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Client Alert

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Second Circuit Wades Into the PSLRA Safe Harbor

The Lessons of *Slayton v. American Express* for Forward-Looking Statements

"Specific, robust and dynamic cautionary language is the best defense to a hindsight review of forward-looking statements, which often prove inaccurate."

The Second Circuit has issued its first opinion analyzing the 15 year-old safe harbor provision in the Private Securities Litigation Reform Act (PSLRA) for forward-looking statements that become the subject of a Rule 10b-5 lawsuit. The opinion, *Slayton v. American Express*,[1] has several important implications for public companies and their officers, directors and advisors. This *Client Alert* is intended to help public companies and their management and advisors understand *Slayton*'s implications for evaluating whether the forward-looking statements will be sufficiently protected by the PSLRA's safe harbor. The *Slayton* decision contains important prescriptions for drafting forward-looking statements and related cautionary statements in periodic reports filed by public companies.

The cautionary language that accompanies forward-looking statements should identify specifically any factors where known risks may materialize to cause a different result than the future projection. Public companies also should ensure that cautionary language is dynamic, rather than static. Repeating the same warnings from the previous periodic report may not be adequate if the underlying risks have changed. Instead, companies should review and update cautionary language as circumstances evolve and new information is received.

In addition, a forward-looking statement not immunized by adequate cautionary language will still be protected by the safe harbor unless a plaintiff pleads specific facts creating a strong inference that the speaker had no "reasonable basis" for making the statement or knew of risks that seriously undermined the accuracy of the projections.

Overview of the *Slayton* Case

In *Slayton*, the Second Circuit considered whether the PSLRA's safe harbor protected American Express from liability for forward-looking statements made in May 2001 in its quarterly report on Form 10-Q for the first quarter of 2001. In the Management's Discussion and Analysis (MD&A) disclosure in the Form 10-Q, American Express had reported that, although it had lost $182 million from its high-yield debt investments in the first quarter of 2001, "total losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter."[2]

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As it turned out, American Express announced in July 2001 a $826 million loss due to additional write-downs on its high-yield debt portfolio. Plaintiff investors brought suit under Section 10(b) of the Exchange Act and Rule 10b-5, alleging that as of the filing of the Form 10-Q on May 15, 2001, American Express knew—but did not disclose—that the true magnitude of the expected losses would be much worse than projected.

The Second Circuit held that defendants' forward-looking statement was not immunized by the first prong of the safe harbor provision because the cautionary language in the Form 10-Q was too vague to be "meaningful." The Form 10-Q stated that "potential deterioration in the high-yield sector, which could result in further losses in [the] investment portfolio" held by American Express Financial Advisors, could "cause actual results to differ materially" from American Express' predictions.

However, the court found that the safe harbor's actual knowledge prong protected the forward-looking statement because plaintiffs failed to plead sufficient facts demonstrating that American Express made the statement with actual knowledge of falsity. As a result, the Second Circuit affirmed the complaint's dismissal. Along the way, the *Slayton* court provided helpful guidance for obtaining the safe harbor protection, the most salient of which are summarized below.

Three Inlets to the Safe Harbor

The Second Circuit initially clarified that there are three separate and alternative inlets for a forward-looking statement to enter the safe harbor. The court applied the plain language of the PSLRA's safe harbor, which employs the disjunctive in providing that a forward-looking statement cannot support a claim of securities fraud if (1) it is identified and accompanied by meaningful cautionary language, **or** (2) it is immaterial, **or** (3) the plaintiff fails to plead that it was made with actual knowledge that it was false or misleading.[3]

The Second Circuit's interpretation, although seemingly self-evident, has not been consistently accepted by other courts. For example, less than a week before *Slayton* was issued, the Southern District of New York held the opposite.[4] Last year, the Fifth Circuit also applied the safe harbor as written in the conjunctive.[5]

The Second Circuit, in contrast, focused on the significance of the word "**or**," and interpreted the statute to require a defendant to satisfy only one of the three tests to enter the safe harbor, creating a circuit split in the process. Notably, the safe harbor's second inlet (the immateriality prong) was not raised by the defendants nor addressed by the *Slayton* court.

