

THE STATUTORY SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS AFTER TWO AND A HALF YEARS: HAS IT CHANGED THE LAW? HAS IT ACHIEVED WHAT CONGRESS INTENDED?

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This Article examines the safe harbor for projections and forward-looking statements created by the Private Securities Litigation Reform Act of 1995 ("Act" or "Reform Act").¹ The Article asserts that the statute essentially codifies, and does not radically modify or extend, the substantial body of judge-made law that has evolved over many years. As a result, given the paucity of judicial interpretations of the Reform Act in the first two and a half years after its enactment, it is to judicial decisions arising under the predecessor statute that one must have recourse in understanding how to apply the safe harbor.

The Article then considers the reasons why the safe harbor, despite congressional expectations that it would foster more forward-looking disclosure by issuers, has wholly failed to achieve this result. Finally, the Article discusses the bills currently pending in Congress that are addressed to the shortcomings of the safe harbor, including the "Securities Litigation Uniform Standards Act of 1988," which has garnered the support of the Securities and Exchange Commission and the White House, and which was passed by the Senate by a vote of seventy-nine to twenty-one on May 13, as well as the similar but not identical bill passed by the House on July 21. This Article argues that enactment of some version of the proposed legislation is necessary to achieve congressional goals, and that the Senate bill is well suited to this end.

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1. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). An earlier version of portions of this Article was published as Walter Rieman et al., *The Private Securities Litigation Reform Act of 1995: A Users Guide*, 24 SEC. REG. L.J. 143 (1996).

I. THE REFORM ACT SAFE HARBOR PROVISIONS

The single greatest impetus to passage of the Reform Act was the perception—amply supported by the evidence—that issuers had been deterred from making projections and from disseminating soft information because of a fear of liability if their public statements failed accurately to predict the future. The Conference Report’s Statement of Managers found that fear of litigation from inaccurate projections had “muzzled” corporate management, and that technology companies with volatile earnings were especially vulnerable. The Statement of Managers focused on significant evidence of abuse in private securities litigation, including all-too-frequent races to the courthouse upon any significant change in an issuer’s stock price, and extortionate settlements that hurt shareholders.²

The Act was intended to bolster the protections for projections, forward-looking statements and other “soft” information by incorporating elements of the SEC’s rule 175 and the highly-developed body of case law construing and applying the so-called “bespeaks caution” doctrine. Recognizing that the previous SEC safe harbor had proven largely ineffective because it could not be readily invoked to end litigation at the pleading stage of a case, Congress crafted a new rule that, it was thought, would enable judges to dismiss cases without inquiring into the state of mind of the defendants or the reasonableness of the assumptions underlying the forward-looking statement itself.

Because the Reform Act is an amendment to the 1933 and 1934 Acts, it does not apply to claims under other federal statutes, or to claims under state law, whether brought in state court or as a diversity case in federal court. As we will see, it is this gap in the protections afforded by the Act that has drastically undermined its effectiveness.

A. What is a Forward-Looking Statement?

The statute defines the types of statements that are “forward-looking” within the meaning of the Act to include, (a) a statement containing a projection of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items; (b) a statement of management’s plans and objectives for future operations; (c) a statement of future economic performance, including statements in the MD&A or in the results of operations; (d) any statement of the assumptions underlying or

2. See 141 CONG. REC. H13,699-705 (daily ed. Nov. 28, 1995) [hereinafter Statement of Managers].

relating to any statement described above; (e) any report issued by an outside reviewer retained by an issuer which addresses a forward-looking statement made by the issuer; or (f) a statement containing a projection or estimate of such other items as may be specified by rule or regulation by the SEC.³

B. What Kinds of Transactions and Issuers Are Protected by the Act?

The Act reaches a narrower category of transactions and issuers, and is thus less broadly applicable to securities transactions that are frequently litigated, than the popular press has suggested. Not all issuers are eligible for the safe harbor. The company must be required to file annual, quarterly, and current reports with the SEC before it can qualify.⁴ The fact that this qualification applies to the company and not to each class of securities indicates that the safe harbor is intended to apply to forward-looking statements made in connection with a privately negotiated transaction involving unregistered securities, so long as the issuer has also issued publicly traded securities.

Certain categories of forward-looking statements are not protected by the Act. These include forward-looking statements contained in a financial statement prepared in accordance with generally accepted accounting principles; contained in a registration statement or other document issued by an investment company; and made in connection with a tender offer or an initial public offering.⁵ The safe harbor is also inapplicable to an offer by or

3. See 15 U.S.C. § 77z-2(i)(1) (Supp. II 1996); *id.* § 78u-5(i)(1). While this definition encompasses virtually all of the types of soft information that generate litigation, one category has generated confusion and concern among those who believe that the legislation may shield dishonest issuers. The protection for statements of “the assumptions underlying or relating to” any forward-looking statement appears on its face to cover statements that are not themselves forward-looking, but which state the underlying assumptions on which the issuer is relying in making the projection—assumptions which, by their nature, may relate to the present state of the company’s affairs rather than to the future. Although this issue—like so many under the statute—will have to await interpretation by the courts, false statements of historical fact are not covered by the safe harbor at all. It is unlikely that they will be held to have been immunized by the Act simply by being recited in the context of the assumptions said to underlie or relate to a forward-looking statement. That is the view expressed in the Conference Report. See Statement of Managers, *supra* note 2, at H13,703.

4. See 15 U.S.C. § 77z-2(a)(1); *id.* § 78u-5(a)(1).

5. See *id.* § 78u-5(b)(2)(A)-(D); *id.* § 77z-2(b)(2)(A)-(D). Beyond this, forward-looking statements concerning the “business or operations of the issuer” are not within the safe harbor if the issuer, within the three prior years, was subject to an antifraud SEC consent decree or cease and desist order or was the subject of a determination that it had violated the antifraud provisions of the securities laws, or had been convicted of any felony or misdemeanor described in section 15(b)(4)(B) of the 1934 Act. See *id.* § 77z-2(b)(1)(A); *id.* § 78u-5(b)(1)(A). Similarly, the safe harbor is not available to protect projections about the “business or operations of the issuer” made in connection with an offering of securities by a blank check company; or the issuance of penny stock; or in connection with a rollup transaction or a going private transaction. See *id.* § 77z-2(b)(1)(B)-(E); *id.* § 78u-5(b)(1)(B)-

relating to the operation of a partnership, limited liability company, or direct participation investment program or, finally, made in a disclosure of beneficial ownership of securities made in a Schedule 13(D) filing.⁶

The two most important exclusions delineated above are undoubtedly those concerning forward-looking statements in financial statements and in connection with initial public offerings. The banking industry, which is frequently the subject of lawsuits concerning loan loss reserves, did not procure hoped-for protection concerning statements in the financial statements describing reserves. One of the most interesting developments of the last two years, however, is that the same kinds of "meaningful cautionary language" and risk disclosure that one sees in disclosure documents that are protected by the safe harbor are *also* showing up in documents disseminated in connection with unprotected transactions.

The Act protects the statements not only of the issuer but also of a person acting on behalf of the issuer and "outside reviewers" (a term undefined anywhere in the Act or its legislative history) who are retained by the issuer and who are making a statement on its behalf.⁷ Forward-looking statements by underwriters are also protected with respect to information either supplied by the issuer or derived from information provided by the issuer (such as an underwriters' own analysis of projections supplied by the issuer).⁸ This leaves ambiguity regarding whether written reports disseminated after the quiet period by an analyst employed by the firm that underwrote a securities issue falls within the safe harbor; such an analyst is not acting on behalf of the issuer and is arguably not himself an "underwriter." Statements made by the underwriters and analysts at "road shows" seem to fit comfortably within the statutory definition. By contrast, the Conference Report states explicitly that the safe harbor is not intended to be applied to the sales practices of brokers.⁹

These exclusions raise interesting litigation issues. As discussed in more detail below, many of the substantive provisions of the new safe harbor rule track current law. Thus, one can expect the plaintiffs' bar to argue that Congress, by excluding certain transactions involving forward-looking statements from the statutory safe harbor, intended to weaken or remove parallel judicially-created protections as applied to those excluded

(E). However, because the exclusion from the safe harbor with respect to these categories only applies to forward-looking statements concerning the "business or operations of the issuer," presumably other types of forward-looking statements may still fall within the Act's safe harbor.

6. See 15 U.S.C. § 77z-2(b)(2)(E),(F) (Supp. II 1996); *id.* § 78u-5(b)(2)(E),(F).

7. See *id.* § 77z-2(a); *id.* § 78u-5(a).

8. See *id.* § 77z-2(a)(4); *id.* § 78u-5(a)(4).

9. See Statement of Managers, *supra* note 2, at H13,704.

statements. Against that position, a defendant could cite the statement in the Conference Report, admittedly made in a different context, that the committee “does not intend to replace the ‘bespeaks caution’ doctrine or to foreclose further development of that doctrine by the courts.”¹⁰ More generally, such a defendant could assert that the statute does not purport to change existing law in areas the statute does not expressly address.

C. *The Role of the SEC*

Each of these exclusions is subject to the proviso that the SEC may—by rule, regulation or order—provide otherwise.¹¹ The Conference Committee specifically stated that it intends the safe harbor to serve as a “starting point,” and that it expects the SEC to promulgate rules *expanding* the statutory safe harbor by providing additional exclusions from liability and extending its coverage to additional types of information.¹² Given the difficulty the SEC has had crafting its own revision to the safe harbor of Rule 175, the SEC is unlikely to move aggressively to expand the Act’s safe harbor until it has had substantial experience operating under the Act. The SEC may be more willing, however, to specify how the safe harbor should apply in particularized settings. For example, the SEC has promulgated rules that require registrants to disclose, among other things, certain market risks arising from certain holdings of derivative instruments.¹³ In so doing, the SEC has invoked its powers under the Act in order to create a safe harbor for forward-looking statements made pursuant to the new proposed regulations.

