The Substantive Limits of Liability for Inaccurate Predictions

By Hugh C. Beck[1]

I. INTRODUCTION

Recent commentary regarding the forward-looking statement safe harbor created by the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act") [2] has focused on the controversy sparked by *Asher v. Baxter International, Inc.*,[3] a 2004 case in which the Seventh Circuit reversed the dismissal of a complaint alleging fraudulent projections after finding that the availability of the safe harbor could not be determined without discovery.[4] Unfortunately, this debate over the stage of litigation at which courts ought to apply the PSLRA safe harbor provisions may obscure more fundamental issues left unsettled by the Reform Act regarding the appropriate substantive limits of liability for inaccurate predictions.

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[2] Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77k, 771, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5 (Supp. I 1995). The PSLRA made a host of other modifications to the federal private securities litigation system, including heightened pleading standards for allegations of securities fraud and changes to the procedures for appointing lead plaintiffs in securities class action suits. The safe harbor provisions are codified at 15 U.S.C. §77z-2 (Section 27A of the Securities Act of 1933 ("Securities Act") and 15 U.S.C. §78u-5 (Section 21E of the Securities Exchange Act of 1934 ("Exchange Act")). The PSLRA defines "forward-looking statement" as:

(A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items; (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer; (C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission; (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C); (E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses 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 of the Commission.

[3] 377 F.3d 727 (7th Cir. 2004).

[4] *See, e.g.*, Joseph De Simone, et al., *Asher to Asher and Dust to Dust: The Demise of the PSLRA Safe Harbor?*, 1 N.Y.U. J.L. & BUS., Sum. 2005 at 799; Sarah S. Gold, et al., *The Not-So-Safe Harbor*, N.Y.L.J., Oct. 13, 2004, at 3; Allan Horwich, *Is There A Breach In The Breakwater Of The Statutory Safe Harbor For Forward-Looking Statements?*, Sept. 2004, available at http://www.wallstreetlawyer.com; O'Melveny & Myers LLP, *Seventh Circuit Limits Applicability of PSLRA Safe Harbor For Forward-Looking Statements*, Aug. 6, 2004, available at http://www.omm. com; and Stanford Law School Securities Class Action Clearinghouse, Headline News: Legal Opinion Letter, "High Court Should Review Ruling On Securities Fraud 'Safe Harbor,'" Dec. 3, 2004, available at http://www.securities.stanford.edu.

The stated policyobjective of the PSLRA safe harbor was "to enhance market efficiency by encouraging companies to disclose forward-looking information."[5] Most studies of corporate disclosure conducted following the Act's passage, however, found no meaningful increase from pre-Act levels in the disclosure of forward-looking information.[6] Among other reasons for managers' reluctance to disclose more forward-looking information, observers cited ambiguities in the language of the safe harbor's provisions,[7] including, most importantly, its first provision, which protects an issuer from liability for an inaccurate forward-looking statement if the statement "is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those [predicted]."[8] Nevertheless, because this provision was widely viewed as codifying the "bespeaks caution" doctrine, many commentators suggested that the courts would soon resolve the provision's ambiguities by

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[5] H.R. CONF. REP. NO. 104-369, at 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 741.

[6] *See, e.g.*, SEC Office of Gen. Counsel, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 3 (1997) ("[B]ased on discussions with the issuer community and review of filings with the Commission, the staff believes that the quality and quantity of forward-looking disclosure has not significantly improved following enactment of the safe harbor for forward-looking statements. So far, it appears that companies have been reluctant to provide significantly more forward-looking disclosure than they provided prior to enactment of the safe harbor."); Current Issues and Rulemaking Projects, § X.B.3, SEC Div of Corp. Fin. (Aug. 17, 1998) ("For the most part, there has not been a noticeable increase in the amount of forward-looking information being provided."); Committee on Securities Regulation, Forward-Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act: A Study of Current Practices, 53 Record Assoc. Bar City of N.Y. 723, 736 (1998) (reporting study finding "no meaningful change in the nature or extent of written forward-looking statements made by reporting companies as a result of the adoption of the Act"); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. L.J. 1, 46 (1998) (reporting that data collected suggests no more than a modest increase in the disclosure of forward-looking information rather than the anticipated "significant post-Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued"). Apparently, only one study has reached the opposite conclusion. *See* Marilyn F. Johnson et al., The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms, 39 J. Acct. Res. 297 (2001).

[7] *See e.g.*, SEC Office of Gen. Counsel, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 5 (1997) (identifying concern about "lack of judicial guidance as to the sufficiency of the required 'meaningful' cautionary language" as a primary cause of issuer reluctance to provide more forward-looking information).

[8] 15 U.S.C. §78u-5(c)(1)(A)(i) (Supp. I 1995). The second provision of the safe harbor immunizes the statement if it is "immaterial" and the third if the speaker who made the forward-looking statement did not have "actual knowledge" that the statement was false or misleading. *Id.* at §78u-5(c)(1)(A)(i) (Supp. I 1995).

holding that its language was short-hand for this doctrine's purportedly well-developed principles.[9]

Nearly ten years have passed since commentators made these hopeful assessments of the judiciary's capacity to fine tune the PSLRA safe harbor provisions, but courts are no closer now to a uniform approach to evaluating liability for inaccurate predictions than they were in 1997 when the first cases implicating the safe harbor were filed. Instead, it is rare that one can easily discern the substantive criteria applied by the court within a given safe harbor opinion let alone trends in the case law toward one particular approach to or another. Left without intelligible judicial guidance, issuers tend to include long lists of unenlighteningcautionary statements and risk factors in Commission filings and press releases containing predictive information, apparently believing that the longer the list, the greater the likelihood that a court, regardless of the criteria it applies, will find something in the list "meaningful."

This article argues that two characteristics of the pre-PSLRA development of regulatory and judicial approaches to forward-looking information are primarily responsible for the continuing confusion in this area of the law. The first is a sharp, but heretofore unacknowledged, doctrinal shift in early 1990s marked by *In Re Donald J. Trump Casino Securities Litigation*, a

[9] *See e.g.*, Regulation of the Association of the Bar of the City of New York, Forward-Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act: A Study of Current Practices (August 1998) ("The former concern [regarding the absence of judicial guidance as to what constitutes 'meaningful' cautionary language] may well be overstated; the intent of the statute in this area was largely to codify the 'bespeaks caution' doctrine, which has been adopted in principle by every circuit to consider it . . . ."), *reprinted in* 1084 PLI/Corp 795, 802 (1998); Richard A. Rosen, *The Statutory safe harbor for Forward-Looking Statements after Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?*, 76 WASH. U.L.Q. 645, Sum. 1998 at 653 ("Although the statute does not define 'meaningful cautionary statements,' an abundance of case law exists on this issue. . . . It should be evident, then, that in interpreting and applying [the first provision 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 adopted in principle by every circuit to consider it . . . ."); and Ann M. Olazabal, S*afe Harbor For Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What's Safe and What's Not?*, 105 DICK. L. REV. 1, Fall 2000, at 12 ("[W]e are not completely without guidance as to how protected forward-looking statements will be treated by the courts. This is true because long before the Reform Act was enacted, there was already an expansive body of judge-made law holding that plaintiffs could not base securities fraud claims on forward-looking statements if such statements were accompanied by language that 'bespeaks caution' as to reliance thereupon.").

1993 case in which the Third Circuit held that appropriately tailored accompanying statements render a projection immaterial.[10] The second is the pre-1993 proliferation of imprecise vocabularies that refer to a single set of concepts of liability but fail to adequately elucidate the judicial inquiries entailed by these concepts. The article further demonstrates that either the SEC or the Supreme Court could take advantage of the flexible language of the PSLRA safe harbor and eliminate both of these sources of confusion by steering the lower courts into a single, clearly articulated framework for assessing liability for inaccurate forward-looking statements.

Part II lays the foundation for these arguments by demonstrating that, with rare exceptions, all regulatory and judicial approaches to forward-looking information employed from the passage of the federal securities acts through the early 1990s (including the pre-1993 bespeaks caution doctrine) conformed to a single doctrinal framework. The framework's underlying assumption is that disclosures of forward-looking information tend to significantly influence investor behavior or, in other words, that such information is generally material. Accordingly, the framework's primary inquiry is whether the forward-looking information in question was false or misleading.[11] This determination is made by evaluating whether a "reasonable" investor would have drawn from the publication of the information the incorrect inferences that allegedly misled the plaintiff. To the extent a reasonable investor would have drawn those inferences they constitute implied *mis*representations, actionable under the securities laws unless, due to exceptional circumstances, they would *not* have significantly influenced a

[10] 7 F.3d 357 (3d Cir. 1993).

[11] The elements of falsity and materiality together establish an initial threshold of proof that a plaintiff must meet for recovery under any of the federal securities antifraud provisions. To recover under SEC Rule 10b-5, a plaintiff must also prove scienter, reliance, and causation. 17 C.F.R. § 240.10b-5 (2001); Twiss v. Kury, 25 F.3d 1551, 1558 (11th Cir. 1994). Rule 10b-5's scienter requirement distinguishes it from the antifraud rules of the Securities Act, under which a plaintiff may recover by proving lesser degrees of culpability. Under §11 of the Securities Act, for example, an issuer is strictly liable for material misstatements or omissions in a registration statement and other participants in the offering may be jointly liable to the extent they failed undertake a reasonable investigation of the truthfulness of the misstatements. 15 U.S.C. § 77k (Supp. I 1995).

reasonable investor's decision-making process. Part II demonstrates that the often dramatic changes in regulatory policy from the mid-1930s to the early 1990s, as well as the inconsistencies in cases involving forward-looking information decided during this time period, generally reflect evolving conceptions of the reasonable investor rather than departures from this basic doctrinal framework.

To be sure, the opinions in pre-1993 cases involving forward-looking information generally, and the bespeaks caution opinions in particular, leave much to be desired in terms of rhetorical precision and, in many cases, suggest that the judges who wrote the opinions failed to fully grasp the traditional framework's structure. For example, language in some of the circuit court bespeaks caution opinions appears to establish a *per se* rule against liability for a failed projection accompanied by cautionary statements. Nevertheless, the underlying basis for all of these courts' decisions was an intuitive judgment, however poorly articulated, that the disclosures accompanying the projection or other factors made the incorrect inferences the plaintiff allegedly drew from the disclosure of the projection unreasonable and that the disclosure therefore would not have misled a reasonable investor regarding the probability of the projected outcome.

Part III explains how the Third Circuit, in its opinion in *Trump*, was able to successfully redirect the course of forward-looking statement analysis by exploiting the ambiguities in the earlier bespeaks caution opinions and misreading Supreme Court precedent. In 1991, the Supreme Court, in *Virginia Bankshares, Inc. v. Sandberg*, applied the traditional framework in a manner that should have ensured its application in future lower court cases involving allegedly misleading forward-looking information.[12] In its *Trump* opinion issued two years later, the Third

[12] 501 U.S. 1083 (1991).

Circuit transformed the bespeaks caution doctrine into a single-factor materiality test and asserted that its "analysis comport[ed] with the Supreme Court's reasoning in *Virginia Bankshares*." As Part III demonstrates, however, it is impossible to reconcile the *Trump* materiality analysis with the doctrinal framework endorsed in *Virginia Bankshares* Nevertheless, because courts and commentators failed to recognize that the Third Circuit's analysis represented a sharp departure from the previous line of "bespeaks caution" cases, lower courts in subsequent cases generally took as granted that the "bespeaks caution" doctrine was, as the Third Circuit had held, a materiality-based approach to assessing the actionability of inaccurate forward-looking information. Against this background of unwitting judicial acquiescence to the Third Circuit's reformulation of the bespeaks caution doctrine, congressional negotiations over private securities litigation reform ultimately produced the PSLRA in 1995. As a result, since the PSLRA's enactment, courts and commentators have often taken as granted that the first provision of the Act's safe harbor "codifies the materiality standard set forth in [*Trump*] and reiterated in numerous other circuits, and makes that standard uniform nationwide."[13]

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[13] Richard A. Rosen, *The Statutory safe harbor for Forward-Looking Statements after Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?*, 76 WASH. U.L.Q. 645, Sum. 1998 at 653. *See also* Ann M. Olazabal, S*afe Harbor For Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What's Safe and What's Not?*, 105 DICK. L. REV. 1, Fall 2000, at 12 ("The statutory language itself and the legislative history of the Act seem to indicate that the safe harbor . . . is based entirely on a materiality analysis. In other words, as to the first two prongs of the statute, forward-looking statements are neutralized – or rendered immaterial – by sufficient cautionary language, or they are found to be immaterial on other grounds"); John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 990 (1996) ("This proposed interpretation that a 'meaningful cautionary statement' is one that sufficiently corrects or mitigates the false statement so as to render it either immaterial or 'non-reliable' is consistent with the 'bespeaks caution' doctrine, which the safe harbor was originally intended to codify."); Eric Talley, *Diclosure Norms*, 149 U.PA.L.REV. 1955, 1979 (2001) ("Finally, it is worth noting that the cautionary language prong of the statutory safe harbor also retains the pre-1995 conception of 'materiality.' As before, satisfactory cautionary language will essentially have the effect of rendering the disclosure immaterial as a matter of law.").

