying the doctrine. *Id.* at 497. The other rationale expressed by the courts is that the cautionary language so dilutes the disclosure that no reasonable person would find an optimistic message. *Id.* at 487. *See also infra* Part III.3, for a discussion of Rubinstein v. Collins.

68. *But see In re* Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 553 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *and cert. denied*, 510 U.S. 1178 (1994)("The 'bespeaks caution' analysis subsumes the misrepresentation analysis. No reasonable inference can be drawn in favor of a plaintiff that a . . . statement which bespeaks caution as to future forecasts contains actionable misrepresentations." 793 F. Supp. at 553). *See also* Langevoort, *supra* note 67, at 488.

69. 501 U.S. 1083 (1991). In *Virginia Bankshares*, the Supreme Court held that statements by management of reasons, opinions, or beliefs, even though conclusory in form, may be material facts that could give rise to misstatement liability under the federal securities laws. *Id.* at 1083-84.

70. 35 F.3d 1407 (9th Cir. 1994).

71. 70 F.3d 1078 (9th Cir. 1995).

In the recently enacted Private Securities Litigation Reform Act of 1995 (Reform Act),[72] Congress provided for a statutory safe harbor for many forward-looking statements based in part upon the bespeaks caution doctrine, which is discussed in Part V.B of this Article. Some examples of risk factors language used in recent public filings can be found in Appendix A. Examples of cautionary language used in press releases pursuant to the safe harbor provision of the Reform Act can be found in Appendix B.

1. In re Donald Trump Casino Securities Litigation

In *In re Donald Trump Casino Sec. Litig.*,[73] investors who purchased bonds to provide financing for the Taj Mahal alleged that the prospectus which accompanied the bond offering contained materially misleading statements and omissions regarding, among other matters, defendant's belief that operation of the Taj Mahal would generate enough money to cover its debt service. The language from the Management Discussion and Analysis section stated: "The Partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal)."[74] However, the above statement was followed by a warning: "No assurance can be given, however, that the actual operating results will meet the Partnership's expectations. See 'Special Considerations—Ability of the Partnership to Service Debt.'"[75] The referenced subsection listed several specific risk factors and scenarios under which the contemplated adverse effects would materialize.[76]

The district court dismissed the action, applying the bespeaks caution doctrine and stating that the prospectus "virtually bristle[d] with warnings" concerning the "extremely risky nature of the investment."[77] The Third Circuit subsequently affirmed the lower court's ruling, concluding that, in light of the disclaimers contained in the prospectus,

72. Pub. L. No. 104-67, 109 Stat. 737 (West Supp. 1995) (codified in scattered sections of 15. U.S.C.) [hereinafter Reform Act].
73. 793 F. Supp. 543, 554 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994).
74. 793 F. Supp. at 555.
75. *Id.*
76. *Id.* at 554.
77. *Id.* at 555.

"no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment."[78] The court stated that:

> [W]hen an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.[79]

On March 7, 1994, the U.S. Supreme Court allowed the federal appeals court's decision to stand.

2. Sinay *and* Mayer

In *Sinay v. Lamson & Sessions Co.*,[80] the Sixth Circuit held that the issuer's optimistic statements regarding its performance and confirmation of an analyst's earnings estimates were not misleading where the predictions bespoke sufficient caution. The issuer also could not predict a decline in the construction market nor a devastating labor strike any better than the public.

But in *Mayer v. Mylod*,[81] the Sixth Circuit appears to have backed down from the bespeaks caution doctrine in light of the Supreme Court's statements in *Virginia Bankshares* that, while publishing accurate facts can render misleading statements too unimportant as to create liability, not every mixture of the true will neutralize the deceptive. In *Mayer*, the Sixth Circuit overturned the district court's application of *Sinay* to several statements of "opinion" made by a Michigan bank, holding that *Virginia Bankshares* requires a weighing of the true with the untrue and thus cautionary statements cannot "as a matter of law" render optimistic statements unactionable.[82]

3. Rubinstein v. Collins

In *Rubinstein v. Collins*,[83] the Fifth Circuit stated that "cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law."[84] Thus, while

---

78. 7 F.3d at 369.
79. *Id.* at 371.
80. 948 F.2d 1037 (6th Cir. 1991).
81. 988 F.2d 635 (6th Cir. 1993).
82. *Id.* at 637.
83. 20 F.3d 160 (5th Cir. 1994).
84. *Id.* at 167.

"[i]nclusion of cautionary language—along with disclosure of any firm-specific adverse facts or assumptions—is, of course, relevant to the materiality inquiry . . . cautionary language as such is not per se dispositive of this inquiry."[85]

In *Rubinstein*, Plains Resources, Inc. (Plains), one of the defendants to the suit, announced on August 19, 1991, that it had made a significant natural gas discovery which was characterized as "substantial."[86] Initial tests of the discovery were conducted, and analysts subsequently gave optimistic opinions about high yields from the discovery. On October 23, 1991, Defendant-Appellee Armstrong, Chief Financial Officer of Plains, was reported to have characterized as "realistic" an analyst's opinion that, among other things, the asset value of Plains was between $66 to $100 per share.[87] In November 1991, Plains filed a registration statement for a proposed secondary public offering which reiterated the initial test results, as well as asserting:

> Although there is insufficient production history and other data available to definitively quantify the proved reserves attributable to this discovery, the Company believes . . . that the . . . well is a significant discovery that, when fully evaluated, could add substantially to the Company's oil and natural gas reserves. There can be no assurance, however, that subsequent production, drilling and other data will not cause the Company to reevaluate its assessment of the significance of this discovery.[88]

Similar statements were made in the prospectus that accompanied the offering.

Plaintiff alleged that this registration statement, as well as the October 23rd statements, was misleading because the defendants knew that the discovery testing done up to that time "was not sufficient to provide a reasonable basis for these statements, and failed to disclose the declines in flow-tube and shut-in pressures."[89] On December 4, 1991, the defendants began to disclose some of the adverse information regarding the discovery.[90] Five days later, however, Plains' CEO announced that the discovery was up and running and was producing gas and condensate

85. *Id.* at 168 (footnotes omitted).
86. *Id.* at 162-63.
87. *Id.* at 163.
88. *Id.* at 163-64.
89. *Id.* at 164.
90. *Id.*

at levels seen before the recent sharp drop in flow-tube pressure.[91] On January 24, 1992, the planned public offering took place. Then, on March 30, 1992, Plains filed its 10-K report in which it reiterated the October test results for the discovery.[92] Finally, on April 13, 1992, an analyst publicly reported that the discovery well had reserves with a value of less than $2 million, which would not even cover the actual cost of the well.[93]

The plaintiffs alleged that defendants violated section 10(b) and section 20(a) of the 1934 Act and Rule 10b-5 thereunder, as well as violating certain state laws. The district court dismissed these claims because the statements by defendants "were made in good faith, suggested reliability and bespoke caution."[94] According to the district court, "positive economic forecasts and predictions such as those made by defendants may not form the basis of a securities fraud action when such statements are couched in cautionary language."[95]

The Fifth Circuit subsequently overturned the district court's decision to grant the motion to dismiss, stating that the district court had applied the bespeaks caution doctrine too broadly.[96] In its decision, the Fifth Circuit declined to follow *Sinay* and instead cited *Mayer* favorably.[97] Thus, it appears that some courts will continue to back down from the bespeaks caution doctrine, as *Mayer* and *Rubinstein* reveal, and instead find that statements couched in cautionary language are merely part of the "total mix of information" that courts look to in determining liability. Conversely, the bespeaks caution doctrine has gained support in other courts, as *In re Worlds of Wonder Sec. Litig.*,[98] discussed below, illustrates.