Many commentators have suggested that the SEC should also use its rule-making authority more vigorously, to clarify various ambiguous provisions of the statute, *e.g.*, by adopting a rule defining the types of cautionary language that are “meaningful” as that word is used in the Act. Indeed, many have criticized the SEC for steadfastly refusing to provide guidance to issuers, either in the context of specific filings reviewed by the staff, or in a release of more general applicability. The staff has consistently indicated that it wants to take a “wait and see” attitude before it plunges into this minefield. Indeed, in November 1997, at the Practising Law Institute’s annual securities

10. *Id.*

11. See 15 U.S.C. § 77z-2(b) (Supp. II 1996); *id.* § 78u-5(B).

12. See Statement of Managers, *supra* note 2, at H13,704.

13. See, *e.g.*, Commodities and Securities Exchanges 17 C.F.R. Parts 210, 228, 229, 239, 240, and 249 (1998) [Release Nos. 33-7386; 34-38223; IC-22487; Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments (Feb. 10, 1997)].

law conference, this author was on a panel with Brian Lane, the SEC's Director of Corporation Finance, who explained the staff's reluctance to provide concrete examples of compliant disclosures this way: "If you say it's a nice one, you're handing a get-out-of-jail-free card; and if you says it's a bad one, you'll get a lawsuit."¹⁴

This position seems short sighted. The SEC staff has a wealth of experience in dealing with these very issues. Leaving issuers and their counsel in the dark about the Commission's view of preferable disclosure practice engenders uncertainty and thus prudent timidity. It is simply unrealistic to think that many counsel will encourage their public-company clients to expand the range of their forward-looking disclosures in the present environment.

There are surely a number of factors that have combined to retard progress in this area, including the agonizingly slow pace at which federal statutory law is clarified by the courts, the continuing vulnerability of all issuers to state court litigation under *state* law and the lack of competitive pressure to make disclosures when business rivals are also being reticent. Nevertheless, it is clear to practitioners that the SEC's reluctance to articulate its views has materially exacerbated the problem.¹⁵

14. See 29 Sec. Reg. & L. Rep. (BNA) 1592 (Nov. 14, 1997).

15. Until recently, little attempt had been made to compile, in any kind of systematic way, evidence concerning actual use of the statutory safe harbor to provide additional forward-looking information. However, in November 1997, the author of this Article, along with three colleagues, published an empirical study of the subject. See Gerald S. Backman et al., *Forward-Looking Statements and Cautionary Language After the 1995 Reform Act: An Empirical Study*, in PRACTICING LAW INSTITUTE, *SAILING IN SAFE HARBORS: DRAFTING FORWARD-LOOKING DISCLOSURES* 153-226 (Ferrara et al. co-chairs, 1997). Our study examined the mechanics of disclosure of forward-looking statements and attempted to identify any changes in the frequency and substance of forward-looking statements made by reporting companies both before and after enactment of the safe harbor. To this end, we studied the filings of more than 60 companies, including firms listed on the New York Stock Exchange, the NASDAQ National Market System and the NASDAQ SmallCap Market. The empirical evidence shows that the safe harbor has had little effect to date on the written disclosure of forward-looking information. We concluded that, in the absence of federal preemption of state law claims, it was unlikely that issuers would dramatically alter their disclosure practices. The study is currently being updated by the Securities Regulation Committee of the Association of the Bar of the City of New York, for publication in the fall of 1998. For a contrary view, at least as it applies to the disclosure practices of high tech companies, see Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, Research Paper No. 1471, Stanford University Graduate School of Business (Jan. 1998). The Stanford study does not identify any company surveyed and quotes no disclosure documents at all, making it impossible to verify the study's conclusions.

D. When Are Forward-Looking Statements Immune from Liability?

The heart of the safe harbor provision is the section that defines the circumstances under which a forward-looking statement is immune from liability.¹⁶ Although as of mid-January 1998 there had been only two district court decisions construing the safe harbor—both very succinct and unilluminating—this does not leave a would-be interpreter of the scope and meaning of the Act at a total loss. The intellectual origins of the Reform Act's safe harbor provisions primarily lie in pre-Reform Act case law. An account of the pre-Reform Act case law is not an exercise in mere antiquarianism, but is a necessary step in any explication of the intended meaning and application of the safe harbor. The Reform Act did little more than codify and make nationally uniform the better reasoned cases from the circuit courts; every concept in the safe harbor is fully contemplated by prior case law. Thus, the result in any given case under the safe harbor as written is likely to be the same as the result under the pre-Act case law.

Pre-Reform Act jurisprudence is, therefore, the best predictor of how the statutory safe harbor provisions will be interpreted, and is thus not only a guide to conduct, but is the best source for elucidating the words of the Act when litigating. The few cases so far that have addressed the merits of the safe harbor both illustrate this point. In *Rasheedi v. Cree Research, Inc.*, the Middle District of North Carolina used analogies to prior Fourth Circuit law in holding that forward-looking statements made by the company in documents filed with the SEC and in press releases bespoke caution.¹⁷ Similarly, in *Harris v. IVAX Corp.*,¹⁸ the court, relying on the Third Circuit's pre-Reform Act case of *In re Donald J. Trump Casino Securities Litigation*,¹⁹ rejected plaintiffs' contention that the cautionary statements were boilerplate, pointing out that they were "tailored" to address the very uncertainties ascribable to the projections at issue. In the *In re Valujet* case, where defendant had raised the safe harbor and the bespeaks caution doctrine as separate defenses, the court nevertheless treated the requirements of the safe harbor and of prior law as though they dictated identical results.²⁰ Also in

16. The safe harbor provisions apply *only* to private civil litigations and not to enforcement proceedings brought by the SEC.

17. Nos. 1:96CV00890, 1:96CV01069, 1997 U.S. Dist. LEXIS 16968 (M.D.N.C. Oct. 17, 1997). The court also emphasized language from the Conference Report stating that "cautionary statements [must] identify important factors that could cause results to differ materially—but not all factors." *Id.* at *4-5.

18. 998 F. Supp. 1449 (S.D. Fla. 1998).

19. 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

20. 984 F. Supp. 1472 (N.D. Ga. 1997). The Northern District of Georgia refused to dismiss claims of misleading statements and omissions against Valujet concerning its business plans and safety

Wenger v. Lumisys, Inc., the court drew on pre-Reform Act case law to support its conclusion that forecasts of future results were actionable only if the issuer lacked a reasonable basis for them when made.²¹

It is worth noting that the enactment of the safe harbor will not stem the flow of pre-Reform Act case law for years to come. This is partly attributable to the fact that many cases filed before December 22, 1995 have not reached the summary judgment motion stage, let alone trial. Moreover, if a case was filed before December 22, 1995, and new defendants or new causes of action are added in amendments to the original complaint thereafter, the current trend in the courts is to hold that the Reform Act does not apply to the amendments.²² By contrast, the argument that the Reform Act should not be read to apply to *conduct* that predates its enactment has been rejected.²³

In private civil actions based on an untrue statement of material fact or an omission of a material fact, an issuer is not liable with respect to a forward-looking statement—whether written or oral—if it meets any one of three alternative tests:

- (a) it is accompanied by meaningful cautionary language;
- (b) it is immaterial; or
- (c) defendants lacked the requisite state of mind to commit fraud.

This Article will now discuss each of these tests in turn.

record because the statements at issue were not “forward-looking” within the meaning of the safe harbor. While the defendant characterized at least some of its statements as forward-looking and covered by the bespeaks caution doctrine, the court countered that “[p]laintiffs do not allege that Defendants fraudulently announced expansion plans and then failed to follow through on these plans. Instead, Plaintiffs allege misrepresentation of existing facts,” *i.e.*, that “FAA approval was required before expansion could be consummated.”

Curiously, in at least two cases governed by the Reform Act, the court applied the new pleading requirements, but ignored the safe harbor when it came to evaluating claims based on forward-looking statements. *See Cherednichenko v. Quarterdeck Corp.*, ¶ 90,108 Fed. Sec. L. Rep. (CCH), at 90,144 (C.D. Cal. 1997); *Powers v. Eichen*, 977 F. Supp. 1031 (S.D. Cal. 1997). In one recent case in which some claims were not covered by the safe harbor (because they were made in connection with an IPO), but other claims were subject to the Reform Act’s rules (because they related to post-offering disclosures), the court subjected all of the claims to exactly the same analysis and ignored the statutory safe harbor. *See In re Grand Casinos, Inc. Sec. Litig.*, ¶ 90,137 (CCH) Fed. Sec. L. Rep. (D. Minn. Dec. 9, 1997). It seems unlikely that application of the safe harbor to the post-offering disclosures would have had any impact on the outcome.

21. *See Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

22. *See, e.g., Baker v. Pfeifer*, 940 F. Supp. 1168 (S.D. Ohio 1996); *In re Prudential Sec. Inc. Lim. Partnerships Litig.*, 930 F. Supp. 68 (S.D.N.Y. 1996); *Wallace v. Systems & Computer Tech. Corp.*, No. Civ. A95-CV-6303, 1997 WL 602808 (E.D. Pa. Sept. 23, 1997). *But see Krear v. Malek*, 961 F. Supp. 1065 (E.D. Mich. 1997); *Rowe v. Marietta Corp.*, 955 F. Supp. 836 (W.D. Tenn. 1997).

23. *See Hockey v. Medheker*, No. C-96-0815 (MHP), 1997 WL 203704 (N.D. Cal. Apr. 15, 1997).

I. Accompaniment by Meaningful Cautionary Statements

There can be no liability for a forward-looking statement if it is:

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.²⁴

This provision stands in marked contrast to the original House bill (House Bill 10), which required only a recitation that actual results could differ from those predicted in the forward-looking statement. In short, Congress ultimately rejected the proposition that boilerplate warnings would suffice.

Congress rejected an SEC proposal to require the identity of the factors “most likely to cause actual results to differ,” and instead required only the identification of “important factors.”²⁵ As the Conference Report states, “the cautionary statements must convey substantive information about factors that realistically could cause results to differ.”²⁶ Although the statute does not define “meaningful cautionary statements,” an abundance of case law exists on this issue. Under both that case law and the Conference Report, an issuer need not identify all factors that could cause results to differ, and the factor that ultimately does cause the difference between an optimistic projection and the final results need not have been one of those identified in order to come within the safe harbor.²⁷

In most respects, the language of the Act codifies the materiality standard set forth in the Third Circuit’s *In re Donald J. Trump Casino Securities Litigation* decision²⁸ and reiterated in numerous other circuits, and makes that standard uniform nationwide. It should be evident, then, that in interpreting and applying this branch of the safe harbor, the key feature of pre-Act case law relevant to understanding and predicting how the safe harbor will be applied is the “bespeaks caution” doctrine, which has been

24. 15 U.S.C. § 77z-2(c)(1)(A)(i) (Supp. II 1996); *id.* § 78u-5(c)(1)(A)(i).