Part IV argues that this view of the safe harbor is misguided for several reasons, not the least of which is its inconsistency with the provisions' underlying logic. The link between the safe harbor's policy objective (enhancing allocative efficiency) and its means (increasing the disclosure of forward-looking information) disappears if one discards the premise that investor behavior *will be influenced* by the disclosures induced by the safe harbor.[14] Put another way, if to satisfy the first provision's test for meaningfulness, accompanying statements must render a forward-looking statement immaterial, then most forward-looking statements that qualify for protection under that provision do *not* contain the kind of information Congress hoped issuers would disclose in greater quantities in response to the legislation. A statutory interpretation that produces such a stark disconnect between the statute's operation and its policy objectives must exhibit other compelling virtues or be discarded. Part IV demonstrates, however, that the materiality-based interpretation continues to fare poorly when measured against other important criteria. Fortunately, the language of the safe harbor permits a falsity-based interpretation of the first safe harbor provision and, if properly grounded in thetraditional doctrinal framework , this interpretation resolves the defects to which the materiality-based interpretation is subject. Part IV concludes with a brief discussion of the key benefits well-crafted SEC or Supreme Court interpretive intervention with respect to the PSLRA safe harbor provisions could yield.

II. PRE-PSLRA REGULATORY AND JUDICIAL APPLICATIONS OF THE TRADITIONAL DOCTRINAL FRAMEWORK

A. The Evolution of the SEC's Conception of the Reasonable Investor

From the creation of the SEC in 1934 through the early 1970s, the Commission continuously discouraged public disclosure of forward-looking information and maintained that

[14] Allocative efficiency, the allocation of capital to its best use, requires securities prices that reflect available information regarding companies' business prospects. Accordingly, an increase in forward-looking information disclosures enhances allocative efficiency only to the extent that the disclosures influence the investor decisions that determine security prices.

the disclosure of business projections in SEC filings was *per se* misleading. Although not immediately apparent, this policy was rooted in the doctrinal framework described in Part I. As a result, statements by courts and commentators from this era regarding the Commission's policy frequently reflect the framework's basic contours. For example, in 1961, former senior SEC staffer Harry Heller, describing the justification for the Commission's policy and decisions by courts in line with that policy, stated: "[A]ttempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held to be misleading because they suggest to the investor a competence and authority which in fact does not exist."[15] Similarly, in the 1964 case of *Union Pacific Railroad Co. v. Chicago and Northwestern Railway Co.*,[16] the court noted that the publication of predictions leads investors to "readily to assume, contrary to fact, that the predictor has special knowledge or unique information to bear out fully his prediction, and be induced to rely upon a supposed expert judgment of the mysteries of finance."[17] The court then found the predictions at issue misleading because they "convey[ed] a certitude which inherently they [could not] possess."[18] As discussed in Part I, the evaluation of such unstated propositions (reflected by Heller's emphasis on what the publication of a prediction "suggest[s] to the investor" and *Northwestern*'s discussion regarding facts a prediction causes investors to "readily to assume") is the traditional doctrinal framework's central analysis.

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[15] Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300, 307 (1961). *See also* Advisory Committee on Corporate Disclosure, report to the Securities and Exchange Commission 305 (Comm. Print 95-29 1977) (hereinafter "Advisory Committee on Corporate Disclosure"). The perception that projections were exceptionally "susceptible to improper manipulation by unscrupulous corporate managers" lent additional support to the Commission's position. *Id*. at A-268.

[16] 226 F. Supp. 400 (N.D. Ill. 1964). Union Pacific and Northwestern were corporate bidders competing to buy the same company. Union Pacific sought an injunction to prevent the target company's shareholders from approving Northwestern's offer based on its allegation that a report Northwestern had sent to those shareholders contained misleading predictions in violation of Rule 14a-9. *Id.*

[17] *Id*. at 409.

[18] *Id.*

In addition to demonstrating the consistency of the SEC's policy with the traditional framework, the statement by Heller reflects the paternalistic conception of the average investor that prevailed at the Commission for the first several decades of its existence.[19] Throughout this time period, protecting investors from their own errors of judgment was one of the Commission's primary objectives. In the 1960s and 1970s, however, new insights regarding the operation of markets and investor behavior called the Commission's focus on protecting the unsophisticated into question. In 1967, the SEC formed an internal study group led by Commissioner Francis M. Wheat to examine the securities laws' corporate disclosure system.[20] Reflecting the emerging view that investors are generally sophisticated enough to discount expected earnings in an effort to identify misvalued stocks, the Wheat Report acknowledged that "most investment decisions are based essentially on estimates of future earnings." Nevertheless, the Wheat report concluded that the "real danger . . . that projections appearing in [documents filed with the SEC] would be accorded a greater measure of validity by the unsophisticated than they would deserve" outweighed the benefits of permitting disclosure.[21] Skepticism regarding the Commission's traditional policy continued to mount, however, and just two years later the Commission held public hearings regarding potential changes to the policy.[22]

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[19] The *Northwestern* court clearly shared this conception. Only by conceiving of the average investor as markedly prone to errors of judgment could the *Northwestern* court conclude that average investors would assume a fact based on Northwestern's predictions (the possession by management of information "bear[ing] out fully [its] prediction") that the court easily recognized could "inherently" not be true.

[20] SEC Disclosure Study Proposed, Securities Act Release No. 33,4885, at 1 (Nov. 29, 1967). The study group planned to focus primarily on the potential for further integration of the disclosure requirements of the Securities Act and Exchange Act. *Id.* As the study progressed, however, securities analysts encouraged the group to also reevaluate the Commission's policy on projection disclosure. Securities and Exchange Commission, Disclosure to Investors: A Reappraisal of Administrative Policies under the '33 and '34 Acts 94 (1969) (hereinafter "Wheat Report").

[21] *Id.* at 94-95.

[22] *See* Commission Orders Public Proceeding in the Matter of Estimates, Forecasts or Projections of Economic Performance and Related Subjects, Exchange Act Release No. 34,9844 (Nov. 1, 1972).

In early 1973, the Commission announced thatas a result of the hearings it had determined that "changes in its present policies with regard to the use of projections would assist in the protection of investors and would be in the public interest."[23] Two years later, the Commission published proposed rules for implementing these changes. The rules outlined an elaborate set of procedures for integrating projections into Commission filings and proposed an equally complex projection safe harbor.[24] Demonstrating the ongoing pull of the Commission's traditional conception of the average investor as unsophisticated, the proposed safe harbor, among its many other requirements, required that a published projection be accompanied by a statement "cautioning that there can be no assurance that the projection will be achieved."[25]

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[23] Commission's Findings on Disclosure of Projections of Future Economic Performance by Issuers of Publicly Traded Securities, Securities Act Release No. 33,5362 (March 19, 1973). The announcement noted that the information the Commission gathered during the hearings simply "reinforced [the SEC's] own observation that management's assessment of a company's future performance is information of significant importance to the investor." *Id.* at 1.

[24] Notice of Proposed Rule 132, Securities Act Release No. 33,5581 (April 28, 1975).

[25] The proposal would have required the accompanying statements to also "disclose the material assumptions underlying the projection" and that the projection be "prepared with reasonable care," have a "reasonable factual basis," and reflect management's "good faith judgment." These and other "projection criteria" were added to various "issuer criteria" to fill out the full set of safe harbor requirements. *Id.* at 10-16. After proposing the "prepared with reasonable care," "reasonable factual basis," and "good faith judgment" standards as prerequisites to safe harbor protection, the Commission noted that "these criteria have generally been considered by courts as requirements concerning the preparation of publicly disclosed projections." *Id*. This statement was likely made in reference to *Dolgow v. Andersen*, 53 F.R.D. 664 (E.D.N.Y. 1971) and *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974), two leading district court cases from the Second Circuit. The *Beecher* court held that "a reasonable prudent investor would conclude [from the disclosure of an internal projection] that it was highly probable that the forecast would be realized" and that publishing a projection less likely to be achieved was therefore misleading. 374 F. Supp. at 348. The *Doglow* court, on the other hand, held that a defendant's disclosure of an internal projection was not misleading so long as it was "the best estimate[] of the people in [the company] most qualified to make [it]." 53 F.R.D. at 676. Thus, under the *Doglow* conception, a reasonable investor does not infer from the disclosure of a projection that the projected results are highly probable but only that they were the best projections that management could make under the circumstances. In other words, under this view, reasonableness is not a quality of the projection itself but of the method used to produce the projection. Accordingly, so long as management uses the best information available and an accepted calculation procedure, the projection's basis should be deemed reasonable even if the quality and/or completeness of the available information suggest a very low confidence level or a very high error rate. This article uses the term confidence level to describe the likelihood that actual results will match a point projection or fall within a range of projected values. The article uses the term error rate to describe how wide a range of projected values must be to achieve a satisfactorily high confidence level. The 1973 release announcing the Commission's intent to change its policy on projection disclosure suggests that the Commission favored the *Beecher* analysis over the *Doglow* analysis. For example, the 1973 release stated that permission to include projection in Commission filings should be limited to issuers "who are reporting companies and who meet certain standards relating to their earnings histories and budgeting experience."

In response to widespread objections to the complexity of the proposed safe harbor and projection disclosure requirements, the SEC tabled the proposals in April 1976 pending completion of a new study on disclosure by an advisory committee appointed by the Commission two months earlier.[26] Referencing the "increasing body of scholarly work examining the economics and structure of information systems . . . [with] increasing consideration [being] given to the 'random walk theory' and the efficient market hypothesis,"[27] the Commission had formed the advisory committee to undertake a comprehensive review of the securities laws' corporate disclosure system and recommend changes to the Commission's policies.[28] According to the efficient market hypothesis, even the most savvy investors will be unable to consistently identify undervalued or overvalued securities because security prices in active markets continuously reflect the views of other market participants that, in the aggregate, take into account all available market information. The flip side of the hypothesis is that even the most misguided participants in active markets will be unable to consistently make *bad* investment decisions. By

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Commission's Findings on Disclosure of Projections of Future Economic Performance by Issuers of Publicly Traded Securities, Securities Act Release No. 33,5362 (March 19, 1973) at 8. The 1975 proposed safe harbor issuer criteria continued this emphasis on operating history through its requirement that issuers "have prepared budgets for internal use for its last three fiscal years" before disclosing projections in Commission filings. Notice of Proposed Rule 132, Securities Act Release No. 33,5581 (April 28, 1975) at 13.

[26] Notice of Adoption of an Amendment to Rule 14a-9 and Withdrawal of the Other Proposals Contained in Release No. 33-5581, Securities Act Release No. 33,5699 (April 23, 1976) at 3. Nevertheless, the Commission noted that "[because] investors appear to want management's assessment of a company's future performance, and since some managements may wish to furnish their projections through Commission filings," the SEC would no longer "object to the disclosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are . . . accompanied by information adequate for investors to make their own judgments." *Id*. at 4. The Commission then proposed non-binding Division of Corporation Finance "Disclosure of Projections of Future Performance" guides under both the Securities Act and Exchange Act.[26] The guides suggest that the Commission's views regarding the meaning of the reasonable basis requirement and the adequacy of accompanying information had not changed. With respect to the reasonable basis requirement the release noted: "The [Division of Corporation Finance] believes that management should have the option to present in Commission filings its good faith assessment of a company's future performance. Management must, however, have a reasonable basis for such an assessment. A history of operations or experience in projecting may be among the factors providing a basis for management's assessment." *Id.* at 7. With regard to the importance of accompanying information the guides stated: "[T]he Division believes that investor understanding would be enhanced by disclosure of the assumptions which in management's opinion are most significant to the projections or are the key factors upon which the financial results of the enterprise depend." *Id.* at 11-12.

[27] Securities Act Release No. 33,5673 at 3.

[28] *Id*. *See also* Advisory Committee on Corporate Disclosure, *supra* note 15, at D-3.

crediting this proposition, the advisory committee embraced a conception of the average or reasonable investor as sophisticated and, as a result, concerns about protecting unsophisticated investors carried little weight in the advisory committee's deliberations. In fact, unlike the previous debates regarding public disclosure of forward-looking information, debate among the advisory committee members focused not on the whether the Commission should *allow* projections, but on whether it should *require* them as a means of enhancing pricing accuracy.[29]

In the end, the committee recommended that the Commission should only "encourage issuers to publish forward-looking . . . information" and proposed a simple issuer-friendly safe harbor rule as the primary means to achieve that goal.[30] In contrast to the web of requirements contained in the Commission's safe harbor proposal, the advisory committee's proposed rule required only that management have "a reasonable basis" for its projections and disclose the projections "in good faith."[31] In addition, although the committee observed that the disclosure of a projection's assumptions "provides a framework for analysis of the projection," it recommended that "to maximize the attractiveness of the program to registrants . . . the disclosure of assumptions should only be encouraged, rather than formally required."[32]

In 1978, the Commission simultaneously published two releases in response to the advisory committee's recommendations. In the first release, the Commission proposed an

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[29] Advisory Committee on Corporate Disclosure, *supra* note 15, 347-357.

[30] The Committee's report noted that its proposed disclosure program was designed to "permit[] wide latitude to companies issuing projections." *Id.* at 353. In contrast to the Commission's earlier proposal, the Committee recommended that "all public companies should be eligible to [disclose internal projections]" regardless of the extent of their operating history or previous budgeting experience because, in the Committee's view, there was no evidence to "'suggest that the "size" of the company has anything to do with the reliability of its projections'" or to "'suggest that a company with established earnings is better able to project than a company without established earnings. . . .'" *Id.* at 356 (quoting James Merrifield, *Projections in SEC Filings: The Debate Rages over Worth*, SEC 149, 166-167 (1974)

[31] *Id.* at 364. The committee omitted the requirement that published predictions be accompanied by a statement "cautioning that there can be no assurance that the projection will be achieved," presumably because it believed that efficient pricing of securities would protect unsophisticated investors from the consequences of the erroneous inference that predicted results were guaranteed.