4. *In re* Worlds of Wonder Securities Litigation

In *Worlds of Wonder*, the Ninth Circuit adopted the bespeaks caution doctrine and affirmed the district court's summary judgment in favor of the defendants regarding the textual part of the Debenture Prospectus.[99]

Worlds of Wonder (WOW) was formed in 1985 and quickly achieved huge success with its two lines of toys: Teddy Ruxpin and Lazer Tag.

---

91. *Id.*
92. *Id.* at 165.
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at 167.
97. *Id.* at n.21.
98. 35 F.3d 1407 (9th Cir. 1994).
99. *Id.* at 1423-24.

Hoping to fund further expansion, WOW conducted a debenture offering in June of 1987, raising $80 million.[100] This additional infusion of capital was inadequate to sustain WOW's uncontrolled growth and, in addition to sluggish sales in the 1987 Christmas season, led to WOW filing for bankruptcy on December 21, 1987.[101] Several purchasers of WOW debentures subsequently filed this class action, alleging that the prospectus accompanying the offering was false and misleading in violations of sections 11 and 12(2) of the 1933 Act and section 10(b) of the 1934 Act.[102]

The district court below had found that where a prospectus contains extensive discussions of the specific risks inherent in investing in a start-up toy company, optimistic statements about such investment are not misleading as a matter of law.[103] The district court stated that "it does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based."[104]

On appeal, the Ninth Circuit considered the issue whether the district court erred by adopting and applying the bespeaks caution doctrine. The Ninth Circuit began its discussion of the doctrine by noting that at least six circuits have adopted some form of the bespeaks caution doctrine.[105] The court further stated that "the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance."[106] The Ninth Circuit then found that the district court had applied the doctrine narrowly and thus affirmed the district court's summary judgment in favor of defendants. The court stated:

> To prevent [an overbroad application of the doctrine], the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.[107]

---

100. *Id.* at 1411.
101. *Id.* at 1412.
102. *Id.*
103. 814 F. Supp. 850, 858-59 (N.D. Cal. 1993).
104. *Id.* at 858.
105. 35 F.3d at 1413.
106. *Id.* at 1414.
107. *Id.* at 1414.

5. Harden v. Raffensperger, Hughes & Co., Inc.

In *Harden v. Raffensperger, Hughes & Co., Inc.*,[108] plaintiffs alleged that Raffensperger, as underwriter, was liable for among other things, misstatements concerning the issuer's ability to secure insurance and its plans to restore company profitability.[109] Raffensperger argued that sufficient cautionary language was used in connection with the alleged misstatements so that it could rely on a bespeaks caution defense.[110] In rejecting Raffensperger's arguments, the court noted:

> Essentially, Raffensperger contends that the word "plans" used in this statement means "future efforts" rather than existing methods, ideas, or means of achieving some goal. We cannot agree. . . . Contrary to Raffensperger's attempt to portray the "plans to restore [profitability] statement" as containing solely "soft information," the statement constitutes a present assertion of fact . . . .[111]

And again, with respect to the issuer's cautionary statement regarding its efforts to secure insurance the court found:

> [The company] knew, prior to the issuance of the registration statement, that there was in fact no possibility of such approval and omitted to disclose this fact. The information . . . does not concern subjective or "soft information," but rather "hard facts." The bespeaks caution doctrine does not, as a matter of law, offset the materiality of such information.[112]

The court's distinction between "hard" and "soft" information has lead some commentators to suggest that the decision cuts back on the bespeaks caution defense. However, the court's emphasis on the language used by defendant in preparing the registration statement suggests that more concise drafting by issuer and underwriter may preserve a bespeaks caution argument even if the cautionary language concerns hard facts.

6. Fecht v. Price Company

In late 1995, the Ninth Circuit signaled that it will carefully review dismissals of securities fraud claims based upon the bespeaks caution doctrine in *Fecht v. Price Co.*[113] The court quoted its ruling in *In re Worlds of Wonder*, but went on to state:

---

108. 65 F.3d 1392 (7th Cir. 1995).
109. *Id.* at 1395.
110. *Id.*
111. *Id.* at 1405.
112. *Id.* at 1406 (footnote omitted).
113. 70 F.3d 1078 (9th Cir. 1995).

> The "bespeaks caution" doctrine is thus wholly consistent with our analysis that whether a statement in a public document is misleading may be determined as a matter of law only when reasonable minds could not disagree as to whether the *mix* of information in the document is misleading. Inclusion of *some* cautionary language is not enough to support a determination as a matter of law that defendants' statements were not misleading.[114]

In early 1996, the Ninth Circuit made clear that it considered *Fecht* to be the controlling case for reviewing dismissals based on the bespeaks caution doctrine. In *Warshaw v. Xoma*,[115] the court applied the *Fecht* standard to a dismissal of the plaintiff's complaint, concluding that effective cautionary language must be so obvious that reasonable minds could not differ as to its meaning.[116] The court concluded: "The Complaint asserts that the defendants knew that the facts contravened their 'optimistic' statements that E5 was safe, effective, and would be approved by the FDA. In this case, we easily conclude that the Complaint satisfied Rule 9(b) requirements."[117]

7. Pozzi v. Smith

In *Pozzi v. Smith*,[118] an electronics and software company, Quad Systems Corp., could not invoke the bespeaks caution doctrine because the company's use of cautionary language was qualified.[119] Quad disclosed certain problems it was having with its software, but qualified the disclosures by saying that the problems were not unusual and could be satisfactorily resolved.[120] The court concluded: "Thus, even though Quad made certain cautionary statements about software limitations and bugs (which it soft-pedaled by describing them as not unusual), it was simultaneously hiding the *effect* of those problems on the Company's business . . . ."[121]

---

114. *Id.* at 1082.
115. 74 F.3d 955 (9th Cir. 1996).
116. *Id.* at 959-60.
117. *Id.* at 960.
118. Pozzi v. Smith, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,967 (Dec. 1, 1995).
119. *Id.* at 93,666.
120. *Id.*
121. *Id.* at 93,669.

V. USE OF FORWARD-LOOKING STATEMENT INFORMATION

Except in self-dealing transactions, such as going private transactions, projections are overwhelmingly not used in public offering documents. This is primarily attributed to the wave of securities fraud class action suits challenging even the slightest misstatement regarding predictive expression.[122]

The SEC has made an effort to promote more forward-looking information through its emphasis on MD&A in its Concept Release,[123] issued last year, designed to implement reform to the 1979 safe harbor rules. The Concept Release included eight alternative proposals to the safe harbor rules and solicited comment on over seventy questions. Despite the large number of alternative proposals and widespread support for expanding the safe harbor rules, during 1995 it became clear that the SEC would not create a new safe harbor rule as recent legislative activity replaced the SEC initiative.