25. Nevertheless, an issuer would be foolhardy to list some, but not all, of the factors that could cause results to differ. Just as there was under prior law, there will be substantial litigation over whether a given set of risk disclosures really was meaningful or covered the important factors. The best protection—and the way to maximize the chances of winning a motion to dismiss—lies in making a serious effort to identify and disclose *all* the known material risk factors.

26. Statement of Managers, *supra* note 2, at H13,703.

27. *See Harris v. IVAX Corp.*, 998 F. Supp. 1449, 1454 (S.D. Fla. 1998) (“The Court will not, looking in hindsight, hold the Defendants to the impossible burden of having to warn of every factor that ultimately causes the forward-looking statement not to come true. Such an approach was not the intent of Congress and would effectively eviscerate the safe harbor.”).

28. 7 F.3d 357 (3d Cir. 1993).

adopted in principle by every circuit to consider it, most recently by the Tenth Circuit in *Grossman v. Novell*.²⁹

The doctrine holds that where a disclosure document's forecasts, opinions, or projections are accompanied by *meaningful* cautionary statements that are *tailored* to and directly concern the reasons for the projection, then the forward-looking statements are immaterial as a matter of law—even if they are alleged to contain misrepresentations or omissions, or flunk the SEC safe harbor test³⁰ of reasonableness.

In the Third Circuit's *Trump* case, decided on a motion to dismiss, the court assumed the truth of the plaintiff's allegations that the forward-looking statement was unreasonable or made in bad faith.³¹ But the court found that this unreasonableness or bad faith did not matter to the outcome, because if the investor is furnished with sufficient concrete risk factors that explain why the forward-looking statement may not be achieved, no reasonable investor could rely, as a matter of law, on that forward-looking statement. It simply does not alter the "total mix" of information. "[C]autionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law."³²

From the outset, courts have made it clear that there are limitations on the availability of the bespeaks caution doctrine. For example, a mere boilerplate disclosure is insufficient.³³ Moreover, as one court has pointed out, "simply disclosing the factual assumptions which underly" forward-looking statements is not sufficient.³⁴ The doctrine does not apply to statements of current or historical facts. The Reform Act adopts the same limitations. As all the prior case law (including *Trump*) also makes clear, protection for forward-looking statements does *not* extend to the misstatement or omission of material historical or present facts. And the Conference Report offers exactly the same proviso, stating that "a cautionary statement that misstates historical facts is not protected."³⁵

29. 120 F.3d 1112, 1120 (10th Cir. 1997).

30. 17 C.F.R. § 230.175 (1997).

31. See generally *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993).

32. *Id.* at 371.

33. See Statement of Managers, *supra* note 2, at H13,703, stating that "boilerplate warnings will not suffice as meaningful cautionary statements. . . . The cautionary statements must convey substantive information about factors that realistically could cause results to differ . . . such as, for example, information about the issuer's business." *Id.*

34. *Jakobe v. Rawlings Sporting Goods Co.*, 943 F. Supp. 1143, 1158 n.13 (E.D. Mo. 1996).

35. Statement of Managers, *supra* note 2, at H13,703. Let us try to make the point clearer with an example. Suppose that a company disseminates optimistic sales projections for a new pharmaceutical, but fails to reveal that the Food and Drug Administration has already advised that it believes the pharmaceutical to be unsafe for use by human beings. That projection would presumably not be protected under the statute because it omits a material and historical fact—the FDA findings—which,

Accordingly, in forward-looking statement cases after the Reform Act—as before its enactment—the main attack one expects to see plaintiffs make is that the omission or misrepresentation at issue is not about projections or soft information at all, but involves nondisclosure or misstatement of present or historical facts. Plaintiffs have become adept at characterizing disclosure of soft information as outside any safe harbor because they “really” contain an implicit statement about the company’s current situation. This has led the courts into considerable difficulties, and the results of all the cases are not readily reconciled.

One of the most clear-headed decisions to tackle this issue is *Harris v. IVAX Corp.* cited earlier, issued in March 1998. Judge Moreno hit the nail on the head:

Plaintiffs’ argument is correct from a grammatical perspective only. While the statement, “We believe that the challenges unique to this period in our history are now behind us,” technically reads as a statement of present condition the meaning of such a statement is clear enough: despite the recent rough period, good times are ahead. Representations regarding the state of a business’ position in a changing market or the soundness of its growth strategies are necessarily forward-looking. This is especially true where, as here, the representations are made mid-quarter, before the calculations businesses use to quantitatively evaluate their financial well being are completed. The IVAX press releases were not formal, periodic SEC filings. Until the numbers were crunched at the end of the quarter, the statements in IVAX’s press releases that the hard times were over and that the state of the company was strong were nothing more than projections intended to advise the market of anticipated third quarter financial results. These are exactly the kind of forward-looking statements that the Reform Act’s safe harbor was intended to shield.³⁶

In the *Gasner v. Board of Supervisors* case from the Fourth Circuit, decided on New Year’s Eve 1996, for example, two judges held that a statement that a solid waste company’s technology was “proven” and had been incorporated from existing facilities using the same “proven” design was not actionable because the prospectus negated this statement with cautionary language that there was no guarantee that the facility would operate functionally and that the issuer had never operated a similar facility.³⁷

because omitted, makes the projection misleading.

36. *Harris v. Ivax Corp.*, 998 F. Supp. 1449, 1453 (S.D. Fla. 1998).

37. 103 F.3d 351 (4th Cir. 1996).

But the dissent said the bespeaks caution doctrine simply does not apply because the statement regarding the “proven” characteristics of the design is not forward-looking at all. “Rather, it involves misrepresentations about, historical facts. ‘Proven’ describes an established fact, not a forward-looking projection.”³⁸

In a recent decision arising under the statutory safe harbor, the Northern District of Georgia refused to dismiss claims of misleading statements and omissions against Valujet concerning its business plans and safety record because the statements at issue were not “forward-looking” within the meaning of the safe harbor. While the defendant characterized at least some of its statements as forward-looking and covered by the bespeaks caution doctrine, the court countered that “Plaintiffs do not allege that Defendants fraudulently announced expansion plans and then failed to follow through on these plans. Instead, Plaintiffs allege misrepresentation of existing facts.” Specifically, that “FAA approval was required before expansion could be consummated.”³⁹ Further, in the case of *In re Westinghouse Securities Litigation*, the Third Circuit partially reversed the district court’s dismissal of the complaint because it could not find, as a matter of law, that defendants’ representations were projections and not misrepresentations of historical fact.⁴⁰

Assuming that the challenged statement is indeed forward-looking, the bespeaks caution doctrine can be a potent defense. *Parnes v. Gateway 2000, Inc.*, a case decided by the Eighth Circuit in August 1997, illustrates the effectiveness of well-drafted cautionary language.⁴¹ The plaintiffs claimed that the computer company misrepresented its obligations to pay sales taxes to states other than South Dakota. But the court pointed out that the prospectus warned investors that taxing authorities in other states had sought information regarding the sufficiency of Gateway’s contacts with the states, that the company had not established any reserves and that it might be required to pay income or franchise taxes in other states. The court found that “any reasonable investor would be on notice that Gateway faced potential state tax liability for states other than South Dakota.”⁴²

Gateway also warned that because of volatility of the computer industry, the introduction of new products was a risky venture and there was no assurance of success. This more generalized risk disclosure was also found to

38. *Id.* at 364.

39. *In re Valujet*, 984 F. Supp. 1472, 1479 (N.D. Ga. 1997).

40. 90 F.3d 696 (3d Cir. 1996).

41. 122 F.3d 539 (8th Cir. 1997).

42. *Id.* at 548.

be sufficient, even though it says little that is specific to a company or its products. Yet there is no question that some courts would have found the latter statement by Gateway to be too general to be “meaningful.”

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

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

In any given securities litigation, there is no way for the court or plaintiffs to know, at the beginning of the case, whether management really committed a fraud and what its actual state of knowledge was. The Reform Act reflects the recognition that the social costs, in the aggregate and over the long haul, of a rule that always allows plaintiffs discovery on the question of the state of mind of defendants in every case are just too high. These costs are especially significant in the high technology field where very often there are product delays and where earnings are frequently volatile and not predictable until the very end of a quarter.

Of course, it would be wonderful to have a rule that allowed courts and litigators unfailingly to be able to discriminate among the cases and to allow discovery to proceed only in those in which there was some reason to believe that, notwithstanding adequate cautionary language, the company’s management really did know that the predictions were not likely to come true. But because no such rule could ever be constructed, any rule will either allow a few dishonest issuers to win motions to dismiss or will impose enormous costs on honest companies and their shareholders. Congress has struck the balance in favor of protecting companies and their shareholders—a

balance which strikes me as absolutely correct.⁴³

2. Immateriality

Even if a forward-looking statement does not meet the test described above, the Act prohibits the imposition of liability based upon a forward-looking statement that is “immaterial.”⁴⁴ On this point the Act merely confirms existing law: an immaterial statement, even if made with knowledge that it is false, is not actionable under the 1933 or 1934 Acts. The Conference Report states that a forward-looking statement can be immaterial on “other grounds” even if it does not fit within the safe harbor.⁴⁵ So much is not in controversy.

What does this mean in the real world? The best way to start to make some sense of where courts draw the line is to review the only post-Reform Act case to address the issue, along with some recent pre-Reform Act cases.