[32] *Id.*

alternative safe harbor rule that used the committee's "reasonable basis" and "good faith" terminology but omitted several issuer-friendly components of the committee's proposal.[33] While the proposed rule did not explicitly require assumption disclosure as the Commission's earlier proposal had, in a companion release the Commission suggested that failure to disclose assumptions could render projections misleading:

> [U]nder certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results: For example, where projected results are based to a significant degree upon the introduction of a new product or service meeting certain anticipated levels of sales and contribution to earnings, disclosure of the projection without this information might be misleading.[34]

This discussion reflects a nuanced conception of the reasonable investor, under which the reasonable investor avoids inferring from the publication of a projection unaccompanied by disclosure of underlying assumptions that projected results are guaranteed but is entitled to infer that the unexplained estimate has, by some standard, a typical confidence level or error rate.[35] In other words, where there are factors that give rise to an unusually low confidence level or high

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[33] *See* Proposed Safe Harbor Rule For Projections, Securities Act Release No. 33,5993 (Nov. 7, 1978). The Commission's proposed safe harbor would have covered only projections made by public companies and placed the burden of proof on the defendant to show that the projection had a reasonable basis and was disclosed in good faith. *See id.* at 5-7. With respect to the burden of proof, the Release noted that: "The Commission is proposing the rule in this manner since it is concerned that the burden imposed on a plaintiff -- including the Commission -- could be insurmountable. It would be extremely difficult to prove the absence of a reasonable basis or good faith, especially as to plaintiffs who would not have the Commission's investigatory procedures available and cannot engage in discovery prior to the filing of a complaint alleging a violation." *Id.* In the end, however, the Commission reversed its position based on criticism that placing the burden of proof on defendants "would deter companies from making projections, thereby negating the Commission's objective" and "would in all likelihood increase the institution of frivolous, nuisance litigation based solely on the failure of the results to match projections." Safe Harbor Rule For Projections, Securities Act Release No. 33,6084 (June 25, 1979) at 3. The Commission also slightly expanded the coverage of the safe harbor beyond projections made by public companies by making the safe harbor applicable to forward-looking statements contained in registrations statements relating to initial public offerings. Due in part to its "continuing concern regarding the selective disclosure of forward-looking information," however, the Commission ultimately determined that "[s]tatements made outside of [Commission filings would] be covered by the rule only if they [were also] included in documents filed with the Commission." *Id.* at 7. The final rules were adopted as Rule 3b(6) under the Exchange Act and Rule 175 under the Securities Act. 12 C.F.R. § 563d.3b-6 (2001). The the two rules are identical with the exception of their references to the Acts under which they were adopted.

[34] Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 33,5992 (Nov. 7, 1978) at 16.

[35] *See supra* note 25 for a description of the terms "confidence level" and "error rate."

error rate, those factors must be disclosed to prevent the projection from misleading the reasonable investor.

Apparently in an effort to persuade courts to this view, the Commission affirmed in its final release announcing its adoption of the safe harbor that "the key assumptions underlying a forward-looking statement are of such significance that their disclosure may [] be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule." [36] The success of this effort was not tested until more than a decade later in the Seventh Circuit case of *Weiglos v. Commonwealth Edison*.[37] *Weiglos* involved cost estimates that proved

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[36] Safe Harbor Rule For Projections, Securities Act Release No. 33,6084 (June 25, 1979) at 6.

[37] 892 F.2d 509 (7th Cir. 1989). *Weiglos* is apparently the only reported circuit court case to address whether Rule 175 requires assumption disclosure. The limited case law on this issue, however, is not surprising because, as a consequence of the Commission's decision to restrict the coverage of the rule to statements included in Commission filings, Rule 175 was implicated in only a fraction of the subsequent cases involving forward-looking information. Nevertheless, during the 1980s and 1990s, the Second, Third, Fifth, Sixth, Seventh, D.C. and Eighth Circuits all applied variations of the Rule 175 test to evaluate the falsity of projections not included in Commission filings. *See* Eisenberg v. Gagnon, 766 F.2d 770, 776 (3d. Cir. 1985) ("[A]n opinion that has been issued without a genuine belief or reasonable basis is an 'untrue' statement…."); Isquith v. Middle South Utilities, Inc. 847 F.2d 186, 203-204 (5th Cir. 1988) ("Most often, whether liability is imposed depends on whether the predictive statement was 'false' when it was made. The answer to this inquiry, however, does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction--with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis."); Rubinstein v. Collins 20 F.3d 160, 166 (5th Cir. 1994) ("In sum, a predictive statement is one that contains at least three factual assertions that may be actionable: 1) The speaker genuinely believes the statement is accurate; 2) there is a reasonable basis for that belief; and 3) the speaker is unaware of any undisclosed facts that would tend seriously to undermine the accuracy of the statement."); Kowal v. MCI Communications Corp. 16 F.3d 1271, 1277 (DC Cir. 1994) ("[P]rojections and statements of optimism are false and misleading for the purposes of the securities laws if they were issued without good faith or lacked a reasonable basis when made."); Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1132 (7th Cir. 1993) ("[P]redictions that don't pan out can lead to Rule 10b-5 liability only if the prediction was unreasonable in light of the information available at the time the statement was made."); Stransky v. Cummins Engine Co., Inc. 51 F.3d 1329, 1333 (7th Cir. 1995) ("[A] projection can lead to liability under Rule 10b-5 only if it was not made in good faith or was made without a reasonable basis."); Exeter Bancorporation, Inc. v. Kemper Securities Group, Inc. 58 F.3d 1306, 1113 (8th Cir., 1995) ("That the [expected outcome] eventually did not materialize is not, by itself, enough to create an inference that the statement was false when made; other evidence is required to show that [the defendant] did not believe, or lacked reason to believe, [the basis for the prediction] at the time it made the statement. Fraud is not shown simply because an expected occurrence did not occur."); Sinay v. Lamson & Sessions Co. 948 F.2d 1037, 1040 (6th Cir. 1991) (citing Isquith v. Middle South Utils., Inc., 847 F.2d 186, 204 (5th Cir.)) ("In determining whether the statements are actionable, the court must scrutinize the nature of the statement to determine whether the statement was false when made. While analyzing the nature of the statement, the court must emphasize whether the 'prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis.'"); and San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Companies, Inc. 75 F.3d 801, 813 (2nd Cir. 1996) ("Finally, with respect to the company's forward-looking statements, plaintiffs have not alleged circumstances to show that the defendants lacked a reasonable basis for their optimistic, but qualified, predictions as to the company's future

inaccurate. In an opinion written by Judge Easterbrook, the court considered whether the defendant's estimates failed to meet Rule 175's reasonable basis test because the accompanying disclosures "did not assist anyone in estimating how likely (and how great) a departure from its point estimates would be."[38] In the court's view, this failure alone was not enough to push inaccurate predictions out of the Rule 175 safe harbor. According to Judge Easterbrook, requiring "issuer[s] to reveal all of the data, assumptions, and methodology behind [their] projections, so that participants in the market could assess them fully and react appropriately" could make the safe harbor "impossible to enter" because the disclosure of such information would frequently impair the companies' competitive position.[39] Thus, the reasonable investor, understanding a company's need to safeguard proprietary information, both "infers from what is said *and* what is omitted how reliable the estimate is"[40] or, in other words, does not automatically infer an industry-typical confidence level or error rate from the absence of assumption disclosures.

Although the conclusions of the Seventh Circuit in *Weiglos* and the Commission of the late 1970s with respect to assumption disclosure are at odds, their approaches can be easily reconciled by blending their alternative conceptions of the reasonable investor. Under this

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performance."). Most of these decisions do not provide significant insight into the relevance of accompanying disclosures to the evaluation of whether a projection was made in good faith or had a reasonable basis. Still, the use of these and similar terms in the opinions reflects the decisions' conformity to the traditional doctrinal framework in the same way that the Commission's use of the good faith/reasonable basis language in its rule-making deliberations reflects the Commission's conformity to the traditional doctrinal framework during its 1970s rulemaking process that produced Rule 175. To say that a projection must be made in good faith is simply to say that investors are entitled to infer that management does not know of undisclosed information that discredits the projection. Similarly, to say that a projection must have a reasonable basis is simply to say that investors are entitled to draw certain inferences about facts underlying a published prediction in order to make judgments about the subject matter of the prediction or, in other words, regarding its confidence level/error rate. Whether an investor was entitled to draw a particular incorrect inference about the subject matter of the published prediction is determined by the conception of the reasonable investor that a judge or jury combines with this general proposition.

[38] 892 F.2d 509, 514 (7th Cir. 1989).

[39] *Id*.

[40] *Id.* at 515.

blended conception, the reasonable investor does not expect companies to reveal a projection's underlying assumptions if such disclosures would materially compromise the company's competitive position; the reasonable investor may assume, however, that if there are known factors that are likely to cause a significant departure from a projected results and disclosure of those factors would *not* pose a material risk to the company's business, any cautionary statements accompanying the projection will disclose those factors.

B. The Development of the Bespeaks Caution Doctrine: A New Label for the Concepts of the Traditional Doctrinal Framework

The Eighth Circuit coined the "bespeaks caution" phrase one year before the adoption of Rule 175 in *Polin v. Conductron*.[41] Both *Polin* and the Second Circuit's much more widely cited "bespeaks caution" decision eight years later in *Luce v. Edlelstein*[42] held only that the boilerplate warnings accompanying projections prevent reasonable investors from drawing the inference that the predicted results are guaranteed. As noted above, the SEC accepted this unremarkable proposition in the early 1970s and by the end of that decade had apparently concluded that reasonable investors generally do not infer from the publication of a forecast that the predicted results are guaranteed even if the publication fails to warn against drawing that inference. The first circuit court opinions to use the "bespeaks caution" language as short-hand for their conclusions that disclosures accompanying predictions rendered unreasonable investors' inferences regarding the predictions' error rate or confidence level did not appear until 1991. This section demonstrates that all of these pre-1993 circuit courtdecisions were rooted in th e traditional framework for assessing the actionability of inaccurate predictions, notwithstanding language in several of the opinions that appears to reflect a more formulaic approach.

[41] 552 F.2d 797 (1977).
[42] 802 F.2d 49 (1986).

1. Preventing the Mistaken Inference that Forecasted Results are Guaranteed

Polin involved loss estimates on the sale of aircraft cockpit simulators.[43] The manufacturer of the simulators allocated its research and development costs to the simulators on a proportional basis.[44] When the manufacturer learned that revenues from the sale of some of the simulators would be inadequate to recover the costs allocated to their production, it began disclosing loss estimates in its annual reports.[45] The plaintiffs alleged that (1) the manufacturer intentionally understated these estimates and (2) statements in the manufacturer's annual report that "results for 1968 were 'expected' to show improvement" and that it "saw a 'possibility' of a break-even soon" were false.[46] Observing that "[t]he terms . . . employed bespeak caution in outlook" and "recognize the imponderable influences of complex variables in a fast-changing field," the court held the manufacturer's statements fell "far short of the assurances required for a finding of falsity and fraud."[47] Stated otherwise, the court's "bespeaks caution" holding was simply that the use of language to present a projection that "recognizes" the inherent uncertainty of its future results requires investors to recognize that uncertainty as well rather than taking the statements as an "assurance" of the predicted outcomes. The court's observation thus mirrors the conclusion implicit in the SEC's early 1970s releases that the accompaniment of a projection with a statement cautioning against the inference that the results predicted are guaranteed is sufficient to prevent a reasonable investor from drawing that inference.[48]

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[43] 552 F.2d 797 (1977).
[44] *Id.* at 801.
[45] *Id.*
[46] *Id.* at 802.
[47] *Id.* at 807.
[48] By itself, the court's "bespeaks caution" statement could easily be read to suggest that a projection cannot be false or fraudulent *unless* it is stated as an assurance of future outcomes. It is unlikely, however, that the Eighth Circuit intended to endorse this proposition. The loss estimates were also not stated as assurances and the court did not base its conclusion that those estimates were not fraudulent on that fact. Instead, it relied on the district court finding that there was "no substantial basis for the contention that any of the reports withheld material information or fraudulently minimized losses which should have been anticipated." 552 F.2d at 807. Presumably,

After *Polin*, nearly a decade passed before the Second Circuit used the Eighth Circuit's "bespeaks caution" terminology to describe its own holding in *Luce v. Edelstein*[49] that cautionary language could immunize inaccurate projections.[50] In *Luce*, the plaintiffs were investors in a partnership created to construct and sell condominium units. Their complaint alleged multiple violations of Rule 10b-5 including that the offering memorandum "contained intentional misrepresentations as to the potential cash and tax benefits of the partnership."[51] The district court found that none of the plaintiffs' allegations had been pleaded with the level of particularity required by Rule 9(b) and dismissed the complaint on that basis.[52]

On appeal, the Second Circuit read the investors' allegation regarding the cash and tax benefits to assert that the offering memorandum implicitly guaranteed that the projected tax and cash benefits would be realized.[53] The Court then held that this allegation did not state a 10(b) claim because:

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then, had the plaintiffs been able to show that the manufacturer *had* withheld information suggesting that there was no "'possibility' of a break-even," its use of language that "recognize[d] the imponderable influences of complex variables in a fast-changing field" would not have insulated the break-even projection from liability.