A. Recent Decisions

The courts have also recently issued rulings which help minimize exposure resulting from the use of forward-looking statements. For example, in *Herman v. Legent Corp.*,[124] Thomas Herman, representative for a class of investors in Legent Corporation, brought a "fraud on the market" securities fraud class action, alleging that Legent made a series of fraudulent public statements about its future performance that inflated the value of Legent's stock over a six-month period.[125] On appeal, the Fourth Circuit held that the statements of future performance were not fraudulent.[126]

The opinion seems, on its face, to restrict the scope of securities fraud in actions pertaining to public predictions of future performance. The court proclaims that statements regarding projections of future performance are actionable under Section 10(b) and Rule 10b-5 only if they are supported by specific statements of fact or are worded as guaran-

---

122. *See* Christie Harlan, *SEC Seeks To Beef Up "Safe Harbor" Provision*, WALL ST. J., May 17, 1994, at B1 (noting that of 218 companies responding to a Journal survey, more than one-half indicated that the prospect of shareholder litigation affected the dissemination of forward-looking information).

123. Concept Release and Notice of Hearing: Safe Harbor For Forward-Looking Statements, Exchange Act Release No. 33-7101, 59 Fed. Reg. 52723 (Oct. 1994).

124. 1995 Fed. Sec. L. Rep. (CCH) ¶ 98,650 (1995).

125. *Id.* at 92,003.

126. *Id.* at 92,010.

tees.[127] The "specific statements of fact" would have to be extremely specific to qualify, such as statements referring to specific business projects.[128] Otherwise, such "soft" or "puffing" statements involving optimistic opinions or predictions of future performance are not material, and thus not actionable as a matter of law. Companies are to be given freedom to prognosticate.

Other courts have relied on the bespeaks caution doctrine to dismiss claims based on faulty projections. In *Saltzberg v. TM Sterling/Austin Assoc., Ltd.*,[129] the Eleventh Circuit Court of Appeals affirmed the grant of summary judgment to defendants under the bespeaks caution doctrine. The Court noted that "when an offering document's projections are accompanied by meaningful cautionary statements and specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law."[130]

Many other decisions during 1995 were unsympathetic to suits claiming the use of false or misleading forward-looking information. Various reasons were used to support dismissals of such claims: The statements were too vague to be material,[131] the statements merely expressed general enthusiasm,[132] and the forward-looking statements had a reasonable basis.[133] As is always the situation, however, some courts have upheld complaints based on allegations similar to the ones other courts have dismissed.[134]

B. *The Private Securities Litigation Reform Act of 1995*

December 1995 was a month of high drama for securities professionals. Congress passed the Private Securities Litigation Reform Act of

---

127. *Id.* at 92,005.
128. *Id.*
129. 45 F.3d 399 (11th Cir. 1995).
130. *Id.* at 400.
131. Searls v. Glasser, 64 F.3d 1061 (7th Cir. 1995).
132. Robbins v. Moore Medical Corp., 894 F. Supp. 661 (S.D.N.Y. 1995).
133. *In re* Cypress Semiconductor Sec. Litig., [1995-1996 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 98,762 (Dec. 29, 1995). *See also* Jonathan Eisenberg, *Securities Litigation: Courts Are Increasingly Willing to Dismiss Weak Claims*, INSIGHTS, Sept. 1995, at 11.
134. *E.g.*, *In re* Valence Tech. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,793 (May 8, 1995); *In re* Clearly Canadian Sec. Litig., 875 F. Supp. 1410 (N.D. Cal. 1995).

1995 (Reform Act)[135] and sent it to the White House. Most observers thought that President Clinton would sign the legislation, but at the last minute he vetoed it.[136] Both Houses quickly overrode the veto and the Reform Act became law before the end of the year.[137] According to the Conference Report (Report), Congress sought to limit abusive, manipulative, and frivolous securities litigation and "to protect investors, issuers and all those who are associated with our capital markets."[138] The Reform Act operates on a number of levels:

- Class action procedures, including the mechanics of settlement, have been significantly tightened.
- A system of proportional liability has in many instances replaced joint and several liability.
- Pleading standards have been raised, especially regarding "state of mind allegations."
- In certain circumstances, discovery has been limited.
- Auditors are required to report illegal acts.
- The SEC—but not private parties—is expressly authorized to prosecute for aiding and abetting violations.
- More specific direction is provided regarding the calculation of damages and the necessity to prove loss causation.
- Except for when there has been a criminal conviction, "any conduct that would have been actionable as fraud in the purchase or sale of securities" cannot be the predicate for a violation of RICO.[139]
- A safe-harbor has been added to both the 1933 and 1934 Acts for a "forward looking statement."

The focus of this section will be on the new safe harbor provisions, although the other provisions of the Reform Act are extremely important and will change the landscape of securities litigation. It is too early to tell, but we "forecast":

- It will take considerable litigation and many years to flush out the meaning of the new legislation.

---

135. Pub. L. No. 104-67, 109 Stat. 737 (West Supp. 1995) (codified in scattered sections of 15 U.S.C.) [hereinafter Reform Act].

136. Presidential Veto Message on the Private Securities Litigation Reform Act, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,714, at 87,234-35 (Dec. 20, 1995).

137. The Reform Act does not affect or apply to any private securities action commenced and pending before the Act was adopted.

138. H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730.

139. Reform Act, *supra* note 135, Tit. I, § 107.

- It will most likely reduce frivolous litigation, but "serious" suits will be more costly to defend and more expensive to settle.
- Proportionate liability may turn out to be a double-edged sword.
- While the contours of the safe harbor provisions are not fully formed, they will in all probability reduce the number of suits filed based upon the use of forward looking information and be of considerable value to defendants defending against such claims.

The safe harbor provisions are rather simple. They apply to both written and oral statements made by or on behalf of a reporting issuer.[140] To fall within the safe harbor provisions, a forward-looking statement must satisfy the following:

> (1) IN GENERAL.—
>
> . . . .
>
> (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
>
> (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

140. *Id.* § 102. The safe-harbor provisions apply to statements made by an issuer, a person acting on behalf of an issuer, an outside reviewer retained by the issuer or an underwriter. *Id.* § 102(a). The term "person acting on behalf of an issuer" is further defined to mean an officer, director or employee of the issuer. *Id.*

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

(2) ORAL FORWARD-LOOKING STATEMENTS.—

. . . .

(A) If the oral forward-looking statement is accompanied by a cautionary statement—

(i) that the particular oral statement is a forward-looking statement; and

(ii) that the actual results could differ materially from those projected in the forward-looking statement; and

(B) if—

(i) the oral forward-looking statement is accompanied by an oral statement that additional information . . . is contained in a readily available written document, or portion thereof;[141]

(ii) the accompanying oral statement . . . identifies [where to locate the additional information]; and

(iii) the [additional] information contained in that written document is a cautionary statement that satisfies the standard established in paragraph (1)(A).[142]

Forward-looking information is broadly defined to include:[143]

- Projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items.
- Plans and objectives of management for future operations, including future products or services.
- Future economic performance, including any statement contained in MD&A. The assumptions underlying any of the foregoing.
- A report issued by an outside reviewer to the extent that it assesses a forward- looking statement made by the issuer.

---

141. "Readily available information" means any "document filed with the Commission or generally disseminated." *See* H.R. CONF. REP., *supra* note 138, at 45.