In *Wenger v. Lumisys, Inc.*, the Northern District of California, relying on pre-Reform Act case law, held that a forward-looking statement is immaterial if it is a vague or general statement of optimism.⁴⁶ Thus, the Court held that the following statements were not actionable:

- “LUMI represents a pure play in the emergence of teleradiology networks, finally coming of age.”
- “We’re the leader in a rapidly growing market.”
- “We were able to perform two successful acquisitions last year . . .”
- “We have the convergence of the health care trends . . . Lumisys is positioned at the crest of those two converging trends.”
- “We have an extremely broad product line. We cover the waterfront.”
- “Fundamentally, we’re just a good company, we know our markets very well, we dominate these markets, we have good people, a good management team, and we’re positioned to move forward now.”⁴⁷

In *Burlington Coat Factory Securities Litigation*, the Third Circuit found a statement that the company “believe[d] [it could] continue to grow net

43. One law professor who read this Article before its publication has drawn my attention to an article of her own that essentially reaches the same conclusion. See Jennifer O’Hare, *Good Faith and the Bespeaks Caution Doctrine: It’s Not Just a State of Mind*, 58 U. PITT. L. REV. 619 (1997).

44. 15 U.S.C. § 77z-2(c)(1)(A)(ii) (Supp. II 1996); *id.* § 78u-5(c)(1)(A)(ii).

45. See Statement of Managers, *supra* note 2, at H13,703.

46. 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

47. *Id.*

earnings at a faster rate than sales” to be immaterial as a matter of law.⁴⁸ In *Grossman v. Novell*, a number of statements regarding growth were found to be “the sort of soft, puffing statements, incapable of objective verification, that courts routinely dismiss as vague statements of corporate optimism.”⁴⁹ As Judge Posner put it, in another case decided last year, a “nonspecific representation that auction process is going well” for a company is immaterial because the “heart of a reasonable investor does not begin to flutter.”⁵⁰

Courts have also recently found the following statements immaterial: the company “should deliver income growth consistent with its historically superior performance” and “we are optimistic about 1993”;⁵¹ the company “is on target toward achieving the most profitable year in its history”;⁵² the company is “‘well-positioned’ for growth”;⁵³ the company “had excellent new opportunities—domestic and international”;⁵⁴ the company is experiencing “continued strong demand.”⁵⁵

What *legal* principles can be derived from the cases?

First, even if a particular forward-looking statement does not fit squarely within the technical requests of the cautionary language exclusion of the Reform Act—for example, because not “identified” as such or not technically “accompanied” by cautionary language—such a statement should nevertheless be held to be immaterial as a matter of law because of the risk disclosures that did appear in the statement.

Second, the “immateriality” provision has also become an avenue for arguing the continuing vitality of the “truth on the market” defense—in other words, that *all* of the information in the marketplace, from whatever source derived, apprised the marketplace of the risks and thus rendered any optimistic statement immaterial. Several pre-Reform Act cases adopted this approach and the post-Reform Act case of *Wenger v. Lumisys, Inc.* suggests that it is doing so, as well.⁵⁶ Thus, in *Shaw v. Digital Equipment Corp.*, the First Circuit held in 1996 that the review for materiality can be “especially robust,” even at the motion to dismiss stage, where the complaint is alleging

48. 114 F.3d 1410, 1427 (3d Cir. 1997).

49. 120 F.3d 1112, 1121-22 (10th Cir. 1997).

50. *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 745 (7th Cir. 1997).

51. *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801, 811 (2d Cir. 1996).

52. *Hillson Partners Ltd. v. Adage, Inc.*, 42 F.3d 204, 212 (4th Cir. 1994).

53. *In re Caere Corporate Sec. Litig.*, 837 F. Supp. 1054, 1057 (N.D. Cal. 1993).

54. *Wallace v. Systems & Computer Tech. Corp.*, No. Civ. A. 95-CV-6303, 1997 WL 602808 (E.D. Pa. Sept. 23, 1997).

55. *Schoenhaut v. American Sensors, Inc.*, 986 F. Supp. 785, 791 (S.D.N.Y. 1997).

56. 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

fraud on the market—and thus the relevant inquiry is whether the market as a whole is likely to have relied on and been fooled by the statement.⁵⁷ The Second Circuit took the same route in the recent *In re Philip Morris Securities Litigation* case.⁵⁸

Third, the statutory “immateriality” standard can be invoked to protect statements that the courts have held to be mere puffery or so generalized in nature that they are immaterial even if unaccompanied by any cautionary language at all. This statutory test is also derived from pre-Reform Act case law, particularly strong in the Fourth Circuit, holding that puffery is not material and thus not actionable. The Fourth Circuit rule was sometimes construed as stating that predictions of growth or other optimistic opinions are not actionable at all. But a more nuanced reading of the cases reveals simply that the courts consistently held that vague, generalized predictions are immaterial and thus cannot be the basis for a fraud claim. Under pre-Reform Act law, puffery is immaterial even if unaccompanied by cautionary language. As the First Circuit put it in *Shaw*, “not every unfulfilled expression of corporate optimism” is material, since such “rosy affirmation[s]” are “numbingly familiar to the marketplace.”⁵⁹

Finally, the immateriality branch of the safe harbor can also be used to argue for dismissal of claims about forward-looking statements that are stale—that is, when they predate plaintiff’s purchase by a significant period, especially where, in the intervening period, information from issuers and other sources has been assimilated by the market.⁶⁰

Although many courts have been reluctant to address questions of materiality on a motion to dismiss under Rule 12(b)(6) for failure to state a claim, a number of judges prior to enactment of the Act have proven willing to do so.⁶¹ The Act and its procedural provisions should be construed as an invitation for judges to dispose of more cases at the Rule 12(b)(6) stage on materiality grounds.

3. Actual Knowledge of Falsity

Even if a forward-looking statement is not accompanied by cautionary

57. 82 F.3d 1194, 1218 (1st Cir. 1996); see also *Wallace*, 1997 WL 602808.

58. 872 F. Supp. 97 (S.D.N.Y. 1995), *aff’d in part and rev’d in part sub nom.*, *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801 (2d Cir. 1996).

59. 82 F.3d at 1217.

60. See, e.g., *Rand v. Cullinet Software Inc.*, 847 F. Supp. 200 (D. Mass. 1994).

61. A recent article discusses this line of judicial decisions. See Steven B. Rosenfeld, *Immateriality as a Matter of Law: An Effective Curb on Securities Fraud Litigation*, 28 REV. SEC. & COMMODITIES REG., Oct. 11, 1995, at 169.

language and is not immaterial, the statement can be immunized from liability on a third independent ground under the Act. If plaintiff fails to plead and prove that the forward-looking statement was made with actual knowledge that the statement was false or misleading, then a claim does not lie.⁶²

This standard sets forth a more rigorous test—actual knowledge of falsity—than is traditional under Rule 10b-5, which courts have construed to create private liability for statements that were merely reckless. Moreover, as the safe harbor for forward-looking statements applies, in identical language, to claims under both the 1933 Act and the 1934 Act, the effect of the statute is to require proof of scienter in actions under the 1933 Act when forward-looking statements are in question. In that way, the Act displaces, for forward-looking statements, the strict liability standard (subject only to a limited due diligence defense) now contained in sections 11 and 12(2) of the 1933 Act. Given the scienter requirement in this standard, a plaintiff will now have to plead fraud with particularity required by Rule 9(b) even in a claim arising under the 1933 Act.⁶³

What must a plaintiff prove to satisfy this rigorous test? Certainly, a plaintiff could do so by proving that when the defendant made the forward-looking statement, he knew the result would be different. Presumably, the plaintiff could also prove the defendant knew that the forward-looking statement was misleading because it omitted to disclose present facts that would foreseeably cause results to differ. Thus, if the issuer knew that it had just lost its biggest customer or that a key product had been found to cause cancer, and further knew that those facts would have a material impact on its projection, but omitted to disclose those facts, a court would be quite likely to find that, under the Act, the forward-looking statement was made with actual knowledge that it was misleading.

62. See 15 U.S.C. § 77z-2(c)(1)(B) (Supp. II 1996); *id.* § 78u-5(c)(1)(B). The Act makes a distinction between statements by natural persons, who must themselves be proved to have made the statement with actual knowledge of fact that the statement was false or misleading, and statements made by the issuer. In the latter category, the plaintiff must show that the statement was made by or with the approval of an executive officer of the issuer and that it was made or approved by such officer with actual knowledge by the officer that this statement was misleading.

63. Note, however, that the now famous enhanced pleading requirements imposed in fraud cases under the Reform Act apply only to claims under the 1934 Act. Thus, although Congress presumably did not intend this result, one has the anomaly that a claim about a forward-looking statement under the 1933 Act will require pleading consistent with *old* Rule 9(b), whereas the same forward-looking statement challenged in the same lawsuit under the 1934 Act will be subject to the new statutory requirement that the plaintiff plead the reasons why the statement was misleading and all facts giving rise to a strong inference that the defendant acted with the required state of mind.

E. Oral Forward-Looking Statements

Many forward-looking statements and projections are made orally by senior executives to the financial press and to analysts. Even before the Reform Act, case law indicated that oral forward-looking statements could bespeak caution and must be reviewed in the context of the disclosure documents that the company has contemporaneously disseminated, at least where the speaker expressly warns of the risks that the projections may not be achieved.⁶⁴

The Reform Act codified this incipient development by providing that, for oral forward-looking statements, the requirement that a forward-looking statement be accompanied by meaningful cautionary language is satisfied if (a) the statement is identified as forward-looking, (b) the speaker states that actual results could differ materially from those projected, and (c) the oral statement is accompanied by an oral statement that additional information concerning factors that could cause actual results to differ materially is contained in a specifically identified and “readily available document”—which, the Conference Report makes clear, means a “widely disseminated” document—such as an SEC filing, annual report, or press release.⁶⁵ Of course, the information contained in the written document must itself contain a cautionary statement that satisfies the statutory standard.

Many companies, in fact, are clearly more comfortable providing “guidance” to analysts and institutional investors in the informal setting of a conference call or a one-on-one telephone conversation, in which a highly ritualized set of code words has evolved. They allow the company’s officials to push the analyst’s conclusions in the right direction—thereby managing the market’s expectations—without falling into the trap of endorsing or “entangling” the company with the analyst’s independent work product, thereby giving rise to liability.⁶⁶ The decided preference for oral “guidance” appears to have continued in the post-Reform Act era; indeed, the latest empirical study suggests that companies are giving more explicit oral “guidance” than ever before.⁶⁷

64. See *In re Seagate Tech. II Sec. Litig.*, [1994-1995 Decs.] No. C-89-2493(A)-VRW, 1995 WL 66841 (N.D. Cal. Feb. 8, 1994).