[49] 802 F.2d at 51. *Luce*, rather than *Polin*, is seen as the progenitor of the bespeaks caution doctrine. *See e.g.*, Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 BUS. LAW., Feb. 1994, at 481, 481.

[50] During this time period, more than thirty published circuit and district court opinions cited other parts of the *Polin* opinion. *Polin's* "bespeaks caution" statements, however, were first cited in the Second Circuit's 1985 decision in *Goldman vs. Belden* 754 F.2d 1059 (1985), three years before the Second Circuit again cited this language in *Luce*. Unlike the *Luce* court, the *Goldman* court found that the plaintiff's complaint (which alleged "that defendants made a series of very positive predictions without qualifications . . . while they . . . knew of many flaws in [their principal product]") stated a valid 10b-5 claim even though the court determined that the predictions were not "quite as unqualified as the [c]omplaint alleged." *Id.* at 1065.

[51] 802 F.2d at 56. The complaint also alleged that the offering memorandum represented that the general partners would take certain actions that they never intended to take and that the defendants mismanaged partnership property. *Id*. at 55-56.

[52] *Id.* at 53. The district court also suggested that even if the allegations had satisfied Rule 9(b) the court would have still dismissed the complaint for failure to state a claim because, in its view, "most of the activities alleged [were] not even colorably within the purview of §10(b) and SEC Rule 10b-5." *Id.* at 55. Accordingly, the district court did not grant the plaintiffs leave to amend the complaint. *Id*. at 53.

[53] This reading of the complaint by the court was primarily based on the complaint's allegations that the "defendants made oral and written *representations* to plaintiffs and the class regarding their returns on investment and cash and tax benefits *apart from the offering memorandum*." *Id.* at 54 (emphasis added). In light of these allegations, the court took the complaint's discussion of "intentional misrepresentation" regarding these cash and tax benefits in the offering memorandum to allege that the offering memorandum served to confirm the oral and written assurances.

> the Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were "necessarily speculative in nature" and that "[n]o assurance [could] be given that these projections [would] be realized." Indeed, the Offering Memorandum warned prospective investors that "[a]ctual results may vary from the predictions and these variations may be material." We are not inclined to impose liability on the basis of statements that clearly "bespeak caution."[54]

Thus, as in *Polin*, the *Luce* bespeaks caution holding was simply a restatement of the SEC's position that generic warnings are sufficient to prevent the inference that the projected results are guaranteed.[55]

Thus understood, both *Polin* and *Luce* were firmly rooted in the traditional doctrinal framework. The plaintiffs in both cases asserted, at least as the courts read their complaints, that they took the predictions at issue as guarantees. Both courts, however, found that the respective accompanying disclosures rendered this inference unreasonable. As a result, the courts concluded that even though the predictions turned out to be inaccurate they were not misleading when they were made.

2. The Bespeaks Caution Doctrine and Assumption Disclosure

Following *Luce*, the "bespeaks caution" language did not appear in another circuit court opinion until 1991, when the First, Second, Sixth, and Eighth Circuits cited either *Luce*, *Polin*, or

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[54] *Id.* at 56 (citing Polin v. Conductron Corp., 552 F.2d 797, 806 n. 28 (8th Cir. 1977)).

[55] The substance of the warning in the partnership's offering memorandum was essentially indistinguishable from the warning set forth in the SEC 1975 safe harbor proposal, which would have required issuers to alert investors that "there can be no assurance that the projection will be achieved." Notice of Proposed Rule 132, Securities Act Release No. 33,5581 (April 28, 1975) at 13. This reading of the *Luce* court's "bespeaks caution" holding is supported by the court's subsequent discussion overturning the district court's refusal to grant the plaintiffs leave to amend their complaint. Although the court stated that "allegations that relate to the mismanagement of the project" could not survive a Rule 12(b)(6) motion "even if made with more particularity," 802 F.2d at 56, it provided specific guidance as to how the misleading projection allegations could be rewritten to pass muster under both Rule 9(b) and Rule 12(b)(6): "Amendments [to the complaint] relating to projections or expectations offered to induce investments must allege particular facts demonstrating the knowledge of defendants at the time that such statements were false." *Id*. Obviously, the court would not have given this instruction if its disinclination "to impose liability on the basis of statements that clearly 'bespeak caution'" had been insurmountable. Accordingly, had the plaintiffs followed the Second Circuit's instruction and amended their complaint to allege that they inferred from the projections that the predicted outcomes were more likely than not (instead of that the projections were implicit guarantees) and that the defendants at the time of the offering held documents, such as IRS private ruling letters, indicating that the predicted tax benefits were extremely unlikely to be realized, the district court would have been unable to dismiss the amended complaint.

both in connection with their holdings that inaccurate predictions did not give rise to liability.[56] All four of these decisions were rooted in the traditional doctrinal framework. The two most instructive opinions, the First Circuit's opinion in *Romani v. Shearson Lehman Hutton*[57] and the Second Circuit's opinion in *I. Meyers Pincus & Associates, P.C. v. Oppenheimer & Co., Inc.,*[58] both reflect the view that cautionary statements disclosing specific underlying assumptions may do more than simply prevent the inference that the projected results are guaranteed.[59]

In *Romani*, the general partners' offering materials contained several optimistic predictions of future success of the partnership's horse breeding operations, including expected

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[56] In 1988, the Fifth Circuit cited the *Luce* court's "bespeaks caution" holding but only in connection with an effort to summarize principles of law relating to predictive statements that it hoped would guide the lower court on remand. Isquith v. Middle South Utilities, Inc. 847 F.2d 186, 203-204 (5th Cir. 1988).

[57] 929 F.2d 875 (1991).

[58] 936 F.2d 759 (1991).

[59] The two other cases that cited Luce were *Moorhead v. Merrill Lynch*, 949 F.2d 243 (8th Cir., 1991) and *Sinay v. Lamson*, 948 F.2d 1037 (6th Cir., 1991). *Moorhead* appears to stand for the unremarkable proposition that disclosures of specific underlying assumptions are just as effective as blanket warnings in preventing the inference that projected results are guaranteed. The case involved an underwritten sale of bonds to finance the construction and operation of a retirement center. The offering materials attached a "generally favorable" study generated by an independent feasibility consultant that disclosed in great detail the assumptions on which the feasibility of the debt repayment was based. Within a year after construction was completed, however, the center became unable to service the debt and soon thereafter filed for bankruptcy protection. The investors alleged that the "defendant . . . knowingly or recklessly issued the feasibility study which misrepresented that sufficient revenues *would be generated* to pay back the debt." (emphasis added) *Id.* at 245. Thus, it appears that the investors, like the *Luce* plaintiffs, asserted that the feasibility study implicitly assured investors that the center would be able to service the bonds. Without extended analysis, the court, citing *Polin* and *Luce*, upheld the district court's grant of summary judgment to the defendant: "We agree with the district court and hold that plaintiffs could not base a federal securities fraud claim on any misrepresentation . . . in the feasibility study which was addressed by the repeated, specific warnings of significant risk factors and the disclosures of underlying factual assumptions also contained therein." *Id*. Although the Sixth Circuit's opinion in *Sinay v. Lamson & Sessions Co.* provides very little doctrinal discussion of the bespeaks caution doctrine, its application of the doctrine appears to be consistent with the reasoning of the *Romani* court discussed *infra* pp. 20-21. In *Sinay*, a manufacturer of construction and transportation equipment products experienced a severe slow down after several years of rapid earnings growth. 948 F.2d at 1038. The plaintiffs alleged that a company officer's statement (made before the slow down became public) that he did "not quarrel with analysts' earnings estimates in the area of $1.50 to $1.60" was misleading. *Id.* at 1039. The court identified various specific risk factors accompanying the statement and then without any discussion of the factors stated that "[i]n light of the cautionary language, [the officer's] statement . . . is hardly the type of statement that would mislead a reasonable investor." *Id.* at 1040. The court then noted that its decision was also based on the fact that "the plaintiffs did not offer any objective evidence that the [forecasts] were anything other than honestly held convictions based on the historical information which Lamson possessed." Accordingly, the absence any discussion of the accompanying risk disclosures does not suggest that the court intended to adopt a bright-line rule that predictions accompanied by such disclosures are non-actionable *per se*, that is, non-actionable even if the predictions are not "honestly held convictions" or based on reliable information.

partnership "cash distributions in excess of 13%."[60] Romani asserted that the predictions were misleading because the defendants did not disclose that "the standardbred horse industry was entering a recessionary period, making past performance an imperfect indicator of the future."[61] The court rejected this assertion because a report attached to the prospectus "detailed a number of specific problems facing the standardbred industry, including overbreeding, declining attendance at races and an average decline in yearling prices."[62] Accordingly, the court concluded:

> [A]lthough the offering materials were optimistic about the prospects for [the partnership], the documents unquestionably warned potential investors in a meaningful way that economic conditions in the horsebreeding industry were uncertain. Documents such at this, which "clearly 'bespeak caution,'" are not the stuff of which securities fraud claims are made.[63]

In contrast to the plaintiffs in *Polin* and *Luce*, Romani did not allege that the 13% cash distribution or any of the other predictions amounted to a guarantee. Instead, Romani alleged that the projection suggested that the partnership's past performance was likely to continue and that this suggestion was false. The court's response was that the disclosures regarding several specific contingencies the occurrence of any of which would cause actual results to differ significantly from those projected made reading the projection to imply such a representation unreasonable. The *Romani* court's analysis thus mirrors the position implicit in the SEC's 1978 and 1979 releases that a projection with a low confidence level or high error rate may remain reasonably based if the factors giving rise to the uncertainties are disclosed.

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[60] 929 F.2d at 877.
[61] *Id.* at 877.
[62] *Id.* at 879.
[63] *Id.*

In *I. Meyers Pincus & Associates, P.C. v. Oppenheimer & Co., Inc.,*[64] the defendant, Oppenheimer, offered shares of a closed-end fund in a registered public offering. In its prospectus, Oppenheimer noted that: "The shares of closed-end investment companies frequently trade at a discount from or premium to their net asset values. The Shares are also expected to trade at a discount or premium."[65] Although Oppenheimer also stated in another section of the prospectus that "[s]hares of closed-end investment companies *frequently* trade at a discount from net asset value, but in *some* cases trade at a premium,"[66] the plaintiff asserted that the first statement suggested that the shares were "as likely to trade at a premium as at a discount" and that this suggestion was misleading because "shares of closed-end investment companies 'usually and typically sell at discounts' from the net asset value."[67]

After observing that "[t]he central inquiry in determining whether a prospectus is materially misleading . . . is . . . whether defendant's representations, taken together and in context, would have misled a reasonable investor about the nature of the investment,"[68] the court concluded that the "discount or premium" statement, read in the context of the other statements in the prospectus, was not misleading: "The statements contained within the prospectus clearly "bespeak caution,' rather than encouraging optimism. . . . No reasonable investor would be misled by the prospectus into believing that the Fund was predicting the success of its shares in a secondary market for them."[69] Of all the pre-1993 circuit court bespeaks caution cases,

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[64] 936 F.2d 759 (2nd Cir. 1991).
[65] *Id.* at 761.
[66] *Id.* at 762.
[67] *Id.* at 761.
[68] *Id.*
[69] *Id.* at 763. The court clearly did not intend to hold that one may always escape liability by discouraging optimism. For example, had plaintiff made credible allegations that the defendant was aware of undisclosed fund-specific factors that made the fund's shares abnormally likely to trade at a discount, the relevant incorrect inference would not be that the shares were as likely to trade at a premium as at discount, but instead that they were not more likely to trade at a discount than the "average" closed end fund. It is unlikely that statements in the prospectus would have rendered this incorrect inference unreasonable.

Oppenheimer's discussion most explicitly reflects the contours of the traditional doctrinal framework. In the Second Circuits's view, Oppenheimer's accompanying disclosures rendered unreasonable the inference that the plaintiff allegedly drew regarding the likelihood that the shares would trade at a premium. Accordingly, the court found that the prediction itself was not misleading even though the fund's shares failed to trade at a premium.

III. EXITING THE TRADITIONAL DOCTRINAL FRAMEWORK: THE BESPEAKS CAUTION DOCTRINE AS A MATERIALITY TEST

Liability under all of the anti-fraud provisions of the securities laws requires, at a minimum, falsity and materiality. The *Oppenheimer* court's observation that "the *central* inquiry" in determining whether projections are "materially misleading" is whether they "would have misled a reasonable investor,"[70] highlights the priority that the traditional doctrinal framework gives to the inquiry into the falsity of a projection. The courts in all of the pre-1993 bespeaks caution cases viewed the inquiry into whether a forward-looking statement was misleading or "false when made" as the "central inquiry" because they assumed that such falsity, if established, would likely be material. Throughout the gradual reversal of the SEC's position on the disclosure of projections discussed above, the Commission and the courts operated under the same assumption.[71]

Because virtually allpre -1993 approaches to forward-looking information placed the falsity inquiry ahead of the materiality inquiry, their development rarely crossed paths with the development of materiality doctrine during this period. In contrast, the materiality, as well as the falsity, of forward-looking information was contested in *Virginia Bankshares v. Sandberg.* [72]

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[70] *Id.* at 761.
[71] Without the assumption that the predictive information would typically influence investment decisions the Commission's policy prohibiting the disclosure of such information in Commission filings would have made little sense. *See supra* note 23 and accompanying text.
[72] 501 U.S. 1083 (1991).