142. Reform Act, *supra* note 135, Title I, § 102(a)(c)(1)-(2).

143. *Id.* § 102(a)(i)(1)(A)-(F).

- Statements containing projections that may be covered by specific rules of the SEC.

Very importantly, the Reform Act specifically provides that the safe harbor provisions do not impose a duty to update forward-looking statements.[144] The SEC, moreover, is expressly granted authority to craft additional safe harbors.[145]

There a number of specific and important exclusions from the safe harbor:[146]

- Forward-looking statements by certain issuers are excluded:
  - Those with a "bad boy" history.
  - Forward-looking statements made by a blank check company in connection with an offering of its securities.
  - Penny stock issuers.
  - An issuer who makes a forward-looking statement in connection with a roll-up transaction.
  - An issuer who makes a forward-looking statement in connection with a going private transaction.
- Forward-looking statements made in certain SEC forms or in certain transactions are excluded:[147]
  - Statements made in certified financial statements.
  - Statements made by investment companies.
  - Statements made in connection with a tender offer.
  - Statements made in connection with an IPO.
  - Statements made in connection with an offering by, or relating to the operation of, partnerships, limited liability companies, or direct participation investment programs.
  - Statements made concerning beneficial ownership in Schedules 13D.

The Report emphasizes that part of the foundation for adopting the safe harbor is to encourage companies to disclose forward-looking

---

144. *Id.* § 102(a)(d).
145. *Id.* § 102(a)(g).
146. *Id.* § 102(a)(b)(1)(A)-(E).
147. *Id.* § 102(a)(b)(2)(A)-(F).

information. It also furnishes some helpful legislative history that will be useful in interpreting and applying the new safe harbor provisions:

- Boilerplate warnings do not qualify as "meaningful cautionary statements"—the cautionary statements must convey substantive information that realistically could cause results to differ from those projected.[148]
- "Important factors" need to be identified, but not "all factors" nor "the particular factor that ultimately causes the forward-looking statement not to come true."[149]
- The courts, "where appropriate," are invited to decide motions to dismiss "without examining the state of mind of the defendant."[150]
- A second prong of the safe harbor does focus on the state of the mind of the person making the forward-looking statement: Such person will not be liable in a private action "unless a plaintiff proves that person or business entity made a false or misleading forward-looking statement with actual knowledge that it was false or misleading."[151]
- The Conference Committee has established the safe harbor as a "starting point" and "fully expects" the SEC to continue rulemaking procedures in this area.

Client education concerning the Reform Act is essential. Emphasis should be on the development of "meaningful cautionary statements" and the adoption of procedures to implement the oral safe harbor, including the magic language in the oral statement and identifying and publishing the "readily available written document."

C. Duty to Update

The cases discussed below, including the well-publicized case *Backman v. Polaroid Corp.*,[152] suggest that issuers have a duty to update statements which were accurate when made, but which become inaccurate due to subsequent developments. These cases confuse the

---

148. H.R. CONF. REP., *supra* note 138, at 43. The cases applying the bespeaks caution doctrine will clearly be useful in interpreting the term "meaningful cautionary statements." Indeed, the Report states that the Conference Committee does not intend that the safe harbor provisions replace the bespeaks caution doctrine or to stop further development of that doctrine by the courts. *Id.* at 46.

149. *Id.* at 43-44.

150. *Id.* at 44.

151. *Id.* at 44.

152. [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,899 (Jan. 23, 1990), *withdrawn*, 910 F.2d 10 (1st Cir. 1990) (en banc).

duty to correct and the duty not to mislead. If an issuer makes a statement that is not accurate or is misleading based on the facts and circumstances existing at the time of such statement, then the issuer has a duty to correct such misstatements. That is not to say that an issuer has a duty to update statements which are accurate when made, but later become inaccurate or misleading due to a change of facts and circumstances. There is virtually no precedent for the proposition that either the duty to correct or the duty not to mislead requires that issuers update prior statements which were accurate when made. Unfortunately, these decisions would impose upon issuers an obligation to continually disclose all material information during the period between SEC reports.

In fact, these cases are misconstrued duty not to mislead claims. The duty to update theory is a misnomer which threatens to negate the established principle that an independent trigger of a duty to disclose is a distinct element of a Rule 10b-5 action. Although a narrower duty to update only so-called forward-looking statements appears more palatable, in practice it would be an unworkable and dangerous precedent. Such a duty to update prior disclosures would discourage issuers from making disclosure in the first place, and, therefore, is counterproductive to a system which encourages timely voluntary disclosure of material information.[153] Nevertheless, issuers should be aware that there is a clear trend to require such a duty, as the recent case, *In re Time Warner Inc. Sec. Litig.*,[154] illustrates.

1. Backman v. Polaroid Corporation

If bad facts make bad law, then the opinion by a panel of the First Circuit in *Backman v. Polaroid Corporation*[155] shows that unique circumstances also can produce bad law. The panel's opinion, recently withdrawn and vacated, would have imposed upon Polaroid a broad duty to disclose material adverse developments concerning its new instant

153. *See, e.g.*, Carl W. Schneider, *Update on the Duty to Update: Did* Polaroid *Produce the Instant Movie After All?*, 23 REV. SEC. & COMM. REG. 83 (1990); Carl W. Schneider, *The Uncertain Duty to Update*—Polaroid II *Brings a Welcome Limitation*, INSIGHTS, Oct. 1990, at 2; Carl W. Schneider, *The Duty to Update:* Time *Requires a Reevaluation of Basics*, INSIGHTS, Apr. 1994, at 2.

154. 9 F.3d 259 (2d Cir. 1993).

155. [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,899 (Jan. 23, 1990), *withdrawn*, 910 F.2d 10 (1st Cir. 1990) (en banc).

movie system called "Polavision" solely to update prior statements which, although accurate when made, were rendered inaccurate by subsequent adverse developments. The panel would have imposed this interim period disclosure obligation even though it was unable to conclude that Polaroid was either trading in its own securities or making statements which, without an update, would have been otherwise misleading.

Fortunately, the court's opinion was withdrawn and the judgment vacated. After a rehearing en banc, the First Circuit held that Polaroid's statements could not have been considered misleading when made, nor did they ever become misleading in light of subsequent events.[156] Nevertheless, because the full court did not completely reject the notion that certain forward-looking statements could require further disclosure, the Polaroid case merits close attention to prevent the so-called duty to update from receiving further credibility.

a. Unique Circumstances: The Third Quarter Report, Polavision Problems, and the Foundation Stock Sale

Polaroid introduced its much-heralded Polavision with a massive ad campaign in the Spring of 1978, projecting sales of 200,000 units for the year.[157] By October, the company had adjusted projected sales to 100,000 units and ordered a decrease in production at its supplier.[158] Polaroid temporarily ceased all production of Polavision in November to deplete excess inventory. On both occasions, Polaroid requested secrecy from its supplier concerning the cutbacks. In early December, 1978 Polaroid circulated among upper management a forecast estimating 1978 sales of Polavision at 97,000 units.[159]

Polaroid's Third Quarter Report to Stockholders, issued on November 5, 1978, emphasized increased earnings, booming sales and record manufacturing output for the company as a whole.[160] These representations were true and correct in every respect. The report made only the following direct reference to Polavision: "[The President] noted also that earnings continue to reflect substantial expenses associated with Polavision, Polaroid's new system of instant movies."[161] The report also attributed a major part of the company's increase in the ratio of cost of sales to net sales for the first nine months of the year and the third

156. 910 F.2d at 16-18.
157. Fed. Sec. L. Rep. (CCH) ¶ 94,899 at 94,938.
158. *Id.* at 94,939.
159. *Id.*
160. *Id.* at 94,938.
161. *Id.* at 94,956 (alteration in original).

quarter, to "substantial expenses associated with Polavision."[162] These statements also were true.