65. 15 U.S.C. § 77z-2(c)(2) (Supp. II 1996); *id.* § 78u-5(c)(2); Statement of Managers, *supra* note 2, at H13,703.

66. For detailed discussions of the case law, see, for example, Olson, et al., *The Perils of Presstek: The SEC Addresses Entanglement and Adoption of Analysts’ Reports*, 12 INSIGHTS 2 (Mar. 1998); Richard A. Rosen, *Liability for “Soft Information”: New Developments and Emerging Trends*, 23 SEC. REG. L.J. 3, 17-22 (1995). For the most recent case, see *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

67. See NATIONAL INVESTOR RELATIONS INSTITUTE, A STUDY OF CORPORATE DISCLOSURE

The Conference Report explains that it is likely to be unwieldy to make oral forward-looking statements that comply with all of the otherwise applicable requirements for the safe harbor, and that therefore more flexible rules are necessary.⁶⁸ The Reform Act, in the context of oral forward-looking statements, calls for the specific incorporation of a detailed cautionary statement by reference to a "readily available written document."⁶⁹

Only one decision to date discusses how the safe harbor for oral statements is actually supposed to work in practice. Rejecting plaintiff's argument that each particular oral forecast in a conference call has to be coupled with cautionary statements, the district judge in *Lumisys*⁷⁰ took a sensible, pragmatic approach that is also consistent with the statutory language:

First, the unwieldy practice advocated by plaintiff appears contrary to the way in which public companies currently deliver oral forward-looking information, and contrary to the way in which people communicate. A court need not adopt an interpretation of statutory language in a way that leads to absurd or futile results at variance with policy or legislation as a whole. *E.E.O.C. v. Commercial Office Products Co.*, 486 U.S. 107, 120, 108 S.Ct. 1666, 100 L.Ed.2d 96 (1998); *United States v. American Trucking Assns., Inc.*, 310 U.S. 534, 543, 60 S.Ct. 1059, 84 L.Ed. 1345 (1940). Moreover, the legislative history supports defendants' view. The House Committee described the rule governing oral statements as "flexible" and as no more cumbersome than the rules governing written forward-looking statements. House Conf. Report No. 104-67, 1995 U.S.C.C.A.N. (109 Stat. 737), 744-45. Furthermore, the Senate Committee Report directly stated:

In the case of oral statements, the Committee expects that the notice will be provided at the outset of any general discussion of future events and that further notice will not be necessary during the course of the discussion.

Senate Report No. 104-98, Pub. L. No. 104-67, 1995 U.S.C.C.A.N.

PRACTICES (1998).

68. Statement of Managers, *supra* note 2, at H13,703.

69. The Act's protection for oral forward-looking statements applies by its terms *only* to the issuer and persons acting on its behalf.

70. 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

(109 Stat. 737) 679, 696.⁷¹

An interesting and unsettled issue is whether the Reform Act has, perhaps inadvertently, *narrowed* the protection afforded by prior judicial decisions to oral forward-looking disclosures. Pre-Reform Act case law consistently recognized that oral statements can bespeak caution when reviewed in the context of all of a company's contemporaneously outstanding public disclosures, as well as in the context of all other information in the market, regardless of its source. Courts find this concept especially compelling where plaintiffs are relying on a fraud on the market theory; if the oral statement is being conveyed to the market by the press or an analyst's report, it becomes part of the total mix and therefore cannot be viewed in isolation, but only in the context of all the information out there in the world—this is the “truth on the market” defense.

The Second Circuit's *In re Philip Morris Securities Litigation* case provides a striking example of a decision which requires consideration of the context of the total mix of information available at the time of each disputed oral statement.⁷² In *Philip Morris*, the court found oral statements of optimism regarding the future performance of Marlboro against discount cigarettes nonactionable, in the context of other disclosures “relating to the defection of consumers from Marlboro to discount brands, as well as references to the difficulties of predicting the impact of the discount market.”⁷³

In *Grossman v. Novell*, decided in August 1997, the Tenth Circuit found that statements made by company executives in interviews and press releases were done so “in conjunction with a registration statement that contained many explicit risk factors and warnings. . . .”⁷⁴ While the plaintiff argued that the cautionary language appeared in separate documents from the interviews and press releases, the court stuck to a theory based on the “total mix” of information available. It found that the challenged statements, made from April to July 1994, were all “closely proximate in time to the registration statement,” itself first filed in April and amended in July 1994, and thus covered by the cautionary language contained in it.⁷⁵ Thus, even though the challenged statements may not have explicitly referred to the cautionary language in the prospectus, the court found that all the statements were

71. *Id.*

72. *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801 (2d Cir. 1996).

73. *San Leandro*, 75 F.3d at 811.

74. 120 F.3d 1112, 1121 (10th Cir. 1997).

75. *Id.* at 1123.

linked by timing and context.

In *Schoenhaut v. American Sensors, Inc.*, another recent decision, a judge in the Southern District of New York dismissed claims that included a claim that the defendant made oral misrepresentations during road shows in support of an offering.⁷⁶ The court found that any road show presentations were both not only mere “estimates of future performance made 18 months in advance,” but were in any event “subsequently contradicted by specific disclosures in the Prospectus—which any plaintiff, regardless of his or her level of sophistication, could have read.”⁷⁷

Whether such a broad view of the context in which oral statements should be considered survives the enactment of the Reform Act remains in question. The Act appears to require a more specific link between oral statement and published cautionary language, yet there is a strong tradition of looking at the “total mix” of information in fraud-on-the-market cases.

The truth of a statement, of course, remains a good defense under both pre-Reform Act and current jurisprudence. In a class action against IBM, the Southern District of New York recently awarded summary judgment to the defendant because it found that oral statements made by company management in October 1992 that IBM would continue to pay dividends “for quite a foreseeable time” were true in the context in which they were made, even though IBM later revised its statements in December 1992 and announced doubts about being able to maintain payments in 1993.⁷⁸

Conversely, as discussed above, patently false oral statements cannot be covered by reference to cautionary language. In *Fugman v. Aprogenex*, the court refused to dismiss a complaint alleging fraud in a company’s oral statement that it had “fixed” a problem with its technology, when in fact the technology would not be marketable in the near future. The court pointed out that the statement that the problem was “fixed” effectively overrode earlier cautionary statements, and was akin to saying that an investment was now safe.⁷⁹

The availability of a new statutory safe harbor for oral forward-looking statements makes it all the more imperative that executives consult with counsel and plan before making oral statements about their company’s future prospects. If such statements are to be made, the speaker should advise his or

76. No. 95 CIV. 1465 (BSJ), 1997 WL 731804 (S.D.N.Y. Nov. 14, 1997).

77. *Id.* at *9.

78. *In re International Bus. Mach. Corp. Sec. Litig.*, 954 F. Supp. 81 (S.D.N.Y. 1997).

79. 961 F. Supp. 1190, 1198 (N.D. Ill. 1997). It was not helpful to the defendant that it had orally “dismissed the cautionary language in their public disclosures as inaccurate and indicated that the language existed only because it was ‘required by the lawyers.’” *Id.* at 1193.

her audience that written documents containing the relevant cautionary language are readily available. Neither the Act nor the Conference Report says that the “readily available” document must already be in existence at the time of the oral statement. Thus, if the speaker is discussing late-breaking developments and is not sure that the appropriate cautionary language is to be found in an extant written document, the company will have to consider promptly issuing an 8-K that contains the requisite cautionary language. Otherwise, however awkward this requirement may be, an oral forward-looking statement can be assured of protection only if the oral statement itself is simultaneously accompanied with meaningful oral cautionary statements identifying important factors that could cause actual results to differ. Thus, the Act makes it more important than ever that companies identify and limit the number of officers who are authorized to provide oral forward-looking statements. These officers must be educated as to the requirements of the Act.

F. The Duty to Update Projections and Forward-Looking Statements

A substantial body of case law from recent years deals with the question of when an issuer has a duty to update prior forward-looking statements. Generally speaking, the judicial consensus had been that the duty to update does not arise whenever a company makes a forward-looking statement or projection that was reasonable at the time but which, because of *subsequent* events, has become untrue. In contrast, however, if a company makes a statement that is revealed by subsequently discovered information to have been inaccurate or unfounded at the time it was made, the company must correct the prior statement within a reasonable period of time. The Seventh Circuit held in *Stransky v. Cummins Engine Co.* that liability cannot be based on circumstances that arise after the speaker makes the statement, because the securities laws “typically do not act as a Monday Morning Quarterback.”⁸⁰

However, this relatively brightline rule is plainly eroding, and the law is just not very clear anymore. The main culprit is a recent decision by the United States Court of Appeals for the Third Circuit in *Weiner v. Quaker Oats Co.*,⁸¹ arising out of Quaker Oats’ acquisition of Snapple. The

80. 51 F.3d 1329, 1332 (7th Cir. 1995). Although a company has no duty to update forward-looking statements merely because changing circumstances have proven them wrong, a company can of course limit its liability for a projection that was unreasonable when made by updating and correcting it. *Id.*

81. 129 F.3d 310 (3d Cir. 1997).

acquisition made Quaker a much more highly leveraged company, raising its total leverage ratio to about eighty percent. Plaintiffs alleged that the company had violated a duty to update its prior disclosures, in which Quaker had advised the market that it had adopted a much lower debt-to-equity “guideline.” The complaint depended on the assertion that the projected debt-to-equity ratio—and the failure to correct the guideline when it became inaccurate—had artificially inflated the price of the company’s common stock.