Accordingly, the Supreme Court's reasoning in *Virginia Bankshares* should have guided subsequent lower court analyses of both the falsity and materiality of forward-looking information. This Part begins with a brief overview of the Court's development of materiality doctrine prior to *Virginia Bankshares.* It then reviews the principles of the *Virginia Bankshares* falsity and materiality analyses and demonstrates their consistency with the traditional framework for evaluating the actionability of inaccurate forward-looking information. Finally, this Part reviews the Third Circuit's analysis in *Trump* and contrasts the analysis with the *Virginia Bankshares* materiality analysis to demonstrate that while courts and Congress accepted *Trump* as an accurate articulation of the bespeaks caution doctrine, the Third Circuit's approach was in fact a fundamental departure from prior case law.

A. The Supreme Court's Development of Materiality Doctrine

Lower courts applied a variety of materiality definitions from the 1930s through the late 1960s.[73] In 1970, the Supreme Court missed an opportunity to establish a uniform materiality standard in *Mills v. Electric* by stating both that materiality "indubitably embodies a conclusion that the defect was of such a character that it *might* have been considered important by a reasonable shareholder" and that materiality requires that the "defect have a *significant propensity* to affect" a shareholder's decision making process.[74] Six years later, in *TSC*

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[73] *See generally* E. C. Lashbrooke, Jr., *The Alternative-Action Requirement: the Derailment of Sante Fe*, 1981 DUKE L.J. 963, 972 ("Since the inception of an implied civil cause of action for a violation of section 10(b) and rule 10b-5, the federal courts have been formulating a definition of materiality. The test for materiality has ranged from a realistic view to a reasonable man standard to a marketplace effects test.")

[74] Mills v. Electric Auto-Lite Co., 396 U.S. 375, 378. *Mills* was decided in the middle of an era of expansive interpretations of the federal securities laws by the courts. According to most commentators this era began about 1965 and continued until 1975. *See* Louis Loss, Fundamentals of Securities Regulation 1058 (1983); *see also* 1 Alan R. Bromberg & Lewis B. Lowenfels, Securities Fraud & Commodities Fraud § 2.2, at 462 (2d ed. 1994). During this time period, the Supreme Court upheld various "implied rights of action" that many lower courts had inferred from the federal securities acts and regulations, including Rule 10b-5 and Rule 14a-9. Starting in the mid-1970s, the Supreme Court gradually pared back these implied rights of action. One of the perceived problems targeted by the Court's decisions was the purportedly unchecked multiplication of forms of liability based on rule 10b-5. The Court's 1975 opinion in *Blue Chip Stamps v. Manor Drug Stores* contained its most explicit

Industries v. Northway, Inc., the Court eliminated much of this ambiguity.[75] The court of appeals, citing *Mills*, had defined material facts as "all facts, which a reasonable shareholder *might* consider important"[76] and applying that definition found that alleged omissions from the defendant's proxy statement were material as a matter of law. Rejecting this standard as "unnecessarily low,"[77] the *TSC Industries* Court stated: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[78]

Although this "substantial likelihood" materiality standard raised the liability bar under the securities laws in several circuits, the Court cautioned against the creation of standards designed to permit courts to resolve materiality issues by summary judgment: "Only if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' by summary judgment."[79] Just a few years later, however, the Third Circuit disregarded this instruction and developed a single-factor materiality test under which a judge could find a company's public statements regarding a potential merger with another company immaterial as a matter of law without ever directly assessing the importance of the statements to

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endorsement of the view that judicial expansion of Rule 10b-5 had gone too far. 421 U.S. 723, 739 (1975) ("There has been widespread recognition that litigation under rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general.")

[75] 426 U.S. 438 (1976).

[76] *Id.* at 445.

[77] *Id.* at 448.

[78] *Id.* at 449. According to the Court, such importance "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

[79] *Id.* at 450 (quoting John Hopkins U. v. Hutton, 422 F.2d 1124, 1129 (D. Md. 1970)).

investors.[80] Several years later, after other lower courts had adopted the Third Circuit's single-factor materiality test, the Supreme Court granted certiorari in *Basic, Inc. v. Levinson* and rejected the test.[81] After holding that *TSC Industries* provided the appropriate definition of materiality in the context of Rule 10b-5, the Court found the Third Circuit's test was fundamentally inconsistent with that definition:

> A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact specific finding such as materiality, must necessarily be overinclusive or underinclusive.[82]

B. *The Supreme Court's Articulation of the Traditional Doctrinal Framework in* Virginia Bankshares

Neither *TSC Industries* nor *Basic* involved forward-looking information. In fact, the Court in *Basic* distinguished the non-predictive soft information at issue from "other kinds of contingent of speculative information, such as earnings forecasts or projections." Consequently, *Basic* left open the possibility that single-factor materiality tests for forward-looking information

[80] *See* Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982).

[81] 485 U.S. 224, 230-241 (1998).

[82] *Id.* at 236. The emergence in the lower courts of bright-line tests occurred in the context of materiality assessments regarding *non*-forward-looking information. As noted above, courts generally assumed the materiality of *disclosed* projections and were rarely were compelled to question that assumption. Several circuit courts that addressed the materiality of *undisclosed* projections during this time period, however, applied heightened materiality standards to find those projections immaterial. Notwithstanding the SEC's position against requiring issuers to disclose projections, the courts in these cases accepted the plaintiffs' contention that defendants were under a general duty to disclose *all* material information related to a certain subject. Thus, to hold that the defendants had not violated this general duty, the courts had to find that the internal projections at issue were immaterial. In the 1978 case of *James v. Gerber Products Co.*, for example, the Sixth Circuit first stated that *TSC Industries* made the reasonable investor inquiry mandatory but then after noting that "[t]he undisclosed information in dispute . . . is comprised of interim earnings figures that circulated through Gerber in the normal course of its business," held that "[s]uch sales figures, projections, forecasts and the like only rise to the level of materiality when they can be calculated with substantial certainty." 587 F.2d 324, 327 (6th Cir. 1978). In its 1984 opinion in *Flynn v. Bass Brothers Enterprise Inc*., the Third Circuit also began by reciting the *TSC Industries* materiality definition and then stated that it saw "no reason not to utilize the same formulation for evaluating materiality in the context of a tender offer." 744 F.2d 978, 984 (1984). The court ultimately held, however, that in the case of undisclosed projections, the *TSC Industries* materiality test requires a court to balance "the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released without a proper cautionary note." *Id.* at 988. Instead of inventing materiality tests inconsistent with *TSC Industries*, these courts should have developed exceptions to the applicable duty to disclose all material information.

might still pass muster.[83] Three years later, when the Supreme Court again addressed materiality in *Virginia Bankshares, Inc. v. Sandberg*, the Court's opinion should have finally foreclosed that possibility.[84] In *Virginia Bankshares*, directors of a bank solicited proxies for approval of the bank's merger into its parent, which owned 85% of the bank's shares. After the transaction was consummated, a minority shareholder of the bank sued the bank and its directors asserting that the proxy statement was materially misleading in violation Exchange Act Rule 14a-9. The Court of Appeals affirmed the judgment of the trial court in favor of the shareholder. In particular, the Court of Appeals found materially misleading the proxy statement's assertions that the Plan of Merger had been approved by the Board of Directors because it provided an opportunity for the Bank's public shareholders to achieve a "high" value for their shares and that the $42 per share merger price was "fair."[85] Before the Supreme Court, the bank argued both that such "statements of opinion or belief . . . cannot be actionable as misstatements of material fact . . . within the meaning of Rule 14a-9" and that even if the statements could violate the rule, the bank's "high" and "fair" statements did not because the assertions were accompanied by "statements of fact sufficient to enable readers to draw their own independent conclusions."[86]

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[83] Besides the Third Circuit in *Trump*, several other Circuit courts have applied single-factor materiality tests to forward-looking information. In *Helwig v. Vencor*, for example, an *en banc* Sixth Circuit case, a six member dissent argued that the Circuit's substantial certainty test developed in the context of undisclosed projections applied to disclosed projections as well. 251 F.3d 540, 546 (6th Cir. 2001). Similarly, the Fourth Circuit has repeatedly used a single-factor "guarantee" materiality test to affirm dismissal of complaints alleging false projections. According to this test, a projection is immaterial unless its presentation suggests to the investor that management has guaranteed the predicted results. *See e.g.*, *Hillison Partners Ltd. P'Ship v. Adage, Inc.*, 42 F.3d 204 (4th Cir. 1994) and *Raab v. Gen. Physics Corp.*, 4 F.3d 286 (4th Cir. 1993). These two single-factor materiality tests have remained largely confined to the Sixth and Fourth Circuits.

[84] 501 U.S. 1083 (1991).

[85] *Id.* at 1088-1089.

[86] *Id.* at 1090.

Although the Court did not attach the "forward-looking statement" label to the board's statements, it clearly recognized that the statements were, at least in part, forward-looking.[87]

Taking the bank's actionability argument first,[88] the Court demonstrated through an articulation of the traditional framework that the bank's "opinion" statements could qualify as misstatements of fact: "[Opinion statements are] factual in two senses: as statements that the directors do . . . hold the belief stated and as statements about the subject matter of the . . . belief expressed."[89] The first sense identified by the court is a straightforward application of the traditional doctrinal framework. Because it is reasonable for an investor to infer from the publication of an opinion statement by management that management in fact holds the opinion published, if that inference is incorrect the opinion statement itself qualifies as a factual misstatement.

The second sense in which an opinion statement is factual, as a statement "about its subject matter," likewise grows out of the traditional doctrinal framework. The bank argued that the statements were not factual in this sense because they were not expressed in "dollars and cents, but focused instead on the 'indefinite and unverifiable' term, 'high' value."[90] Rejecting this argument, the Court described the meaning of "subject matter" it had in mind:

> [This] objection ignores the fact that such conclusory terms in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading. Provable facts either furnish good reasons to make a conclusory judgment, or they count against it, and

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[87] For example, the Court observed that "whether $42 was 'high,'" depended upon "actual and *potential* levels of operation." *Id.* at 1094 (emphasis added).

[88] The Court easily concluded that management's statements of opinion could be material. After briefly discussing the importance to investors required for materiality under *TSC Industries*, the Court stated: "We think there is no room to deny that . . . a statement of belief by corporate directors about a recommended course of action . . . can take on just that importance. Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources . . . . " *Id.* at 1090-1091.

[89] *Id.* at 1092.

[90] *Id.* at 1093.

> expressions of such judgments can be uttered with knowledge of truth or falsity just like more definite statements. . . .[91]

In other words, because it is reasonable for shareholders and investors to infer from management's publication of its judgment about a certain matter that the judgment rests on a factual basis, if this inference is incorrect the judgment statement itself qualifies as a factual misstatement.[92] Applying this approach to the bank's "high" and "fair" value statement, the Court found that the evidence adduced by the plaintiff warranted the conclusion "that the statement was misleading about its subject matter and a false expression of the director's reasons [for recommending the merger to shareholders]."[93]

The Court then turned to the bank's argument that its statements were not actionable because the proxy statement contained "statements of fact sufficient to enable readers to draw their own independent conclusions."[94] Although the Court could have read this allegation to pertain to the "falsity" of the bank's statements, it chose instead to read the allegation as an

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[91] *Id.*

[92] It follows from the Court's discussion that material falsity of either "sense" should be sufficient to trigger liability. The Court, however, held that where statements are not also false as to "subject matter," a plaintiff may not prevail solely on "proof of mere disbelief or belief undisclosed:" "[T]o recognize liability on mere disbelief or undisclosed motive without any demonstration that the . . . statement was false or misleading about its subject would authorize . . . litigation confined solely to what one skeptical court spoke of as the 'impurities' of a director's 'unclean heart.' This, we think, would cross the line that *Blue Chip Stamps* sought to draw. . . .[T]he temptation to rest an otherwise nonexistent . . . action on psychological enquiry alone would threaten just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage." *Id.* at 1096 (citing *Stedman v. Storer,* 308 F.Supp. 881, 887 (SDNY 1969) (dealing with § 10(b)). The same concerns regarding "strike suits and attrition by discovery" would later motivate Congress' enactment of the PSLRA. As discussed *infra* Part IV, *Virginia Bankshares*' response to these concerns foreshadows a necessary adjustment to the contours of a PSLRA safe harbor interpretation based on the traditional doctrinal framework. It is also worth noting that the court's "psychological" and "subject matter" senses of falsity mirror the good faith and reasonable basis elements of Rule 175. The "misstatement of the psychological fact" that a manager holds the opinions he is stating and the absence of "good faith" are forms of what is often referred to as subjective falsity. Implicit "subject matter" or "reasonable basis" misrepresentations, on the other hand, are both forms of objective falsity. The conjunctive nature of Rule 175 suggests that, in contrast to the view of the *Virginia Bankshares* Court*,* the Commission believed that liability could be based on subjective falsity alone.

[93] *Id.* at 1094.