Forward-Looking Statements Contained in MD&A Qualify for the Safe Harbor

The safe harbor excludes forward-looking statements "included in a financial statement prepared in accordance with generally accepted accounting principles (GAAP)."[6] The plaintiffs in *Slayton* argued that American Express' Form 10-Q included GAAP financial statements and thus a projection included in that document is not eligible for safe harbor protection.

The Second Circuit disagreed. The court noted that the Form 10-Q includes multiple parts, some of which constitute financial statements prepared in accordance with GAAP and others that do not (such as the MD&A disclosure that contained the forward-looking statement). The Second Circuit held that the safe harbor applied to forward-looking statements within MD&A based on both the text and legislative history of the PSLRA, which indicates that Congress understood financial statements and MD&A to be distinct,

and based on the different treatment of financial statements and MD&A in Securities and Exchange Commission (SEC) rules.[7] This holding is consistent with the SEC's position in an amicus curiae brief submitted to the *Slayton* court.[8]

'Boilerplate' and Static Cautionary Language Are Not 'Meaningful'

Having found the safe harbor available, the Second Circuit then turned to whether the safe harbor's "meaningful cautionary language" prong protected the allegedly misleading statement. The *Slayton* court quickly dispensed with plaintiffs' argument that the statement was not "identified" as a forward-looking statement because the statute does not require a forward-looking statement to be labeled as such or presented in a separate section.

Determining whether the cautionary language was "meaningful" presented a more challenging task. Here, plaintiffs had pled facts suggesting that defendants knew of certain risks regarding the debt portfolio, but did not warn investors about them. The question was whether the cautionary language identified "important factors" that could cause actual results to differ materially from the projection when it omitted known factors. Acknowledging that "a defendant need not include the particular factor that ultimately causes its projection not to come true,"[9] the Second Circuit noted that Congress had not defined the ambiguous term "important."

Turning to the PSLRA's legislative history, the court found conflicting instructions. The legislative history indicated that the safe harbor required substantive information about realistic risks but eschewed an evaluation of a defendant's state of mind. This limitation troubled the *Slayton* court because any evaluation of the listed factors requires a reference point and "the most sensible reference is the major factors that the defendants faced at the time the statement was made."[10] The court concluded that this reference point is unavailable if it cannot examine the defendant's knowledge. Unable to reconcile this problem, the Second Circuit called for legislative action:

> Congress may wish to give further direction on how to resolve this tension, and in particular, the reference point by which we should judge whether an issuer has identified the factors that realistically could cause results to differ from projections. May an issuer be protected by the meaningful cautionary language prong of the safe harbor even where his cautionary statement omitted a major risk that he knew about at the time he made the statement?[11]

The Second Circuit avoided this "thorny issue" because it found the cautionary language to be "boilerplate," "vague" and static. Considering the statement that actual results could "differ materially" because of "potential deterioration in the high-yield sector, which could result in further losses in [the] investment portfolio," the court determined that American Express had essentially warned investors only that "if our portfolio deteriorates, then there will be losses in our portfolio."[12] This tautology was not meaningful.

Moreover, the court emphasized that the exact same language had appeared in several filings before and after the Form 10-Q filed in May 2001. The court found that the consistency of the language—even when the problems relating to the debt portfolio changed—demonstrated that it had not been "tailored to the specific future projection," and instead verged on "mere boilerplate," which could not be "meaningful" as the safe harbor provision requires.[13]

Although the court focused only on one of many cautionary statements in the Form 10-Q, the court noted that the

defendant must prove that meaningful cautionary language protects the statement at issue. American Express had not argued that any *other* factors were "important factors" that could realistically cause results to differ materially, and the court therefore had "no way of knowing if they were."[14] As a result, the court found that American Express had failed to prove that its projection was accompanied by meaningful cautionary language.

'Actual Knowledge' Standard Proposed by the SEC Is Proper

Finally, the Second Circuit analyzed whether American Express was entitled to protection under the third prong of the safe harbor, *i.e.*, whether plaintiffs failed to plead sufficient facts to give rise to a strong inference that the projection was made with actual knowledge that it was false or misleading.