The Third Circuit held that it was a question of fact as to whether the market would have expected the company to make another prediction about its leverage guideline if its leverage ratio were going to change significantly by virtue of the anticipated acquisition. The Third Circuit relied heavily on its own earlier decision in *In Re Phillips Petroleum Securities Litigation*,⁸² in which the court recognized that the anti-fraud provisions of securities laws do not impose a general duty to update or correct prior statements that were accurate when made, but that “a duty exists to correct prior statements, if the prior statements were true when made but misleading if left unrevised.”⁸³ Since the *Phillips* case involved a fairly unequivocal statement of intent, rather than a more amorphous projection or guideline, many practitioners had read the *Phillips* case relatively narrowly and as largely consistent with the general concept that there is no duty to update projections. The *Quaker Oats* decision casts substantial doubt on whether, at least in the Third Circuit, even accurate predictions must be updated if the underlying circumstances change.

The Reform Act is no help to one in search of illumination on this subject. It appears to have neither expanded nor contracted the prior law. There is a section of the statute called “Duty to Update,” which reads in its entirety as follows: “Nothing in this section shall impose upon any person a duty to update a forward-looking statement.”⁸⁴

The Conference Report does not add anything to this statement. Although some have suggested that the intent of the provision is to *eliminate* any duty to update, the more plausible reading is that the Act does not impose any obligation to update that does not already exist.

What *does* seem clear, however, is that Quaker Oats might have had a strong defense if it had cast its statement about its debt-to-equity ratio guideline as forward-looking. It could have told the market that the guideline was subject to revision or abandonment if the company ever decided to make a strategic acquisition.

82. 881 F.2d 1236 (3d Cir. 1989).

83. *Id.* at 1245.

84. 15 U.S.C. § 77z-2(d) (Supp. II 1996); *id.* § 78u-5(d).

G. Duty to Disclose Forward-Looking Statements During the Quarter

Another subject on which the Reform Act sheds no light relates to the extent to which issuers must make disclosure during a quarter about changes in their business as they occur. Issuers ordinarily do not have to disclose operating results as a quarter progresses—for example, declining sales or reverse trends, changes in product mix or margins, delays in new product introductions, etc.—unless it is necessary to correct a prior statement inaccurate at the time it was made. Financial information is normally disclosed quarterly—as is a company's views of known trends and uncertainties—in the MD&A section of its Forms 10-K and 10-Q. No rule requires the routine reporting of mere changes, or anticipated changes, in operating results during a quarter. A number of cases have said that there is no duty to make intraquarter disclosures, even if results are below a company's own, and the market's, expectations.⁸⁵

Strong policy reasons support this rule. It takes time for a company to generate accurate and reliable information regarding current performance, to analyze the information meaningfully. Requiring disclosure of such information is therefore tantamount to requiring disclosure of internal projections that will constantly change as the quarter progresses. That information is inherently transitory and fragmentary, even if it is in some metaphysical sense "current" or "unknown." As one district court has held, "regardless of whether a public offering occurs seventeen or only two days before the close of a fiscal quarter, data concerning a quarter that is in progress is necessarily incomplete."⁸⁶

There is one context, however, in which the case law suggests that a company might sometimes be required to make additional intraquarterly disclosures—where the company is effecting a public offering and there is a trend that, if continued through the end of the quarter, is likely to result in an "extreme departure" from the range of results expected by the marketplace based on publicly available information. The precise scope of this duty is not clearly defined.

The two key cases are from the same court and were both written by the same judge. The First Circuit has rejected a brightline rule that operating

85. See *Steckman v. Hart Brewing, Inc.*, No. CIV. 96-1077-K, 1996 WL 881659, at *4 (S.D. Cal. Dec. 24, 1996) ("companies have no duty to disclose intraquarter results, even if those results are lower than the company's internal projections"), *aff'd on other grounds*, 143 F.3d 1293 (9th Cir. 1998).

86. *Zucker v. Quasha*, 891 F. Supp. 1010, 1016 (D.N.J. 1995), *aff'd*, 82 F.2d 408 (3d Cir. 1996), *cert. denied*, 117 S. Ct. 85 (1996); *accord Schoenhaut v. American Sensors, Inc.*, No. 95 CIV 1464 (BSJ), 1997 WL 731804 (S.D.N.Y. Nov. 14, 1997).

information is never subject to disclosure until the quarter comes to an end, but appears to have drawn distinctions based on the *timing* of the public offering. In *Shaw v. Digital Equipment Corp.*, the court reversed the district court's dismissal of the complaint because it could not conclude, in the absence of any factual record, that there was no duty to disclose intraquarter financial information when Digital's public offering became effective eleven days before the end of its quarter, and when it may have had information—if plaintiff's allegations were true—"indicating some substantial likelihood that the quarter would turn out to be an extreme departure from publicly known trends and uncertainties."⁸⁷

In *Glassman v. Computervision Corp.*, by contrast, the First Circuit affirmed the district court's denial of plaintiff's motion to file an amended complaint.⁸⁸ In *Computervision*, plaintiffs alleged that the company had made material omissions in the prospectus for an initial public offering regarding its intraquarter performance. While the First Circuit reaffirmed aspects of the position it had taken in *Digital*, saying that "there is a strong affirmative duty of disclosure in the context of a public offering," it distinguished this case from *Digital* based on the timing of the public offering.⁸⁹ Here, the IPO was "more remote in time and causation" from the end of the quarter—the offering took place seven weeks into the quarter. Requiring disclosure at this juncture, the court said, amounted to requiring an issuer to "divulge[] its internal predictions" about how the quarter might ultimately turn out.⁹⁰

While *Digital* and *Computervision* presented similar facts, the court appears to have been heavily influenced by the timing of the public offerings in each case. Thus, the court seemed to say that the earlier in the quarter is the offering, the less predictive the intraquarter information is likely to be of the actual results. In other words, the information becomes so attenuated as to be immaterial as a matter of law.⁹¹ Indeed, the *Computervision* panel cited

87. 82 F.3d 1194, 1211 (1st Cir. 1996). The author represents Digital in this case, which is ongoing.

88. 90 F.3d 617 (1st Cir. 1996).

89. *Id.* at 623.

90. *Id.* at 632.

91. For a discussion of these two cases and the First Circuit's materiality analysis, see Note, *Living in a Material World: Corporate Disclosure of Midquarterly Results*, 110 HARV. L. REV. 923 (1997). Other recent cases involving a duty to disclose, or a duty to update information that has become misleading, simply reflect the maxim that when a company is required to make disclosures, as in the 10-K or 10-Q, those disclosures should be fully accurate. In *Simon v. American Power Conversion Corp.*, 945 F. Supp. 416 (D.R.I. 1996), the court refused to dismiss a claim alleging that a manufacturer failed to fully disclose all the material information that may have been available to it—namely, that a product defect was causing increases in inventory and delays in production—in a quarterly report. Relying on SEC regulations governing the content of quarterly reports, the court

Zucker v. Ouasha,⁹² without disapproval, presumably because the information in that case was remote in time and causation from the results it purportedly predicted.

III. THE NEED FOR FURTHER LEGISLATIVE ACTION

When Congress enacted the Reform Act, it appeared to have given little or no consideration to the risk that the enhanced procedures and substantive legal protections accorded to forward-looking disclosures could be nullified by resort to state courts where purported nationwide class actions are pursued under state law causes of action.⁹³ Yet in the two and a half years since the Reform Act was enacted, there has been a pronounced shift within the plaintiffs' bar toward filing cases in state court, especially where the core claim turns on whether projections were unreasonable or made in bad faith. My own case load of new matters in the last two years is now evenly divided between nationwide actions filed in federal and state courts. There has been a remarkable and sustained change in strategy by plaintiffs, the full effects of which will take years to sort out.

The most recent statistics bear this conclusion out objectively. Stanford Law School maintains a website called the Securities Class Action Clearinghouse, which tracks such filings. As of December 1997, in the two years after enactment of the Reform Act at least 104 class actions had been filed in state courts across the country—not just in California, but in Alabama, Arizona, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Maryland, Massachusetts, Montana, Nevada, New Jersey, New Mexico, New York, Ohio and Texas.

Although some surveys suggest that there has been a modest decline in the absolute number of such filings in 1997 compared to 1996, it is clear that state court securities class action filings have increased dramatically compared to the volume before the Reform Act. Moreover, all samplings undercount the actual state filings, because there is no central repository of

concluded those regulations "imposed an obligation to disclose the discovery of the defect in its first quarter 10-Q report, even though the effects of the discovery would not be realized for accounting purposes until the next quarter." *Id.* at 431. Because the information was "hard" information about a "known trend or uncertainty," disclosure was required.

92. 891 F. Supp. 1010 (D.N.J. 1995), *aff'd*, 82 F.2d 408 (3d Cir.), *cert. denied*, 117 S. Ct. 85 (1996).

93. Some portions of this section of this Article appeared in a different form in a dissent, authored by Martin Seidel and me, to the Report on *Securities Litigation Uniform Standards Legislation*. See Commercial and Federal Litigation Section of the New York State Bar Ass'n, *Securities Litigation Uniform Standards Legislation* (Dec. 1997).

information concerning such cases.⁹⁴ The significance of the 1997 figure is also doubtful in light of the bull market experienced in the past year.

The most up-to-date and comprehensive study of filing rates in both state and federal court demonstrates conclusively that (a) the Reform Act has not caused a decline in the volume of securities class action litigants, wherever filed; and (b) that the volume of state court litigation remains dramatically higher than before enactment of the Reform Act.⁹⁵ This study also appears to confirm what every litigator knows from experience—the weaker cases, which would not pass muster in federal court under the safe harbor and the new stringent pleading requirements, are the ones being filed in state court.

The numbers over the relevant two-year period thus reflect a shift that is surely a direct response to a gaping hole in the regulatory scheme enacted by Congress. In attempting to encourage more forward-looking disclosure by narrowing the grounds on which liability can attach, Congress neglected to preempt inconsistent state laws.