On January 9, 1979, the Rowland Foundation, a charitable organization run by Dr. Edwin Land, Polaroid's founder, Chairman, and CEO, issued a press release through Polaroid's public relations department announcing its intent to sell 300,000 Polaroid shares.[163] The press release had been reviewed by Polaroid's in-house counsel and the Foundation's attorney, a vice-president and director of Polaroid. The press release cited the Foundation's desire to diversify as its reasons for the sale and mentioned Dr. Land's impending retirement as Chairman and CEO of Polaroid. The release made no reference to Polavision. The stock was sold on January 11, 1979 for $52 per share.

On January 15, 1979, Polaroid circulated to management an internal report estimating fourth quarter earnings slightly lower than anticipated, and recommending a reserve for additional Polavision expenditures.[164] Polaroid booked a reserve of $6.8 million for Polavision losses on February 1. At the close of the market on February 22, 1979, Polaroid issued a press release announcing a twenty-six percent increase in earnings for fiscal year 1978 and earnings per share of $1.32 for the fourth quarter. The release further disclosed that Polavision had incurred manufacturing and marketing expenses "substantially in excess of revenues" and that the project would continue to make such demands on cash and earnings in 1979.[165] Polaroid's stock fell from almost $50 on February 22 to $43 on February 23, stabilizing at about $40 by March 1.

Plaintiffs sued, alleging that Polaroid misled investors by intentionally de-emphasizing the Polavision difficulties when it announced record earnings for the third quarter.[166] The plaintiffs alleged that Polaroid had a duty to disclose the subsequent Polavision production cuts and the December and January internal reports to prevent the Third Quarter Report from "becoming misleading."[167] Finally, the plaintiffs asserted that the press release announcing the Foundation stock sale was

162. *Id.*
163. *Id.* at 94,939.
164. *Id.*
165. *Id.*
166. *Id.* at 94,939-40.
167. *Id.* at 94,940.

misleading because it did not discuss the adverse developments in the Polavision project.

After a bifurcated trial, the jury returned a verdict for the plaintiffs and awarded an aggregate of $9.75 per share in damages to all the class participants.[168] Polaroid appealed the verdict, arguing that it never uttered any misleading statements or engaged in any conduct that would trigger a duty to disclose. Polaroid also challenged the jury instructions regarding materiality and the duty to disclose.

b. *Duty to Disclose—No Misstatements*

The First Circuit panel in *Polaroid* held that the trial judge's instructions to the jury regarding Rule 10b-5 improperly equated the duty to disclose with materiality and failed to specify the events that would trigger a duty to disclose.[169] Writing for the panel, Judge Bownes properly stated the circumstances that would trigger an obligation to disclose material information: "1) when a 'corporate insider trades on confidential information,' 2) when a corporation has made 'inaccurate, incomplete, or misleading prior disclosures,' and 3) when a statute or regulation requires disclosure."[170]

The panel also determined that the Third Quarter Report was accurate and not misleading at the time of its issuance.[171] Due to its significant involvement in the Rowland Foundation press release, the panel found that Polaroid was responsible for its content. Judge Bownes expressed significant reservations, however, that the release, standing alone, would provide an adequate basis to impose liability on Polaroid for the alleged omissions.

c. *Bad Law: The Duty to Update*

Notwithstanding that the Third Quarter Report was accurate and not misleading when made, the panel held that a reasonable jury could conclude that the report "became misleading" once Polaroid ordered the November production halts and had assembled earnings estimates showing poor fourth quarter performance. The panel asserted that even though the statements were accurate when made, "a duty to disclose can

---

168. *Id.*

169. *Id.* at 94,939-40. The panel also found that the trial judge failed to specifically instruct the jury with respect to the good faith defense to scienter. *Id.* The Rule 10b-5 scienter requirement is beyond the scope of this article.

170. *Id.* at 94,942 (citing Roeder v. Alpha Industries, Inc., 814 F.2d 22, 26-27 (1st Cir. 1987)).

171. *Id.* at 94,950.

arise if a company possesses material facts that must be released in order to render *prior* statements not misleading."[172] Therefore, rather than overturn the jury verdict, the First Circuit panel ordered a new trial.

d. Dubious Relief: The En Banc Opinion

In the opinion en banc, the First Circuit reasserted that a duty to disclose would arise only if the issuer is either trading in its own securities, has made prior inaccurate statements, or is required by a specific statute or regulation.[173] The full court also concluded that Polaroid's statements in the Third Quarter Report about Polavision's negative effect on earnings were complete and accurate when made, and remained true and correct at all times thereafter.[174] The court ruled that Polaroid had satisfied its obligations by disclosing that Polavision was being sold below cost.[175] The court rejected the claim that Polaroid misled investors by electing not to say how much below cost.[176] The court stated that the duty not to mislead "does not mean that by revealing one fact about a product, one must reveal all others that, too, would be interesting, market-wise, but means only such others, if any, that are needed so that what was revealed would not be 'so incomplete as to mislead.'"[177]

Finding no evidence in the record to suggest that Polaroid knew by November that Polavision was a commercial failure, the court refused to consider the Polavision statements misleading simply because the Third Quarter Report omitted to mention exact sales figures.

The court also confirmed that if the Polavision statements had been misleading when made, Polaroid would have had a duty to correct them.[178] Because the Polavision statements remained true and correct at all times after their utterance, no duty to correct ever arose. As for the so-called duty to update, the full court stated that "in special circumstances, a statement, correct at the time, may have a forward intent and

172. *Id.* at 94,944.
173. *Polaroid*, 910 F.2d at 17.
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.* at 16 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)).
178. *Id.* at 16-17.

connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for."[179]

The court acknowledged that it need not face that question, however, because even if the Polavision statements were forward-looking, they remained precisely correct after their release.[180] Hence, the court's statements as to the duty to update are dicta.[181]

e. A Bad Precedent

Although the First Circuit's rejection of a broad duty to update is a welcome relief, the dicta language suggesting that certain forward-looking statements require further disclosure is very troubling. To distinguish statements of present fact from purely speculative and forward- looking disclosure is practically impossible. Issuers also have no reasonable guidance as to the duration of viability of such statements in the market. Because of the compliance difficulties it presents, acceptance of even a limited duty to update would eviscerate the traditional rule that issuers have no general duty to disclose.

Various commentators and the SEC have long recognized the peculiar problems raised by forward-looking statements, speculative analysis, and projections.[182] The SEC has historically accepted a modicum of "touting" as an acceptable business practice and has adopted Rule 175

---

179. *Id.* at 17.

180. *Id.* at 17-18.