[94] *Id.* at 1097.

assertion that the "high" and "fair" value statements were immaterial.[95] This decision precipitated the Court's development of analytically clear precedent regarding the appropriate materiality standard for forward-looking information accompanied by disclosures pertaining to the "subject matter" of the prediction:

> While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. Since liability under § 14(a) must rest not only on deceptiveness but materiality as well . . . petitioners are on perfectly firm ground insofar as they argue that publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability. But not every mixture with the true will neutralize the deceptive. . . . Only when the inconsistency would exhaust the misleading conclusion's capacity to influence the reasonable shareholder would a § 14(a) action fail on the element of materiality.[96]

After settling on this framework for assessing the impact of accompanying statements on a misleading statement's materiality, the court required little effort to find that the bank's accompanying statements did not substantially diminish the importance of the bank's assertions that the deal offered shareholders a "high" and "fair" value: "Suffice it to say that the evidence

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[95] In other words, the Court read the bank's pleadings to assert that even assuming the use of the word "high" was an *inaccurate* statement of the directors' opinions, that inaccuracy was immaterial. The Court might have read this contention to assert that the accompanying "statements of fact" (notwithstanding the omission of other relevant facts) gave shareholders an *accurate* picture of what the directors believed when they stated that $42 was a "high" price or, in other words, that, taken in context, the use of the word "high" was not misleading. Neither of these two analyses of the impact of accompanying disclosure is reducible to the other. When a court reads an asserted defense based on accompanying statements in terms of falsity, then its discussion should focus on what investors should have understood the prediction or opinion to mean in the context of the accompanying statements. In contrast, where the defendant contends that accompanying statements rendered a prediction or opinion immaterial, the defendant is asking the court to assume for purposes of the contention that the statement is false and to assess whether the false impression created by the statement really mattered to investors. Because it adopted the latter approach, the *Virginia Bankshares* Court assumed that the proposed deal did not offer a "high" value under any reasonable interpretation of that term. To find this statement was immaterial, the court would have had to conclude that the accompanying statements so clearly demonstrated that the proposed deal did not offer a "high" value that no reasonable investor would have given any credence to the contrary statement in the proxy materials.

[96] *Id.* at 1097-1098.

invoked by [the bank] in the instant case fell short of compelling the jury to find the facial materiality of the misleading statement neutralized."[97]

Two observations regarding the Court's description of the circumstances under which accompanying disclosures may render an opinion statement immaterial bear mention here. First, the description is consistent with *TSC Industries* and *Basic*. If after undertaking the "delicate assessment" required by *TSC Industries* of the impact of the disclosures on an inaccurate opinion or forward-looking statement, a judge or jury finds that the accompanying disclosures "discredit" the statement "so obviously that the risk of real deception drops to nil," the statement may be properly deemed immaterial. In other words, an opinion or prediction is immaterial when the accompanying disclosures prevent reasonable investors from drawing *any* inference from the projection's disclosure that would "assume[] actual significance in [their] deliberations."[98] Second, the Court's materiality analysis will almost never be useful to a defendant seeking to avoid liability for an inaccurate prediction. Situations in which an issuer's accompanying disclosures obviously discredit a published prediction are very rare if they exist at all. It difficult to conceive of circumstances, for example, in which a company press release providing earnings guidance might contain other statements that discredit the guidance. The same is true of all types

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[97] *Id*. In addition, it is not clear from the facts of the *Virginia Bankshares* case that the $42 fair price statement would have been rendered immaterial even if the Board *had* disclosed the omitted facts relating to the subject matter of the $42 fair price statement. One of those omitted facts was that the market for the Bank's shares was "closed, thin, and dominated by [a single large shareholder]." 501 U.S. at 1093. Another was evidence of a "going concern" value of more than $60 per share. In the absence of these disclosures, a reasonable investor, depending on his prior understanding of the Bank's business and trading history, may have inferred either (1) that the $42 per share merger price reflected a higher value than the Bank's value as a going concern or (2) that notwithstanding the Bank's higher value as a going concern, other factors made the merger at the $42 price compelling, including, perhaps, that the merger represented shareholders' only liquidity opportunity for the foreseeable future. Disclosure of the evidence of a going concern value of more than $60 and of the thinness of the trading market obviously would have rendered the first inference unreasonable. The disclosure would not necessarily have made the second inference unreasonable, however, and because this inference likely would have assumed actual significance in the minds of reasonable investors, the Board's statement that $42 represented a fair value would likely have remained material.

[98] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

of projections intentionally published by issuers whether in press releases, SEC filings, or other written format.[99]

C. The Third Circuit's Conversion of the Bespeaks Caution Doctrine Into a Materiality Test in In Re Donald J. Trump Casino Securities Litigation[100]

The *Virginia Bankshares* discussion of the "sen ses" in which management's published beliefs or opinions may qualify as factual misstatements was a relatively complete, if somewhat obscure, articulation of the traditional doctrinal framework. Accordingly, the case should have led courts to apply the framework in subsequent cases involving allegedly misleading forward looking information. Unfortunately, this did not happen. Instead, *Virginia Bankshares*, as misread by the Third Circuit in *Trump* two years later, to some extent inspired the Third Circuit's materiality-based version of the bespeaks caution doctrine. The *Trump* defendants formed a partnership for the acquisition and completion of the Taj Mahal casino in Atlantic City.[101] The Taj Mahal construction was completed but the partnership was ultimately unable to service the debt.[102] When the plaintiffs learned that the partnership planned to file for bankruptcy protection, they sued alleging that the prospectus covering the bond issuance was materially misleading because the defendants had "neither an honest belief in nor a reasonable basis [for]" the partnership's prediction in the prospectus that "funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal)."[103]

[99] The Court's holding may be useful in the case of the over-exuberant executive prone to making off-the-cuff projections. The Court's analysis suggests that the executive's company or the executive himself could render any inaccuracies in such projections immaterial by immediately correcting the projection in a way that obviously discredits it.

[100] 7 F.3d 357 (1993).

[101] *Id.* at 364.

[102] *Id.* at 365.

[103] *Id.* at 366. The plaintiffs buttressed this contention with allegations that "1) the Taj Mahal required an average 'casino win' of approximately $1.3; 2) Donald Trump had personally guaranteed hundreds of millions of dollars in bank loans for other properties; and 3) the Taj Mahal had an 'unprecedented' debt to equity ratio," none of which was disclosed in the prospectus. *Id*.

After summarizing earlier bespeaks caution cases, the district court concluded that the cases established *per se* rule against the actionability of projections accompanied by cautionary language such as that contained the defendants' prospectus.[104] The court then acknowledged the "troubling possibility" that such a doctrine would "encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language."[105] The court therefore held that the *per se* rule should only be triggered by "precise cautionary language which directly addressed itself to future projections, estimates or forecasts in a prospectus."[106]

On appeal, the Third Circuit multiplied the district court's errors. Failing to perceive the common doctrinal framework underlying the holdings in the previous bespeaks caution cases and the *Virginia Bankshares*' discussion of the "senses" in which a management's published judgments may be factual and therefore false, the Third Circuit instead linked the bespeaks caution doctrine to the separate discussion in *Virginia Bankshares* of the impact of accompanying disclosures on an opinion statement's materiality: "[B]y recognizing that an accompanying statement may neutralize the effect of a misleading statement, the [*Virginia*

[104] *In re Donald J. Trump Casino Securities Litigation*, 793 F.Supp. 543 (N.J. 1992). The district court began its analysis by reviewing the "origins of the 'Bespeaks Caution' approach." *Id.* at 549. After citing *Polin* and briefly discussing *Luce*, the court turned to "recent developments in the bespeaks caution doctrine" and summarized the four 1991 circuit court bespeaks caution cases discussed *supra* Part II. *Id*. at 549-551. The court then described the conflict between the parties' positions as follows: "[Plaintiffs] argue that they have adequately pled [that the prospectus contained misrepresentations]. . . . However, defendants maintain that a prospectus which 'bespeaks caution' displaces a misrepresentation claim. . . . Thus, we must decide which comes first in our consideration of this case: the cautionary language of the prospectus, or the allegation of misrepresentation in the complaint." *Id.* at 552. The court then stated its view that, properly applied, the "'bespeaks caution' analysis would subsume or obviate the analysis regarding adequate allegations of falsity" and cited the following instruction from *Sinay v. Lamson* as support for this proposition: "[I]n determining whether the statements are actionable, the court must scrutinize the nature of the statement to determine whether the statement was false when made. While analyzing the nature of the statement, the court must emphasize whether 'the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis.'" *Id.* at 553. In the district court's view, by using the word "emphasize" and including whether a statement bespoke caution among its list of considerations, the Sixth Circuit "indicat[ed] that such a factor is at lease a powerful consideration and may even be dispositive." *Id.*

[105] *Id.* at 554.

[106] *Id*.

Bankshares] court impliedly accepted the logic of the bespeaks caution doctrine."[107] As a result, the Third Circuit asserted that the reasoning of *Virginia Bankshares* "support[ed]"[108] its version of the bespeaks caution doctrine, which it described as "essentially shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law."[109]

Because the Third Circuit so explicitly based its "bespeaks caution" analysis on materiality, the distinctiveness of the court's approach from the reasoning in the prior bespeaks caution cases is unmistakable despite the general lack of rhetorical precision in the earlier bespeaks caution opinions. For example, after choosing its materiality-based approach, the Third Circuit began its analysis with a discussion of the Supreme Court's definition of materiality in *TSC Industries*.[110] In contrast, none of the prior circuit court bespeaks caution opinions contained any reference to *TSC Industries*. Following its discussion of *TSC Industries*, the Third Circuit cited each of the 1991 circuit court bespeaks caution cases and then asserted that the lower court had only "followed the lead" of these courts, which "dismissed securities fraud claims under Rule 12(b)(6) because cautionary language in the offering document negated the materiality of an alleged misrepresentation."[111] Not surprisingly, however, the court did not quote any language from the courts' opinions or discuss other aspects of the cases that could suggest that the judges in those cases understood the cautionary language in question to "negate[] the materiality of an alleged misrepresentation." Nevertheless, purportedly on the basis of these cases, the court concluded "as a general matter" that:

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[107] 7 F.3d at 372.
[108] *Id.*
[109] *Id.* at 364.
[110] *Id.* at 369.
[111] *Id.* at 371.

> When an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged . . . misrepresentations immaterial as a matter of law.[112]

Although this statement has nothing to do with the logic of the pre-1993 bespeaks caution decisions, the statement faithfully summarizes the *Virginia Bankshares's* holding that accompanying disclosures may so obviously discredit an estimate that it ceases to assume actual significance in the minds of investors. Such information would indeed fail to impact the total mix of information affecting investment decisions regarding the security in question. If the error in the Third Circuit's analysis had been nothing more than mislabeling the *Virginia Bankshares* materiality analysis as an application of the bespeaks caution doctrine, the court's decision may have done little harm. Had the Third Circuit actually applied the *Virginia Bankshares* materiality analysis to the *Trump* facts, however, it could not have affirmed the district court's dismissal of the case. As noted above, the plaintiffs' primary allegation was that the statement in the prospectus of the Partnership's prediction that "funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service"[113] was materially misleading. Neither the defendants nor the court asserted that the accompanying disclosures in the prospectus so obviously discredited this prediction that its capacity to influence potential buyers of the debt was exhausted. In fact, both the parties and the court apparently understood that the investors chose to invest in the bonds, notwithstanding the risks disclosed in the prospectus, precisely because they accepted the Partnership's view that the likelihood that cash flows from operations would be sufficient to repay the debt was great enough to accept those risks. In other words, this

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[112] *Id.*
[113] *Id*. at 366.

prediction was not just a material motivation for the investors' decision to invest, it was the primary motivation. Accordingly, if the statement was actually false as the plaintiffs alleged, it was impossible for the Third Circuit to apply the *Virginia Bankshares* materiality holding to dismiss the plaintiffs' case. Because the Third Circuit was unwilling to question its mistaken premise that under the bespeaks caution doctrine accompanying statements negate the materiality of a projection, this impossibility forced the court to develop a substitute test for the assessment required by *Virginia Bankshares* of whether "the inconsistency would exhaust the misleading conclusion's capacity to influence the reasonable shareholder." In the district court's conclusion that the "bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections,"[114] the Third Circuit found the content. By slightly altering the language of the district court's per se rule, the Third Circuit converted the rule into a new single-factor "bespeaks caution" materiality test: "To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions . . . which the plaintiffs challenge."[115] Applying the new test to facts before it, the court held "that the plaintiffs have failed to state an actionable claim regarding the statement that the Partnership believed it could repay the bonds. We can say that the prospectus here truly bespeaks caution . . . . [T]he cautionary statements were tailored precisely to address the uncertainty concerning the Partnership's prospective ability to repay the bondholders."[116]

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[114] *In re Donald J. Trump Casino Securities Litigation*, 793 F.Supp. 543, 554 (N.J. 1992).

[115] 7 F.3d at 371-372.