One particularly alarming and unintended consequence of the procedural rules for securities litigation that were enacted by the Reform Act—particularly the safe harbor and discovery stay—has been an apparent increase in the filing of state court actions that are brought by the same plaintiffs and law firms who have filed federal class actions, with identical or nearly identical allegations. Both the SEC and Professors Grundfest and Perino have noted this trend. In its April 1997 Report on the impact of the Reform Act, the SEC stated:

[T]he number of state filings reportedly has increased. Moreover, many of the state cases are filed parallel to a federal court case in an apparent attempt to avoid provisions of the Reform Act.⁹⁶

94. See, e.g., Price Waterhouse Securities Litigation Study, (visited Jan. 13, 1998) <<http://www.10b5.com>>. It is bewildering, to say the least, to encounter the argument that, since a large percentage of the state class actions are being filed in California, this is a purely local problem that it is up to the California legislature to solve. On the contrary, national corporations that have no more meaningful contact with California than with any other state are repeatedly being required to defend their national disclosure practices under state law even if no federal law was violated—a spectacle that presents a *national* problem that calls out for a national solution.

95. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998).

96. See Securities and Exchange Commission, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, Apr. 1997 [hereinafter Staff Report]; see also Joseph Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, at 7 (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 140, Feb. 1997).

In 1997 congressional testimony, SEC Chairman Levitt stated that 55% of the state claims filed since the Reform Act were “essentially identical to those brought by the same law firm in federal

This phenomenon is especially striking in California, but has not been confined to that state. The California courts have often denied defendants' motions to stay the state court discovery, even though the parallel proceedings are transparently designed to end-run the federal stay. And the California Supreme Court recently denied certiorari in one such case—making it likely that, without congressional action, this problem will not go away any time soon.

To make matters worse, defendants have been sued by rival plaintiff's law firms in functionally identical purported nationwide class actions in two or more different states. Because each plaintiff's firm wants to be lead counsel and thus have access to the lion's share of any ultimate fee award, it is not always possible to get them to cooperate and voluntarily consolidate the cases in one forum. If the cases are not removable to federal court, there is no reliable procedural mechanism to force the litigants into one forum. Defendants must fall back on state law doctrines of "forum non conveniens" and "prior action pending," which do not always result in all the cases being sent to the same judge. This increases costs and gives rise to the risk of inconsistent adjudications.⁹⁷ Thus, rather than reduce the litigation costs imposed by class actions, the availability of state law claims filed in separate actions to end-run the Reform Act has perversely forced defendants to fight multi-front wars.

The risk of liability—or at least the risk of losing on a motion to dismiss or for summary judgment—is dramatically enhanced by the fact that the law of many states in this field is relatively undeveloped. As can readily be appreciated, the task of counseling clients and predicting and controlling liability exposure is made significantly more complex where the legal regime to be applied is unstable, and where the judge before whom one appears is likely never to have seen a securities case before. Small wonder, then, that most well-counseled companies are taking a very conservative, go-slow approach to forward-looking disclosure opportunities.

Curiously, while the SEC report was often cited by opponents of preemption legislation (at least prior to the SEC's announcement on March

court." Testimony of Arthur Levitt Before the House Subcommittee on Finance and Hazardous Materials, Oct. 21, 1997, at 12. The Staff Report further suggests that some of the state claims "may migrate to federal court after discovery has taken place." Staff Report, *supra*, at 22.

97. Of course, this problem is not peculiar to securities litigation, but arises in several types of class actions, including mass torts and product liability. Amendments to the *United States Code* to enlarge federal subject matter jurisdiction over purported class actions are under active debate; they would liberalize the rules under which such cases filed in state court can be removed to the federal district courts and provide that diversity jurisdiction can be satisfied so long as *any* class member is a citizen of a state diverse from that of any defendant.

24 that it *favored* preemption legislation), its key findings plainly support the perceived need for just such a statute. Among other points, although the Commission recognized that “state court has not traditionally been the primary forum for securities class actions,” the Report verifies that there has been a discernable increase in state court filings since passage of the Reform Act.⁹⁸ Strikingly, the SEC posits that this increase “may be *the most significant* development in securities litigation post-Reform Act.”⁹⁹ The SEC also acknowledged that this development “may reflect a migration of weaker cases to state court”¹⁰⁰ and that many defendants now face parallel federal *and* state cases, which leads to “*greater* litigation expense than pre-Reform Act.”¹⁰¹

It is evident that the availability of state court actions for common-law fraud or under state blue-sky laws continues to undermine the utility of the safe harbor for forward-looking statements provided by the Reform Act. Corporations remain reluctant to take advantage of the safe harbor for forward-looking disclosures because of a perfectly reasonable fear that state-law securities or common-law fraud claims can be brought against them in state class actions. Although a handful of states such as Ohio have adopted, or are considering adoption, of “Baby Reform” Acts that emulate the substantive provisions of the federal law, the vast majority of states have common law or statutory standards that are far less restrictive.

Although some have expressed skepticism that fear of state court liability is “really” behind the underwhelming corporate response to the safe harbor, the empirical evidence is convincing. The SEC, in the Staff Report, stated that:

Companies have been reluctant to provide significantly more forward-looking disclosure than they had prior to enactment of the safe-harbor The two most frequently cited reasons are (i) the safe harbor provision is still new and companies are waiting to see how courts will interpret it and how other companies are using it; and (ii) fear of state court liability, where forward looking statements may not be protected by the Federal safe harbor.¹⁰²

Fear of state court liability has been repeatedly stressed by representatives of corporate issuers as the primary reason they have not availed themselves

98. Staff Report, *supra* note 96, at 69.

99. *Id.* at 2.

100. *Id.* at 80

101. *Id.* at 70.

102. *Id.* at 3.

of the safe harbor.¹⁰³

That these fears are far from capricious is borne out by further findings of the SEC Report. Thus, the Commission found empirical evidence that state court complaints “are more likely to be based solely on forecasts which have not materialized.”¹⁰⁴ As a matter of fact, the Commission’s data shows that allegations based on forward-looking statements are more than *twice* as likely to be filed in state than in federal court: twenty-five percent of “stand alone” state complaints (those filed without a parallel federal suit) “are based solely on failed forecasts (as compared to twelve percent at the federal level).”¹⁰⁵

To be sure, some have called for more empirical research to attempt to measure how significant is the fear of state court litigation. Wholly apart from the fact that there is no empirical way to segregate fear of state law liability from the impact of other factors, I submit that the objection is incorrect in principle. Even if fear of state law liability is only one obstacle to realization of congressional intent, and even if the absolute number of state court filings has abated, there is an omnipresent risk that any given issuer will be sued in state court, thus evading core federal policies. Passage of uniform standards legislation will eliminate at least one obstacle to greater use of the safe harbor.

Similarly, some critics have contended that legislation is superfluous because it is unlikely that plaintiffs will shift claims to state court because of substantive and procedural problems with nationwide class actions in state courts. They point to the fact that most states—including California and Delaware¹⁰⁶—have refused to endorse the fraud-on-the-market doctrine, enshrined in the Supreme Court’s decision in *Basic Inc. v. Levinson*,¹⁰⁷ that is a *sine qua non* of federal securities class actions. Moreover, they contend that there are major due process obstacles to applying the substantive law of one state to all members of a nationwide class—as illustrated by the Supreme Court’s decision in *Phillips Petroleum Co. v. Shutts*.¹⁰⁸

But these trends (however salutary they may be) are of cold comfort to issuers today. These issues are being litigated in state courthouses all over the

103. Letter from American Electronics Associates to Representative Thomas J. Bliley, Jr. (Apr. 10, 1997), *quoted in* Staff Report, *supra* note 96, 23.

104. Staff Report, *supra* note 96, at 2, 5.

105. *Id.* at 73.

106. See *Mirkin v. Wasserman*, 858 P.2d 568 (Cal. 1993); *Gaffin v. Teledyne, Inc.*, 611 A.2d 467 (Del. 1992).

107. 485 U.S. 224 (1988).

108. 472 U.S. 797, 818, 821-22 (1985). *Accord, e.g., Osborne v. Subaru of America, Inc.*, 198 Cal. App. 3d 646, 654-59 (1988).

country, often in states that have little or no law on the subject, before judges who have often never had prior experience with such matters. Until and unless definitive decisions on these issues—and numerous other outstanding questions—are rendered by the supreme courts of each of the fifty states, no issuer can be confident about what legal regime—and what procedural rules—will apply to a nationwide class action about its soft information disclosures. Yet that process will take decades, during which the plaintiffs' bar will be looking for every opportunity to expand the scope of liability by invoking various legal theories, grounded in expansive contract, tort and fiduciary duty claims, in every jurisdiction in the country.

The ultimate risk is what I call the "least common denominator" problem. If only one state appellate court adopts a standard of liability that is radically inconsistent with federal law in this area, there will be a rush to that forum. This is no way to run a *national* securities disclosure regime.

Waiting to see how plaintiffs' lawyers use the state courts has the real-world consequence of imposing the multi-million dollar costs of defending these actions upon corporate defendants. Similarly, to the extent the Reform Act intended to eliminate the burden of early discovery by requiring that discovery be stayed during the pendency of motions to dismiss, delay in eliminating parallel state court litigation—in which many courts have declined to issue such stays—simply thwarts the relief Congress intended to provide in 1995.

IV. THE PENDING LEGISLATIVE PROPOSALS

Two similar but not identical bills have been passed by the Senate and House, which, in one way or another, would require certain securities class actions based on false or misleading statements to be brought in federal court exclusively under federal law. As of this writing (early August 1998) Senate Bill 1260 has been endorsed by the President and three SEC Commissioners, including Chairman Levitt, and was passed by a large majority in the Senate on May 13.¹⁰⁹ The House passed its version¹¹⁰ of the legislation by a vote of

109. Senator Gramm introduced Senate Bill 1260 on October 7, 1997 with 18 co-sponsors. The bill was referred that same day to the Senate committee on Banking, Housing and Urban Affairs. The Subcommittee on Securities held hearings October 29, 1997 on Senate Bill 1260. On April 29, the Senate Banking Committee voted to report the bill—now called the "Securities Litigation Uniform Standards Act of 1998"—to the full Senate. The SEC's support for Senate Bill 1260 is evidenced in a March 24, 1998 letter to Senators D'Amato, Gramm and Dodd, and was reiterated the following day at the Senate hearing on Chairman Levitt's nomination to a second term. See Letter from Arthur Levitt et al., Chairman, Securities and Exchange Commission, to Alfonse M. D'Amato, Chairman, Committee on Banking, Housing & Urban Affairs (Mar. 24, 1998) (on file with *Washington University Law Quarterly*).