181. Ironically, Judge Bownes' dissent to the opinion en banc provides a better discussion of the disclosure issue than that given in the majority opinion. *See id.* at 18 (Bownes, J., dissenting). Judge Bownes admits that the language in the panel opinion could be construed as creating an overly broad "duty to update" past accurate statements of historical fact and that no such "duty to update" should exist. *Id.* at 21. Unfortunately, Judge Bowne also stated that the duty to correct should apply to forward-looking statements which remain "alive" and become inaccurate due to events that occur while the statement is still viable in the marketplace. *Id.* (quoting Ross v. A. H. Robins Co., 465 F. Supp. 904, 908 (S.D.N.Y 1979)).

182. Carl W. Schneider describes statements which could possibly warrant a "duty to update" because of an "implied representation and/or reasonable expectation of continuity." *See* Schneider, *Update on the Duty to Update: Did* Polaroid *Produce the Instant Movie After All?*, *supra* note 153, at 86. Schneider states that if a company announces a long-term contract award which would double its sales, and loses that contract months later, then the company should have to disclose the loss of that contract, solely because of its prior disclosure. Management should be entitled, however, to exercise its business judgment and delay disclosure of this information to assess the impact on the business and develop strategies to counter any losses. *See* Dirks v. SEC, 463 U.S. 646, 658 n.17 (1981). Regardless, the company's next MD&A would require disclosure of the contract, loss if the company's liquidity or capital resources would be affected, or if the cancellation would cause the historical financial data in the report not to be indicative of future operating results or financial condition.

as a safe harbor to encourage issuers to provide projections of future performance, estimates, and forecasts.[183] A duty to continually update all material statements, including forward-looking statements, would discourage voluntary disclosure and undermine the SEC's efforts in this regard.

To undermine the doctrine of timely disclosure in this manner appears particularly short-sighted given the development of the MD&A as a quarterly disclosure vehicle, requiring issuers to disclose all material changes or subsequent developments in their 10-Q reports. Because virtually all such material changes relating to forward-looking statements would be encompassed by the MD&A, courts should refuse to eliminate the flexibility and business judgment afforded management under the current regulatory scheme.

2. *In re* Time Warner Inc. Securities Litigation

After the takeover by Time of Warner, the resulting company faced a substantial debt. Time Warner embarked on a highly publicized campaign to find international "strategic partners" who would infuse it with billions of dollars of capital. This plan was unsuccessful, however, and Time Warner resorted to a stock offering that had the effect of diluting the rights of the existing shareholders, some of whom brought this lawsuit, *In re Time Warner Inc. Sec. Litig.*[184] The plaintiffs alleged that Time Warner and certain executives misled the investing public by making certain statements and omissions that were generally optimistic about the progress of the "strategic partnerships" and never indicated the actual difficulties.

The district court considered two categories of misstatements: (1) press releases and public statements from the individual defendants and (2) unofficial statements from unnamed sources given to analysts and the press. With regard to the first category, the court found that the statements indicating that talks were ongoing were accurate when made, and that later attempts did not give rise to a duty to correct or update the statements. As to the second category, the court concluded that the

---

183. Rule 175 generally provides a safe harbor for projections that are made with a reasonable basis and in good faith. *See* 17 C.F.R. § 230.175 (1994). For a discussion regarding efforts to amend the safe harbor rule, see *supra* Part V.B.

184. 794 F. Supp. 1252 (S.D.N.Y. 1992).

defendants could not be held responsible for any of the unattributed statements and that the statements were not actionable for the same reasons that the attributed statements were not actionable. The district court then dismissed the complaint for failure to plead adequately either material misrepresentations or omissions attributable to the defendants, and for failure to plead scienter adequately.

The Second Circuit Court of Appeals, however, reversed and partially granted the defendant's motion to dismiss.[185] The court discussed, among other matters, two updating issues with regard to the attributed statements and corporate press releases: (1) failure to disclose problems in the strategic alliance negotiations and (2) failure to disclose the active consideration of an alternate method of raising capital.

With regard to the first issue, the plaintiffs' theory is that the defendants' statements hyping strategic alliances gave rise to a duty to disclose problems in the alliance negotiations as those problems developed. The court found, however, that the attributed public statements "lack the sort of definitive positive projections that might require later correction."[186] Thus, these statements "did not become materially misleading when the talks did not proceed well."[187]

Addressing the second issue of the failure to disclose alternative methods of raising capital, the Court of Appeals found that the information about the consideration of the stock offering alternative was material because the offering could have a negative effect on the market price for the company's stock.[188] The court then considered whether there was a duty to disclose the omitted fact. The court stated:

> Time Warner's public statements could have been understood by reasonable investors to mean that the company hoped to solve the *entire* debt problem through strategic alliances. Having publicly hyped strategic alliances, Time

---

185. 9 F.3d 259 (2d Cir. 1993).

186. *Id.* at 267.

187. *Id.* The court added in a footnote:

> Although the statements are generally open-ended, there is one sense in which they have a solid core. The statements represent as fact that serious talks with multiple parties were ongoing. If this factual assertion ceased to be true, defendants would have had an obligation to update their earlier statements. But the complaint does not allege that the talks ever stopped or ceased to be "serious," just that they eventually went poorly.

Id. at n.4. Carl W. Schneider argues that this footnote should be interpreted to require at most "terminal" disclosures, i.e., when either an agreement is reached or the "serious" negotiations end with no agreement. Schneider, *The Duty to Update:* Time *Requires a Reevaluation of Basics*, *supra* note 153, at 2, 4. Thus, updating disclosures during the course of ongoing negotiations should not be required. Further, it is unclear whether the duty to update would arise if the terms being negotiated were announced but were subsequently changed materially during the course of negotiations. *Id.*

188. 9 F.3d at 267.

> Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.[189]

The court concluded that, "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."[190]

3. Good v. Zenith Electronics Corporation

Unfortunately, the duty to update refuses to die a rational death. In *Good v. Zenith Electronics Corp.*,[191] the district court suggested that Zenith may have violated a duty to update certain earnings projections which were accurate and reasonable when made, but subsequently proved unattainable.[192] Zenith's 1988 Annual Report stated that the company "expect[ed] further profit improvements in 1989."[193] On April 25, 1989, Zenith reported a $4 million first quarter loss. The release stated that the company's initial forecasts had anticipated the loss and confirmed that the company still expected profit improvement for the full year. On July 21, 1989, Zenith reported a $13 million loss for the second quarter. The price of Zenith stock fell significantly. The plaintiffs alleged that Zenith's April statements confirming the initial projections and projecting profit improvement constituted securities fraud.[194]

In denying the defendant's motion for summary judgment, Judge Bua held that Zenith may have violated Rule 10b-5 by confirming the prior earnings projections at a time that the company may have been in possession of information which undermined the accuracy of such projections.[195] It is unclear from the opinion whether Zenith actually had actual knowledge of facts contradicting the initial projections, because certain materials relating to this charge were submitted under

189. *Id.* at 268.
190. *Id.*
191. 751 F. Supp. 1320 (N.D. Ill. 1990).
192. *Id.* at 1322.
193. *Id.* at 1321 (quoting *Statement of Uncontested Facts in Support of Defendants' Summary Judgment Motion* at ¶ 6).
194. *Id.*
195. *Id.* at 1323.

seal. Any voluntary confirmatory statements, if made at a time when the company had reason to believe that the initial projections were no longer accurate, would likely violate the duty not to mislead.