[116] *Id*. at 372. That the debt service prediction in the partnership's prospectus was material under an application of the *Virginia Bankshares* materiality test does not mean that the plaintiffs' complaint should have withstood the defendant's 12b-6 motion. Had the Third Circuit applied the traditional doctrinal framework it may well have found that the accompanying disclosures made any potentially misleading inferences unreasonable and thus that the prediction itself, although inaccurate, was not misleading. For example, had the *Trump* plaintiffs asserted that they inferred from the debt service predictions that repayment was very likely, or even more likely than not, it is quite possible that the court could have found that this inference was unreasonable in light of the accompanying disclosures, which the Court correctly observed did "address the uncertainty concerning the Partnership's prospective ability to repay the bondholders." In the terminology of *Virginia Bankshares*, inferences

Unlike prior single-factor materiality tests, which remained confined to the circuits in which they developed, the Third Circuit's reformulated bespeaks caution doctrine was quickly absorbed into the case law of other circuits. Between 1993 and 1995, most lower courts that used the "bespeaks caution" phrase cited *Trump's* statement that "cautionary language, if sufficient, renders the alleged . . . misrepresentations immaterial as a matter of law" as an accurate description of the bespeaks caution doctrine.[117] Not surprisingly, this wide-spread judicial acceptance of the Third Circuit's materiality-based bespeaks caution doctrine gradually spilled over into ongoing Congressional deliberations regarding reform the nation's private securities litigation system.[118] For example, a June 1995 report by the Senate's Committee on

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drawn from the publication of the prediction regarding the likelihood of debt service are inferences regarding the "subject matter" of the prediction. The *Trump* plaintiffs apparently emphasized the other "sense" in which an opinion or prediction may be factual and therefore false, namely, as "a misstatement of the psychological fact of the speaker's belief in what he says." *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1092 (1991). Again, had the Third Circuit applied the traditional doctrinal framework to the plaintiff's allegation that this implied representation was false, it could have required the plaintiffs to demonstrate the existence of inside information suggesting that revenues from operations would almost certainly be inadequate to service the bonds. Because the issue in *Trump* was the sufficiency of the plaintiffs' complaint, the court could have required the plaintiffs to make particularized factual allegations from which a legal inference that such inside information existed at the time of the offering could be drawn. The plaintiffs' alleged that just such information existed with respect to another projection in the prospectus, which estimated "that as of its opening date the Taj Mahal would be worth approximately $1.1 billion." *Id.* at 373. The estimate was based on a third-party appraisal. The allegation stated that the third party had used an irrational appraisal method and that the use of this method was not disclosed. *Id.* The court held that the cautionary language regarding the estimate still met its "substantive and tailored" test, but, perhaps sensing the weakness of its materiality-based approach, added: "We further note that the plaintiff's allegation concerning the appraisal report fails to satisfy the particularity requirements of Rule 9(b)." *Id.*

[117] *See, e.g.,* Rubinstein v. Collins, 20 F.3d 160, 166-167 (5th Cir. 1994) and Saltzberg v. TM Sterling/Austin Accocs., 45 F.3d 399 (11th Cir. 1995).

[118] The first securities litigation reform bills were introduced in 1993. *See* S. 3181 102nd Cong. (1992); H.R. 417 103rd Cong. (1993); and S. 1976 103rd Cong. (1994). Around the same time, the Commission began considering changes to the Rule 175 safe harbor. In 1994, the Commission issued a concept release and solicited public comment regarding whether the Rule 175 safe harbor was "effective in encouraging disclosure of voluntary forward-looking information and protecting investors or, if not, [whether it] should be revised. . . ." Safe Harbor for Forward-Looking Statements, Securities Act Release No. 33,7101 (Oct. 13, 1994) at 9. The release began by reasserting the Commission's position on the importance to investors of projections: "Forward-looking information occupies a vital role in the United States securities markets. Investors typically consider management's forward-looking information important and useful in evaluating a company's economic prospects and consequently in making their investment decisions. Analysts and other market participants report that they view consideration of management's own performance projections, i.e., earnings and revenues, to be critical to their own forecasts of a company's future performance. As such, forward-looking information is often considered a critical component of investment recommendations made by broker-dealers, investment advisers and other securities professionals." *Id.* at 1. After Republicans took control of the House of Representatives in 1994, party leaders made elimination of

Banking, Housing and Urban Affairs on proposed securities litigation reform legislation quoted at length *Trump*'s description of the doctrine as a materiality-based approach to evaluating inaccurate forward-looking statements and singled-out *Trump* as an "oft-cited" bespeaks caution case.[119] Similarly, the December 1995 conference committee report on H.R. 1058 (which ultimately became the PSLRA after Congress voted to override a veto of the bill by President Clinton) reflects the assumption by members of the Committee thatthe legal significance of statements accompanying a prediction is their impact on the prediction's materiality.[120]

IV. INTERPRETING THE PSLRA SAFE HARBOR PROVISIONS TO ESTABLISH A SINGLE FRAMEWORK FOR EVALUATING LIABILITY FOR INACCURATE PREDICTIONS

The widespread assumption among members of Congress that the bespeaks caution doctrine developed as a materiality-based approach to forward-looking information led members of the H.R. 1058 conference committee to also assume thatby adoptinga "meaningful cautionary statements" safe harbor provision Congress would establisha statutory formula for rendering predictions immaterial. Nothing in the legislative history of the PSLRA, however, suggests that this view was based on any deliberations regarding the distinctions between

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perceived abuses in private securities litigation a key objective in their broader private civil litigation reform campaign. H.R. CONF. REP. NO. 104-369, at [43] (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 741. In early 1995, House Republicans introduced a new securities litigation reform bill that was much more aggressive than the earlier proposals. H.R. 10, 104th Cong. (1995). H.R. 10 would have become the "Common Sense Legal Reform Act of 1995." Title I of the bill dealt with product liability reform and Title II with private securities litigation reform. As the year wore on, however, most of the provisions in Title II were softened or replaced entirely through efforts to create broader congressional support for the reforms. In the end, a compromise bill passed by the House and Senate garnered sufficient support to override a veto of the bill by President Clinton. *See generally* H.R. 1058, 104th Cong. (1995). For a chronology of events leading to the enactment of the PSLRA, *see* John W. Avery, Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995, 51 Bus. Law. 335 (1996).

[119] 1995 Committee Reports, p. 12, June 19, 1995.

[120] After discussing the types of information that should qualify accompanying statements as "meaningful" for purposes of the first prong of the safe harbor, the Committee's report states: "Courts may continue to find a forward-looking statement immaterial . . . on other grounds." H.R. CONF. REP. No. 104-369, [43] (1995). Although this statement is somewhat ambiguous, it appears to reflect the assumption that judicial application of the bespeaks caution doctrine might in some instances render a statement immaterial even though the accompanying statements in question did not satisfy the first prong of the safe harbor. This reading of the statement is confirmed by a subsequent section of the report that notes the Committee did "not intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts." *Id.*

materiality-based and falsity-based evaluations of forward-looking information. In fact, there is no indication in the legislative history that any of the legislatorsgrasped that the legal relevance of accompanying statements could be conceptualized in any terms other than materiality. Instead, it appears that members of Congress simply took as granted *Trump's* assertion that the primary relevance of accompanying cautionary language is its impact on a projection's materiality because cases subsequent to *Trump* gave them no reason to questions this assertion.

The safe harbor language that Congress enacted, however, does not clearly require a materiality-based approach to evaluating whether issuers should be liable if their published predictions turn out to be wrong. Instead, congressional negotiations and ultimately unsuccessful attempts to satisfy the concerns of the Clinton White House about the language of the safe harbor produced a set of provisions that is both less precise and more complex than the safe harbor provisions contained in earlier reform bills. The full text of the "meaningful cautionary statements" prong provides that an issuer "shall not be liable with respect to any forward looking statement . . . if and to the extent that the forward-looking statement 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."[121] To this prong, the safe harbor adds two other provisions which protect an issuer from liability for an inaccurate forward-looking statement if the statement is "immaterial" or if the speaker who made the statement did not have "actual knowledge . . . that the statement was false or misleading."[122]

[121] 15 U.S.C. §78u-5(c)(1) (Supp. I 1995).
[122] *Id.* Subsection (c)(2) extends, with certain qualifications, the principles of subsection c(1) to oral forward looking statements. *Id*. at §78u-5(c)(2) (Supp. I 1995).

Referring to these and other provisions of the PSLRA, Professor John Coffee argued in 1996 that, with its many "ambiguous gaps and statutory hiatuses," the Reform Act was like "wet clay . . . shaped into an approximation of a human form" that would becomeeither "high art" or "competent mediocrity" in the hands of the courts.[123] Unfortunately, the judiciary's interpretive work to date with respect to the safe harbor provisions falls far short of high art. The lower courts are no closer now to a uniform approach to evaluating liability for inaccurate forward-looking statements than they were in 1997 when the first complaints implicating the PSLRA were filed. In many cases, judges have attempted to interpret the language of the safe harbor provisions without reference to pre-PSLRA case law.[124] Not surprisingly given the ambiguous nature of the statutory terms "important" and "meaningful," this approach has produced inconsistent results. When judges have instead looked to pre-PSLRA cases for guidance, they have failed to distinguish and separately evaluate the alternative interpretative frameworks suggested by pre-PSLRA case law and regulatory materials.[125] The course beyond the prevailing "competent mediocrity" in the case law regarding the safe harbor must begin with a clear articulation of the differences between these alternative frameworks and the selection of one as the starting point for all assessments of liability for inaccurate forward-looking information subject to the safe harbor. By outlining the shortcomings of the materiality-based interpretation of the "meaningful cautionary statements" safe harbor provision and demonstrating that an interpretation properly rooted in the traditional doctrinal framework resolves these defects, this

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[123] John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 975 (1996).

[124] *See, e.g.*, *Asher v. Baxter International, Inc.*, 377 F.3d 727 (2004); *Miller v. Champion Enterprises, Inc.*, 346 F.3d 660 (6th Cir., 2003); and *Elhert v. Singer,* 245 F.3d 1313 (11th Cir. 2001).

[125] In many cases, courts have cited cases applying materiality-based approaches and falsity-based approaches together as if the cases conformed to a single analytical framework. *See, e.g.*, *In re: Immune Response Securities Litigation*, 2005 U.S. Dist. LEXIS 12602, *117-128 (S.D. Cal. 2005); *In re: Regeneron Pharmaceuticals, Inc.*, 2005 U.S. Dist. LEXIS 1350, *42-55 (S.D.N.Y. 2005).

part argues that the traditional framework is the best available alternative for interpreting the PSLRA safe harbor.

As discussed in Part I, the most obvious problem with reading the first safe harbor provision as a formula for rendering predictive information immaterial is the inability of this approach to connect the provision to the safe harbor's stated policy goal of enhancing allocative efficiency.[126] A safe harbor that leads companies to increase disclosures of only immaterial information will have little impact on the accuracy of equity prices on which allocative efficiency depends. The only response to this criticism is that some forward-looking information deemed immaterial under the *Trump's* materiality framework will still influence investor decision-making. This response, however, amounts to an acknowledgement that the framework does not really filter forward-looking information according to its importance to investors or, in other words, that the *Trump* framework is inconsistent with the Supreme Court's definition of materiality. Of course, Congress has the power to replace the Court's definition of materiality with a definition of its own. Accordingly, this apparent defect of the *Trump*-based interpretation could be overlooked if other interpretive criteria suggested that the statutory language of the PSRLA safe harbor can only be interpreted as the outcome of a deliberate legislative effort to redefine materiality for purposes of forward-looking information.

Besides maintaining a logical relationship between policy objectives and statutory means, any proposed interpretation of the safe harbor ought to also satisfy at least the following three criteria: (1) because the provisions are disjunctive, the interpretations of the three safe harbor provisions taken together ought to ensure that each provision protects some set of forward-

[126] This criticism would apply with even greater force to an interpretation of the first provision that takes the provision as a codification of the *Virginia Bankshares* materiality analysis, under which, as discussed above, statements are only immaterial if they obviously discredit the predictive information.

looking statements that the other two provisions do not (in other words, none of the three prongs should be rendered superfluous by the other two);[127] (2) the interpretations of the three provisions taken together ought to provide acceptable guidance to managers; and (3) the interpretations taken together ought to be reasonable constructions of the statutory language. Although little effort is required to satisfy any two of these three criteria, simultaneously satisfying all three is more difficult than it may seem. For example, one can easily satisfy the first and third criteria by interpreting the first safe harbor provision to immunize all predictions that are not intentionally misleading, the second - statements that are immaterial under current law, and the first - even intentionally misleading predictions accompanied by appropriate cautionary statements. This set of interpretations fails to meet the second criterion, however, because it invites managers to intentionally deceive the investing public. Similarly, one can easily satisfy the first two criteria by using the same interpretations for the second and third provisions but interpreting the first to immunize predictions accompanied by properly constructed cautionary statements *unless* the prediction itself was intentionally misleading. Because all statements immunized by the first provision are also immunized by the third

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[127] In his discussion of the safe harbor soon after the enactment of the PSLRA, Professor Coffee highlighted the challenge of finding independent significance for each of the provisions of the safe harbor as follows: "Probably the most striking feature of the Reform Act's safe harbor is the immunity it seems to give to a bald, knowing lie that is surrounded by 'meaningful cautionary statements' . . . . Arguably, the [third] prong would add nothing and thus be superfluous if the first prong did not protect a false statement that was accompanied by 'meaningful cautionary statements.' As a matter of statutory interpretation, any reading of these two prongs that renders the [third] prong superfluous must be avoided." John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 981 (1996). Although Coffee focuses on the danger that the third prong could be rendered superfluous, the larger obstacle is finding relational significance for the first prong. A provision is not superfluous if it immunizes some portion of the set of statements that are clearly not immunized by either of the other two prongs. The third prong will have such relational significance under almost any interpretation because by immunizing statements that the speaker did not actually know were false (regardless of the quality of the accompanying disclosures) the third prong clearly covers a portion of the set of statements that the first prong does not immunize (because they are either not accompanied by cautionary language or accompanied by cautionary language that is inadequate). The second prong, of course, would also not immunize the statements so long as they were material. Finding independent significance for the first prong is more difficult, however, because the only statements that the third prong appears to leave unprotected are statements that the speaker *did* actually know were false.

provision under this set of interpretations, however, the interpretations render the first provision superfluous and thus fail to satisfy the relational significance criterion.