340 to 83 on July 22.

The stated goal of these bills is to forestall the efforts, described above, by the plaintiffs' bar to end-run the safe harbor under the Reform Act by filing securities class actions in state court. As Representative Bliley put it:

[T]he explosion of cases being brought in state court since the Reform Act demonstrates that the problem has not been eliminated, it has just changed venue. The Uniform Standards Act will permit meritorious claims to continue to be filed, while preventing the migration of baseless class actions to state courts.¹¹¹

If enacted, any of the bills under consideration would prevent evasion not only of the Reform Act's safe harbor for forward-looking statements, but also of the correlative procedural innovations under the Act, including the discovery stay, lead plaintiff and pleading standards provisions.

A. *What the Bills Do*

Both bills would amend the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). The bills would create exceptions to section 16(a) of the 1933 Act, which currently preserves "all other rights and remedies that may exist at law or in equity." A proposed section 16(b) under both of the proposed amendments would create new limitations on actions brought under state statutory or common law, irrespective of whether such actions were commenced or maintained in state court or federal court.

House Bill 1689 and Senate Bill 1260 would prohibit the pursuit in state court of a "class action" (a broadly defined term in both bills that is much broader than its meaning under Rule 23) if the suit alleges:

- (A) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or
- (B) that the defendant used or employed any deceptive device or contrivance in connection with the purchase or sale of a covered security.

110. H.R. 1689, 105th Cong. (1997).

111. See Securities Litigation Uniform Standards Act of 1998, 144 CONG. REC. H6052-60, H6055 (daily ed. July 21, 1998); see also *id.* at H6059 (remarks of Rep. Eshoo); H6059 (remarks of Rep. Cox); Report on the Securities Litigation Uniform Standards Act of 1998 (to accompany House Bill 1689), H.R. REP. NO. 105-640, at 10, 12 (1998) [hereinafter HOUSE REPORT]; Report on the Securities Litigation Uniform Standards Act of 1998 (to accompany Senate Bill 1260), S. REP. NO. 105-182, at 1-4 (1998) [hereinafter SENATE REPORT].

House Bill 1689 and Senate Bill 1260 also propose to add a new section 16(c), which would provide for the removal to federal court of any class action pending in a state court which involves a "covered security" if the allegations specified in section 16(b) are asserted. House Bill 1689 and Senate Bill 1260 would also subject the removed action to the prohibition of section 16(b) against asserting any state securities law claims in class actions.

B. Definition of "Covered Security"

The most important difference between the two bills lies in their definitions of the term "covered security."

Senate Bill 1260 defines "covered security" to encompass securities that satisfy the standards of either section 18(b)(1)¹¹² or section 18(b)(2)¹¹³ of the 1933 Act. Senate Bill 1260 thereby includes the securities of investment companies that are registered, or which have filed registration statements, under the Investment Company Act of 1940. The Senate bill also covers senior securities of listed companies, even if the security was not itself listed on a national exchange at the time of the alleged misconduct.¹¹⁴

House Bill 1689 adopts the definition of section 18(b)(1) of the 1933 Act as its definition of "covered security," with a twist. It excludes debt securities that are issued in private placements. House Bill 1689 does not cover shares of mutual funds.

One regrettable change from earlier incarnations of the House bill is that it originally covered all securities of a corporate issuer which has at least one

112. Section 18(b)(1) provides as follows:

For the purposes of this section, the following are covered securities:

(1) Exclusive Federal Registration of Nationally Traded Securities. A security is a covered security if such security is:

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

(B) listed, or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determined by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in subparagraph (A); or

(C) is a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B).

15 U.S.C. § 77r(b)(1) (1994).

113. Section 18(b)(2) provides as follows: "Exclusive federal registration of investment companies—a security is a covered security if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940." 15 U.S.C. § 77r(b)(d) (1994).

114. For a critique of this provision, see John C. Coffee, Jr., *State Securities Preemption: The Hidden Issues*, N.Y.L.J., May 28, 1998, at 5.

nationally traded security outstanding. If an issuer has any class of security outstanding that is not subject to the uniform standards legislation, it remains at risk for state law claims for any forward-looking disclosure made in reliance on the safe harbor. These issuers have one management and make one disclosure which can impact all their securities. To be effective, the safe harbor should protect issuers as to all outstanding classes of their securities.¹¹⁵

C. Definition of Class Action

Both House Bill 1689 and Senate Bill 1260, in proposed section 16(f)(3), define class action broadly to include any single lawsuit or group of lawsuits (other than a derivative action) filed in or pending in the same court involving common questions of law or fact, in which:

- (A) damages are sought on behalf of more than 50 persons and in which common questions (without reference to issues of individualized reliance) predominate; or
- (B) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated and common questions predominate; or
- (C) one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit and common questions predominate.¹¹⁶

The definition also applies to any *group* of lawsuits filed or pending in the same court in which damages are sought on behalf of fifty or more persons and the actions are joined, consolidated or otherwise proceed as a single action.¹¹⁷ Thus, defendants may have the opportunity to use the combined rules governing removal of such case (which is permitted under the statute without regard to diversity) and then transfer the scattered cases under section 1404 to consolidate them in one forum. The net result may be that an individual investor who sued under state law may find himself part of an involuntary “class” whose claim is preempted by federal law.

The broad definition of a “class” is especially important in light of the recent flurry of activity in the filing by plaintiffs’ bar of the so-called “mass

115. It is of some concern that neither of the bills as currently drafted cover municipal securities or limited partnerships—the focus of some of the largest and costliest of class action litigation in recent years. This can easily be corrected by extending the definition of “covered securities” to include all of the securities identified in section 18(b) of the 1933 Act.

116. H.R. 1689, 105th Cong. (1997); S. 1260, 105th Cong. (1997).

117. See S. 1260 § 16(g)(2)(A)(ii); H.R. 1689 § 16(f)(2)(A)(ii).

action,” brought in the names of hundreds of individually named plaintiffs, who are often limited partners in an investment partnership.¹¹⁸ Especially with the dismantling in most states of the rules against solicitation of clients and lawyer advertising, many plaintiffs’ firms have aggressively sought to recruit clients, on a fixed-fee basis, to bring mass actions—often in the very same matters that have already given rise to a class action under Rule 23 or its state law analogues. Touting the purported advantages of such mass suits over class actions, largely based on the assertion that the damage recovery will be higher than the paltry actual return on most class actions, these plaintiffs’ lawyers urge class members to opt out and pursue separate remedies. Both proposed bills, quite appropriately, are written to cover such suits—which pose many of the same risks to issuers that conventional class actions do. Importantly, the bills also enable defendants to force all actions arising out of the same facts into one forum, thus avoiding the all-too-common problem of being forced to litigate in several state and federal forums simultaneously.

D. Proposed Amendments to Section 28 of the 1934 Act

All three bills would amend section 28 of the 1934 Act, to the same effect as the amendments to section 16 of the 1933 Act.

E. Retroactivity

The provisions of House Bill 1689 and Senate Bill 1260 are expressly limited so as not to affect or apply to any action commenced before and pending on the date of their enactment.

F. The Scope of the Proposed Legislation

Critics have been quick to assert that passage of any of either version of a uniform standards bill would eliminate all state court class actions involving corporate governance or extraordinary corporate transactions such as mergers, acquisitions or reorganizations. The SEC pressed its concerns on this subject, as well. The sponsors of the legislation and their allies have repeatedly and emphatically stated that each of the proposed bills is intended to address *only* claims for misstatements or omissions in connection with the purchase or sale of securities. Derivative suits, which raise claims for breach of fiduciary duty due to mismanagement, corporate waste or conflict of

118. This is a point stressed in the Senate Report. See SENATE REPORT, *supra* note 111, at 4-5.

interest, are not affected.

Drawing on a task force of practitioners and law professors who recommended certain amendments which have drawn the endorsement of Chairman Levitt and two other SEC commissioners, both bills contain an exclusion for causes of action traditionally arising under state laws imposing a fiduciary duty of disclosure. Specifically, the exclusion is designed to preserve the availability of class actions in state court where state law *already* provides that directors of corporations have fiduciary disclosure obligations to current shareholders. The exclusion has been drafted to be directly responsive to the concern of critics that certain well-entrenched state law remedies should not inadvertently be preempted by the new federal legislation.

Specifically, under both Senate Bill 1260 and House Bill 1689, a class action is not preempted by the federal statute if it involves:

- (A) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or
- (B) any recommendation, position or other communication with respect to the sale of the securities of the issuer that
 - (i) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and
 - (ii) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.¹¹⁹

Although there is little published history concerning the evolution of this language—which has become known as the “Delaware carve out”—it is evident that the provision is designed to preserve remedies where directors have recommended a vote or acceptance of a tender offer under Rule 14D(9) or where shareholders must vote on a transaction between the corporation and minority shareholders.¹²⁰ This list of transactions matches precisely those

119. See S. 1260 § 16(f)(3)(B); H.R. 1689 § 16(f)(3)(A).

120. See SENATE REPORT, *supra* note 111, at 4; HOUSE REPORT, *supra* note 111, at 17. Specifically, the Senate Report states:

The Committee is keenly aware of the importance of state corporate law, specifically those states that have laws that establish a fiduciary duty of disclosure. It is not the intent of the Committee in adopting this legislation to interfere with state law regarding the duties and performance of an issuer's directors or officers in connection with a purchase or sale of securities by the issuer or an affiliate from current shareholders or communicating with shareholders with respect to voting their shares, acting in response to a tender or exchange offer, or exercising dissenter's or appraisal rights.

SENATE REPORT, *supra* note 111, at 4.

circumstances in which the Delaware courts have already held that directors have a fiduciary duty of disclosure to existing shareholders. Since the preemption legislation, in any of its versions, does not now preempt traditional derivative actions, the Delaware carve out does not attempt to deal with derivative actions at all. Rather, as noted, its focus is on that narrow category of class actions, often brought in state court, in which *current* shareholders of a corporation allege that the directors, in specific circumstances—normally involving extraordinary transactions—breached a fiduciary duty of disclosure.