Unfortunately, Judge Bua went on to state that Zenith also may have had a "duty to update" the initial projections, which were accurate when made, "if additional information became known to the parties that changed the meaning of the statement."[196] Because Zenith's April statements apparently were inaccurate, Judge Bua need not have attributed his ruling to an independent duty to update the initial projections and his statements in this regard are dicta.[197]

4. Stransky v. Cummins Engine Co., Inc.

Although the debate is far from over, the Seventh Circuit repaired some of the damage in *Stransky v. Cummins Engine Co., Inc.*[198] In *Stransky*, Cummins Engine Co. issued optimistic press releases regarding its newly redesigned engines, and later discovered that warranty costs were skyrocketing because of faulty design problems.[199] Alan Stransky filed a class action suit for securities fraud and based the case (at least partially) on a duty to update. The court noted that some legal scholars have argued that a duty to update arises when a company makes a forward-looking statement that, because of subsequent events, becomes untrue.[200] The court emphatically stated, however, that "[t]his court has never embraced such a theory, and we decline to do so now."[201]

The Seventh Circuit explained that Rule 10b-5 implicitly precludes liability in circumstances that arise after the speaker makes the statement.[202] It commented that "the securities laws typically do not act as

---

196. *Id.* at 1322.

197. Another case where the court applied the "duty to update" is *In re* Kulicke & Soffa Indus. Sec. Litig., 747 F. Supp. 1136, 1147-49 (E.D. Pa. 1990), where the jury responded in special interrogatories that an issuer had a duty to disclose material information which rendered a prior projected sales forecast misleading, even though defendants made no statements supporting the projections once the projections became unattainable. However, both the jury and the court found that defendants lacked scienter in their failure to correct the forecast immediately. The court in *In re* Meridian Sec. Litig., 772 F. Supp. 223, 227 (E.D. Pa. 1991), suggested that an issuer had a duty to correct and update between periodic reports its optimistic statements regarding certain successful business operations after difficulties arose. However, in Capri Optics Profit Sharing v. Digital Equip., 760 F. Supp. 227 (D. Mass. 1991), the court cited *Polaroid* and rejected the claim that an issuer had a duty to disclose "additional information" regarding expected company performance.

198. 51 F.3d 1329 (7th Cir. 1995).

199. *Id.* at 1330.

200. *Id.*

201. *Id.*

202. *Id.*

a Monday Morning Quarterback,"[203] and it noted that the securities laws approach matters from an ex ante perspective. Consequently, forward-looking statements can lead to liability only if they are unreasonable in light of the facts known at the time.

The duty to update thus appears to have been eliminated, at least in the Seventh Circuit. The huge question now is whether the other courts will see the light and follow the lead of *Stransky*.[204]

VI. FREE RIDING INTERPRETATION

On March 18, 1994, the National Association of Securities Dealers, Inc. (NASD) filed with the SEC certain rule changes to the NASD "free-riding" interpretation of the NASD Manual of Rules of Fair Practice.[205] These changes were approved by the SEC on December 7, 1994.[206] Some of the key changes to the interpretation include the following:

1. Stand-by Arrangements

The prior interpretation restricted sales to "stand-by" purchasers in certain instances by disallowing persons restricted under the prior interpretation from having a beneficial interest in a "stand-by" account. The new interpretation now provides that securities purchased pursuant to a "stand-by" arrangement (an agreement to purchase securities not purchased during the offering) are not subject to the provisions of the interpretation if: (1) the "stand-by" is disclosed in the prospectus, (2) the "stand-by" arrangement is the subject of a formal written agreement, (3) the managing underwriter represents in writing that it was unable to find any other purchasers for the securities, and (4) the securities

203. *Id.*

204. Such a trend appears to be developing already. The opinion in *In re* Cypress Semiconductor Sec. Litig., 891 F. Supp. 1369 (N.D. Cal. 1995), echoes the Seventh Circuit distaste for the duty to update: "All of Cypress forward-looking statements had a reasonable basis at the time they were made, which is the only time that matters as far as the securities laws are concerned." *Id.* at 1381.

205. Notice of Filing of Proposed Rule Change Relating to the NASD's Free-Riding and Withholding Interpretation, Exchange Act Release No. 34-34485, 59 Fed. Reg. 40,933 (August 3, 1994).

206. Order Approving Proposed Rule Change Relating to the NASD's Free-Riding and Withholding Interpretation, Exchange Act Release No. 34-35059, 59 Fed. Reg. 64,455 (Dec. 7, 1994) [hereinafter *NASD Release*].

purchased are restricted from sale or transfer for a period of three months.[207]

2. *Definition of Immediate Family*

The old interpretation restricted immediate family members or persons associated with broker/dealers and persons having a connection to the offering and individuals related to banks, insurance companies, and other institutional-type accounts, from participating in "hot issue" distributions. The amendment to the interpretation now provides that

> the prohibition shall not apply to sales to a member of the immediate family of a person associated with a member [who] is not supported directly or indirectly to a material extent by such person if the sale is by a broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.[208]

3. *Venture Capital Investors*

The NASD concluded that venture capital investors should be allowed to purchase a hot issue to maintain their percentage ownership in an entity, notwithstanding that the venture capital investor may be a restricted person, or that such person may have a beneficial interest in a venture capital account. The new interpretation therefore provides that venture capital investors may purchase hot issues without implicating the interpretation's restrictions if:

(a) there is one year of preexisting ownership in the entity;
(b) there is no increase in the investor's percentage ownership above that held for three months prior to the filing of registration statement in connection with the initial public offering;
(c) there is a lack of special terms in connection with the purchase; and
(d) [the] Venture Capital Investor shall not assign, sell, pledge, hypothecate or otherwise dispose of the securities for a period of three months following the effective date of the registration statement in connection with the offering.[209]

4. *Definition of Public Offering*

The NASD concluded that the definition of "public offering" implicated private placements of securities which do not present the

---

207. *See id.* at 64,935.
208. *Id.*
209. *Id.*

abuses that the interpretation was designed to guard against. The amended interpretation therefore provides that private placements are not within the purview of the interpretation. Specifically, the amended interpretation defines a public offering as "any primary or secondary distribution of securities made pursuant to a registration statement or offering circular . . . of any kind whatsoever except any offering made pursuant to an exemption under §4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended, or pursuant to Rule 504 . . . or Rule 506."[210]

VII. ROAD SHOWS

Road shows are an integral part of the public offering process. They serve a useful function as the issuer and its principal officers are displayed before potential investors. This leads to incisive questioning by experts and produces, in some respects, a negotiated transaction.

Lawyers generally play a small or nonexistent part in either the road show or its preparation. Cautious issuer counsel frequently advises the client to confine its presentations at the road show to material included in the registration statement, to refrain from making predictions, and not to distribute other materials. There is very little case law, and few formal SEC rulings, dealing with statements made at road shows. Many of the class action securities fraud suits brought in the past few years have specifically alleged that the road show is used as a vehicle to create demand for the securities by painting an extremely positive picture of the issuer and by having the issuer and underwriter both make forecasts that the issuer will enjoy continued profit growth.