Adopting the SEC's pleading standard proposed in its amicus curiae brief,[15] the Second Circuit held that the relevant inquiry was whether a reasonable person would:

> deem an inference that defendants (1) did not genuinely believe the May 15 statement, (2) actually knew that they had no reasonable basis for making the statement, or (3) were aware of undisclosed facts tending to seriously undermine the accuracy of the statement, "cogent and at least as compelling as any opposing inference."[16]

Plaintiffs failed to meet their burden. The court found that the allegations supported an inference that defendants actually knew that they did not know the extent of the likely deterioration of the debt portfolio and therefore had no reasonable basis for predicting that losses on these investments were expected to be substantially lower. However, the court also noted that the opposing nonfraudulent inference—that defendants subjectively believed that the extent of the deterioration would lead to losses substantially less than $182 million—was more compelling. Moreover, plaintiffs had not alleged any theory as to defendants' motive to deceive investors, which also undercut any inference of knowing falsity.[17] On balance, the court found that the inference of nonfraudulent intent was more compelling than plaintiffs' inference of fraud.

Accordingly, the Second Circuit concluded that the safe harbor's "actual knowledge" prong protected the statement in the Form 10-Q, and the court affirmed the dismissal of the securities fraud claims.

Post *Slayton*: Implications for Forward-Looking Statements

Slayton makes clear that there are three separate and independent inlets into the safe harbor. A forward-looking statement: (1) is identified and accompanied by meaningful cautionary language; (2) is immaterial; or (3) plaintiffs fail to plead that it was made with actual knowledge of falsity. When defending forward-looking statements, public companies should recognize that it may assert safe harbor protection on *any* of these independent grounds. Although *Slayton* addressed only the first and third inlets (defendants did not assert the immateriality of the allegedly misleading statement in the Form 10-Q), the second inlet remains a viable defense.[18]

Slayton demonstrates that specific, robust and dynamic cautionary language is the best defense to a hindsight review of forward-looking statements, which often prove inaccurate. The inclusion of custom-tailored warnings would provide a significant deterrent to potential plaintiffs who might otherwise pursue Rule 10b-5 claims challenging forward-looking statements that are not borne out. *Slayton* underscores the importance of providing detailed, robust and regularly customized cautionary language for each significant forward-looking statement.

Public companies should routinely evaluate and tailor those types of cautionary statements in response to any changed circumstances. Finally, any areas of heightened risk or known uncertainties warrant fact-specific disclosures that are tailored to the particular risks underlying each forward-looking statement.

Endnotes

[1] 2010 WL 1960019 (2d Cir. May 18, 2010).

[2] *See id*. at *1.

[3] The PSLRA, enacted in 1995, created the safe harbor and expressly made the tests disjunctive:

(A) the forward-looking statement is —

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

(ii) immaterial***; or***

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

(ii) if made by a business entity; was —

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

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

15 U.S.C. § 78u-5(c) (emphasis added).

[4] *Freudenberg v. E*Trade Financial Corp.*, 2010 WL 1904314, at *20 (S.D.N.Y. May 11, 2010) (“Even where the safe harbor is triggered, it does not protect statements made with actual knowledge or falsity.”).

[5] *Lormand v. U.S. Unwired, Inc.*, 2009 WL 941505, at *14 (5th Cir. Apr. 9, 2009) (rejecting a safe harbor defense because plaintiff had adequately pled defendants’ actual knowledge and noting that, even if the plaintiff had failed to plead actual knowledge, “the safe harbor provision still would not apply here, because the alleged misrepresentations are not accompanied by ‘meaningful cautionary language’”).

[6] 15 U.S.C. § 78u-5(b)(2)(A).

[7] *Slayton*, 2010 WL 1960019, at *7.

[8] The amicus brief, which details the SEC’s views on drafting forward-looking statements, is available at http://www.sec.gov/litigation/briefs/2010/slayton0110.pdf.

[9] *Slayton*, 2010 WL 1960019, at *12.

[10] *Id*. at *10.

[11] *Id*.

[12] *Id*. at *11.

[13] *Id*. (quoting *Inst. Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009)).

[14] *Id*. at *12.

[15] *See supra* note 8.

[16] *Id*. at *13 (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323 (2007)).

[17] *See id*. at *13-15.

[18] *See, e.g., Raab v. Gen. Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (forward-looking statements not worded as “guarantees” are immaterial).

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