Measured against the criteria of relational significance, reasonable construction, and market guidance, the *Trump*-based framework continues to fare poorly. This framework would give the first prong significance in relation to the third provision because the first provision would immunize even a projection management actually knew was baseless so long as it was accompanied by disclosures tailored to the subject matter of the projection. As in the first example above, however, the guidance implicit in this approach is perverse. In any situation in which the interests of managers favored publishing misleading disclosures, they could do so without fear of liability so long as they could create content for accompanying statements that facially tied into the subject matter of the projection. While this task may require more creativity than attaching boilerplate warnings to projections, the effort required would hardly deter executives bent on deceit from publishing misleading projections.[128] For the same reason, a *Trump*-based framework also fails to provide a reasonable construction of the statutory language of the first provision; accompanying disclosures that are tailored to a forward-looking statement yet fail to disclose contingencies management knows are more likely to cause a departure from projected results would hardly strike a person aware of the omissions as "meaningful."

Moreover, the *Trump*-based interpretation does not fully satisfy the criterion of relational significance. If the first provision offers a formula for rendering projections immaterial, all statements it immunizes are already immunized by the second provision. In other words, although the interpretation clearly gives the first provision significance in relation to the third, it

[128] Whether the safe harbor under this interpretation would actually enhance market efficiency depends on whether the positive effects of the resulting increase in "true when made" projections would outweigh the negative effects of the increase in deliberately misleading projections caused by the safe harbor.

fails to give the first provision significance in relation to the second. Accordingly, if Congress' intended for the "meaningful cautionary statements" language to serve as content for a new definition of materiality for purposes of forward-looking information, it should have passed a two-prong safe harbor comprised of the "immateriality" and "actual knowledge" prongs of the enacted safe harbor along with a separate provision defining "immaterial" statements to include statements "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."

A properly constructed interpretation of the safe harbor rooted in the traditional doctrinal framework avoids all of the defects to which the *Trump*-based interpretation is subject. Under this interpretation, to demonstrate that a prediction falls outside the protection of the first safe harbor provision a plaintiff must show that a reasonable investor would have drawn important incorrect inferences from the publication of the prediction despite the disclosures in the accompanying statements. If there are no important incorrect inferences that a reasonable investor would have drawn from the prediction in light of the accompanying disclosures, the disclosures should qualify as "meaningful cautionary statements." Accordingly, clearly material forward-looking information, the kind of information that is likely to enhance allocative efficiency, may be protected by the first safe harbor provision under this interpretation.[129]

[129] Under this interpretation, the omission of an important factor or even of the most important factor would not automatically render the remaining disclosures "meaningless," particularly where disclosure of such information would substantially undermine the company's competitive position. On the other hand, an omission of one of the most important factors that can *only* be explained by management's intent to mislead investors ought to render the remaining statements "meaningless." Moreover, while courts arguably must take into account Congress' intent "not to provide an opportunity for plaintiffs' counsel to conduct discovery on what was known to the issuer at the time the forward-looking statement was made," courts' application of the PSLRA's heightened pleading standards ought to adequately ensure that plaintiffs have a clear idea of what the defendants knew and how they knew it before they are given access to discovery. For example, where a plaintiff asserts that the cautionary statements accompanying a projection were not meaningful because an internal company report describes factors that were *not* contained in the cautionary statements accompanying the projection, but which were much more likely to affect actual results than the disclosed factors, a court could still dismiss the complaint under the pleading standards if the complaint does not identify "the sources of [the plaintiff's] information with respect to the reports, how [the plaintiff] learned of the

In addition to being consistent with the underlying logic of the safe harbor, an interpretation rooted in the traditional doctrinal framework clearly satisfies the acceptable guidance and reasonable construction criteria. Interpreted in light of the traditional doctrinal framework, the first provision would encourage managers seeking the protection of the provision to disclose the information they believe will prevent reasonable investors from drawing incorrect inferences from the projection's publication and defining the terms "meaningful" and "important" in terms of the propensity of the accompanying statements to prevent incorrect inferences that investors might otherwise draw from the publication of the prediction requires no stretching of these terms.[130]

With certain adjustments, the interpretation rooted in the traditional doctrinal framework also satisfies the relational significance criterion. Because, under this interpretation, accompanying statements render predictive statements "not misleading" rather than immaterial, the interpretation clearly gives the first provision significance in relation to the "immateriality" prong. For the same reason, however, the traditional doctrinal framework could fail to give the first provision significance in relation to the third provision. As the *Virginia Bankshares* opinion demonstrates, the traditional doctrinal framework yields the insight that a prediction can be false either because the inference that management believes in the prediction is incorrect (as "a misstatement of the psychological fact of the speaker's belief in what he says"[131]) or because a reasonable inference about the likelihood or magnitude of a departure from the predicted results

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reports, who drafted them, or which officers received them." *In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 985 (9th Cir. 1999).

[130] This approach also matches the following description by the Conference Committee of the intent of these statutory terms better than the *Trump* "tailoring" criterion: "The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business." H.R. CONF. REP. NO. 104-369, at 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 741.

[131] *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095 (1991).

is incorrect (because the prediction is "misleading about its subject matter.")[132] If one applies this view of falsity to the safe harbor, accompanying statements would fail to be "meaningful" for purposes of the safe harbor if they failed to prevent either kind of inference. Accordingly, whenever the third provision was unavailable (because the speaker had actual knowledge that the statement was false) the first provision would necessarily be unavailable as well because the inference that the speaker actually believed the prediction could not be correct.

Fortunately, *Virginia Bankshares* also suggests a solution to this interpretive problem. Recognizing that, as a matter of theory, proof that a published opinion statement amounted to a "misstatement of the psychological fact of the speaker's belief in what he says"[133] should suffice for liability, the *Virginia Bankshares* Court decided against establishing this rule because "the temptation to rest an otherwise nonexistent . . . action on psychological enquiry alone would threaten . . . strike suits and attrition by discovery."[134] Incorporation of the same limitation into the falsity-based interpretation of the first safe harbor prong carves out a narrow set of statements that are protected by the first provision but not by the third, which is all that is necessary to satisfy the criterion of relational significance.[135] If evidence adduced by a plaintiff demonstrates

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[132] *Id.* This is generally not true with respect to factual statements about the past. If, for example, a manufacturing company manager attempted to defraud investors by failing to disclose product defects reported internally, his deceitful intent would not constitute fraud if the internal reports are incorrect and products are actually free of defects. In the case of management's opinions or predictions, however, investors must decide how much weight to give the statements and, as a result, seek to understand the depth of management's belief in the opinions or predictions.

[133] *Id.* at 1095.

[134] *Id.* at 1096 (citing *Stedman v. Storer,* 308 F.Supp. 881, 887 (SDNY 1969) (dealing with § 10(b)). Note that the two senses identified by the Court in which statements of opinion are factual mirror the good faith and reasonable basis elements of Rule 175. By making both elements prerequisites to the protection of Rule 175, the SEC suggested that it would be possible for a plaintiff to prevent even reasonably based projections from coming within the safe harbor solely by showing that the speaker made them in bad faith.

[135] That the first prong would only immunize a small set of statements left unprotected by the third prong under this set of interpretations does not mean that reliance on the first prong would rarely make a difference in practice. Managers at the same company often take different views of a company's future. Accordingly, whatever set of internal projections are ultimately disclosed by a company, they may frequently be inconsistent with the views of one or more managers at the company. Particularized allegations of such inconsistencies might prevent a court from relying on the third provision to dismiss a complaint at the pleading stage. The first provision, however, would

management's belief that a prediction was false but fails to show that a reasonable investor would have drawn an important incorrect inference from the prediction's publication, the first safe harbor provision will immunize the statement even though the third will not.

It is fair to question whether the incorporation of this limitation into the safe harbor interpretation does not give managers the same license to lie that, along with the other defects discussed above, makes the *Trump*-based interpretation unacceptable. The basis for a negative response to this question lies in the overlap between falsity evidence and evidence of the defendant's intent to mislead of scienter. In the context of securities fraud litigation, there are two types of *direct* evidence of scienter: (1) internal memoranda, notes, emails, or other documents that record officers' beliefs concerning the subject matter of public statements and (2) a manager's testimony regarding his own deceitful state of mind when the allegedly false statements were made. Both types of evidence are rare and the latter is extremely rare. Accordingly, plaintiffs more commonly rely on indirect evidence of scienter. That is, to prove scienter, plaintiffs argue that company officers knew or were reckless in failing to comprehend that public statements were false because internal facts to which they were exposed were inconsistent with their public statements. In other words, such "indirect" evidence of scienter is simply direct evidence of falsity combined with evidence of personal exposure to that evidence. Because of this evidentiary overlap, in most cases where evidence adduced demonstrates management's "actual knowledge" that a prediction was false, the same evidence will also demonstrate that statements accompanying the prediction were not "meaningful" because they failed to prevent important incorrect inferences a reasonable investor would have drawn about

continue to offer protection so long as management had properly disclosed the key assumptions on which the prediction in question was based.

the likelihood and extent of a departure of actual results from the predicted outcome.[136] Accordingly, as managers perpetrating a fraud through the use of baseless predictions leave a trail of "actual knowledge" evidence they will generally be unable to avoid creating evidence of the "meaninglessness" of the statements accompanying the predictions at the same time.

As discussed in Parts II and III, virtually all *pre*-1993 judicial and regulatory approaches to forward-looking information conformed to a single doctrinal framework. Courts and commentators have failed to recognize this common underlying framework (and the sharp departure from the framework marked by *Trump*) largely because of the multiplication of vocabularies that refer to the framework's basic concepts. In other words, the use of the terms "good faith" and "reasonable basis" in some forward-looking information cases, "bespeaks caution" in others, and "subject matter" and "psychological facts" in still others has obscured the conformity of the inquiries entailed by the use of any of these terms to a single doctrinal framework. Moreover, none of these terms clearly reveals the nature of the framework's underlying analysis as first, an inquiry into the reasonableness and accuracy of unstated propositions or inferences in light of disclosures accompanying the predictive statement and, second, an inquiry into the importance of the inferences thatthe finder of fact finds reasonable and inaccurate. Accordingly, by incorporating the content of these inquiries into a rule defining

[136] The *Virginia Bankshares* Court found that this limitation would not substantially restrict liability for misleading statements of belief for essentially the same reasons: "[I]t would be rare to find a case with evidence solely of disbelief or undisclosed motivation without further proof that the statement was defective as to its subject matter. While we certainly would not hold a director's naked admission of disbelief incompetent evidence of a proxy statement's false or misleading character, such an unusual admission will not very often stand alone, and we do not substantially narrow the cause of action by requiring a plaintiff to demonstrate something false or misleading in what the statement expressly or impliedly declared about its subject." *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1096 (1991). Note, however, that the interpretation of the safe harbor provisions rooted in the traditional doctrinal framework must go beyond codification of the *Virginia Bankshares* falsity analysis. *Virginia Bankshares* apparently permits liability based on evidence that a statement "was false or misleading about its subject" in the absence of evidence that the statements also represented a "misstatement of the psychological fact of the speaker's belief in what he says." Because the safe harbor's provisions are disjunctive, the provisions should foreclose this possibility with respect to covered forward-looking information.

the PSLRA safe harbor statutory term "meaningful," the Commission could eliminate the confusion caused bythe proliferation of materiality-based analyses of forward-looking information following *Trump* and also force courts prepared to dismiss cases based on allegedly misleading predictions to state explicitly that each of the incorrect inferences allegedly drawn by the plaintiff from the prediction was either unreasonable or reasonable but immaterial. Intervention by the Supreme Court in the right case could similarly rule out materiality-based interpretations of the first safe harbor provision and precisely describe the inquiries that should flow from a safe harbor interpretation rooted in the traditional framework. In either case, lower courts, in turn, could generally require plaintiffs to allege with particularity the incorrect inferences they drew at the time the prediction was made and why those inferences were reasonable despite the accompanying disclosures. Finally, an authoritative regulatory or judicial definition of the statutory term "meaningful" would also provide standards to which courts could look in cases involving predictive information that is not covered by the PSLRA safe harbor,[137] though such courts would be free from interpretive constraints posed by the language and disjunctive structure of the safe harbor.[138]

[137] Subsection (a) of the PSLRA safe harbor limits the applicability of the safe harbor to public companies and certain persons acting on their behalf. 15 U.S.C. §78u-5(a) (Supp. I 1995). Subsection (b) further limits the applicability of the safe harbor by excluding statements made in certain circumstances, such as initial public offerings, or by certain persons, such as felons convicted in the three years prior to the statement. *Id*. at §78u-5(b).

[138] For example, courts evaluating forward-looking information not covered by the safe harbor could permit culpability less than "actual knowledge" to suffice for scienter.