In *In re Hyperion Sec. Litig.*,[211] the plaintiffs attempted to bolster their allegations of securities fraud through excerpts of information—scripts and slides—used during the road shows. The court agreed that the "roadshow scripts were more optimistic about risks and returns than the prospectuses."[212] Despite this, the court, looking at the total mix of information available and applying the bespeaks caution doctrine, held that the plaintiffs could not "predicate their claims on inferences drawn from statements made during the roadshows, if, as here, those

210. *Id.* at 64,937.
211. [1995-96 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,906 (July 14, 1995).
212. Id. at 93,362.

inferences are contradicted by specific disclosures in the prospectuses."[213]

CONCLUSION

Major developments have recently occurred in the law surrounding disclosure. The SEC has not been the principal catalyst, but instead the courts and Congress have created these developments. Both are clearly signaling that there is far too much securities fraud litigation. Volatile markets—especially steep declines—have generally prompted a rash of litigation. Based on the more limiting court decisions and the Reform Act, it is likely that the litigation explosion will be reduced.

213. *Id.*

APPENDIX A

CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS MADE IN REGISTRATION DOCUMENTS

Genus, Inc., S-3 Registration Statement, Feb. 16, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"This Prospectus contains forward-looking statements that involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, the "Risk Factors" described below."

CNS, Inc., S-3 Registration Statement, Mar. 8, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"An investment in the Common Stock offered hereby involves a high degree of risk. In addition to the other information contained in this Prospectus, prospective investors should carefully consider the following risk factors relating to the business of the Company before making an investment. This Prospectus, including the information incorporated by reference herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Actual results could differ significantly from those projected in the forward-looking statements as a result, in part, of the risk factors set forth below. In connection with the forward-looking statements which appear in these disclosures, prospective purchasers of the Common Stock offered hereby should carefully review the factors set forth in this Prospectus under 'Risk Factors.'"

Molecular Biosystems, Inc., S-3 Registration Statement, Apr. 10, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"In addition to the other information contained in or incorporated by reference into this Prospectus, the following factors should be carefully considered in evaluating an investment in the Common Stock offered by this Prospectus. This Prospectus contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences

include, but are not limited to, those discussed in the following section and in 'Management's Discussion and Analysis of Financial Condition and Results of Operations' and 'Business'."

Electronic Data Systems Holding Corp., S-4 Registration Statement, Apr. 22, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"This Solicitation Statement/Prospectus contains certain forward-looking statements and information relating to EDS that are based on the beliefs of GM or EDS management as well as assumptions made by and information currently available to GM or EDS management. When used in this document, the words "anticipate," "believe," "estimate" and "expect" and similar expressions, as they relate to GM, EDS or GM or EDS management, are intended to identify forward-looking statements. Such statements reflect the current views of GM or EDS with respect to future events and are subject to certain risks, uncertainties and assumptions, including the risk factors described in this Solicitation Statement/Prospectus. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated or expected. Neither GM nor EDS intends to update these forward-looking statements."

Hambrecht & Quist Group, Inc., S-1 Registration Statement, June 20, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"This Prospectus contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those discussed in the forward-looking statements as a result of certain factors, including those set forth below and elsewhere in this Prospectus. The following factors should be considered carefully in addition to the other information contained in this Prospectus before purchasing the common stock offered hereby."

The UniMark Group, Inc., S-3 Registration Statement, June 14, 1996, *available in* LEXIS, COMPNY Library, FILING File:

"The discussion in this Prospectus contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ significantly from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business," as well as those discussed elsewhere in this Prospectus. Statements contained in this Prospectus that are not historical facts are forward-looking statements that are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. A number of important factors could cause the Company's actual results for 1996 and beyond to differ materially from those expressed in any forward-looking

statements made by, or on behalf of, the Company. These factors include, without limitation, those listed below in 'Risk Factors'."

APPENDIX B

CAUTIONARY "SAFE HARBOR" LANGUAGE CONTAINED IN PRESS RELEASES PURSUANT TO THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Motorola Reports Higher Sales and Earnings for the Full Year 1995, Business Wire, Inc., Jan. 9, 1996, *available in* LEXIS, COMPNY Library, ALLNWS File:

"'Safe Harbor' statement under the Private Securities Litigation Reform Act of 1995: The statements under "Review and Outlook" and the other statements which are not historical facts contained in this release are forward looking statements that involve risks and uncertainties, including, but not limited to, product demand and market acceptance risks, the effect of economic conditions, the impact of competitive products and pricing, product development, commercialization and technological difficulties, capacity and supply constraints or difficulties, the results of financing efforts, actual purchases under agreements, the effect of the Company's accounting policies, and other risks detailed in the Company's Securities and Exchange Commission filings."

Motorola Reports Higher First Quarter Results, Business Wire, Inc., Apr. 9, 1996, *available in* LEXIS, COMPNY Library, ALLNWS File:

"'Safe Harbor' statement under the Private Securities Litigation Reform Act of 1995: The statements quoted in "Review and Outlook" and about the Iridium financing negotiations are forward looking and the continuation of the factors listed in the first paragraphs of "Review and Outlook" and "General Corporate" as well as product and technology development and commercialization risks and uncertainties, the outcome of these financing negotiations and the factors listed on pages F-10 and F-11 of Motorola's 1996 proxy statement appendix and other SEC filings could cause Motorola's actual results to differ materially from those statements."

Intel Fourth Quarter Outlook, Business Wire, Inc., Nov. 6, 1996, *available in* LEXIS, COMPNY Library, ALLNWS File:

"The above statements contained in this outlook are forward-looking statements that involve a number of risks and uncertainties. In addition

to the factors discussed above, among the other factors that could cause actual results to differ materially are the following: business conditions and growth in the personal computer industry and general economy; change in customer order patterns, including timing of delivery and changes in seasonal fluctuations in PC buying patterns; competitive factors, such as rival chip architectures, competing software-compatible microprocessors, acceptance of new products and price pressures; risk of inventory obsolescence due to shifts in market demand; variations in inventory valuation; timing of software industry product introductions; continued success in technological advances, including the manufacturing ramp; excess or shortage of manufacturing capacity; risks associated with foreign operations; changes in the mix of microprocessor speeds and related motherboards; costs and yield issues associated with production at factories; litigation involving intellectual property and consumer issues; and other risk factors listed from time to time in the company's SEC reports, including but not limited to the report on Form 10-Q for the quarter ended June 29, 1996."

Zebra [Technologies Corporation] Announces First Quarter Financial Results, PR Newswire Ass'n Inc., April 24, 1996, *available in* LEXIS, COMPNY Library, ALLNWS File:

"The estimates contained in this release are forward looking statements subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. Management cautioned that these projections are estimates of future performance and are highly dependent upon a variety of important factors which could cause actual results to differ materially from the estimate. These factors include the acceptance of the company's printer and software products by the market and product offerings made by its competitors. Profits will be affected by the company's ability to control manufacturing and operating costs. Due to the company's large investment portfolio, interest rate conditions will also have an impact on results, as will foreign exchange rates due to the large percentage of the company's sales in international markets. Readers of this press release are referred to filings with the Securities and Exchange Commission, and specifically Zebra's prospectus of December 7, 1995 for further discussions of factors that could affect Zebra's future results."