How Safe Are the PSLRA Safe Harbors for Forward-Looking Statements?

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Congress enacted the Private Securities Litigation Reform Act of 1995 (the “PSLRA”) to combat frivolous lawsuits and curb abuses of the discovery process, which often imposed costs so burdensome that it was economical for defendants to settle rather than defend a suit. Among other reforms in the PSLRA, Congress made the policy judgment to encourage companies to continue to issue forward-looking statements regarding earnings guidance, revenue projections, anticipated business ventures, and other forms of future performance, by building in a series of safeguards that operate to limit the circumstances under which those statements can form the basis of liability. The PSLRA, through two independent “safe harbors,” immunizes a forward-looking statement from liability: (i) where it is “accompanied by meaningful cautionary language”; or (ii) where the plaintiff fails to plead or prove that it was made with “actual knowledge” of falsity.

As the legislative history makes clear, Congress created these safe harbors “to encourage issuers to disseminate relevant information to the market without fear of open-ended liability.” As one court has stated, “Congress enacted the safe harbor provision in order to loosen the ‘muzzling effect’ of potential liability for forward-looking statements, which often kept investors in the dark about what management foresaw for the company.”

Notwithstanding the plain language of the statute and Congressional intent, the first safe harbor, which immunizes statements “accompanied by meaningful cautionary” language, has proven somewhat problematic to implement in practice. Read literally, so long as meaningful risks are disclosed in conjunction with forward-looking statements, any complaint alleging that a forward-looking statement is false or mis-
leading should be dismissed at the pleading stage. However, this safe harbor has not been uniformly applied by the courts. First, courts are divided on (i) what standard to apply in determining whether cautionary language is sufficiently “meaningful” to invoke the protections found in the safe harbor; and (ii) whether that analysis is undertaken at the pleading stage (as opposed to following discovery). Second, there is some dispute as to whether, when actual knowledge of falsity is properly pled, the use of the cautionary statement safe harbor is prohibited. These inconsistencies threaten to undercut the intended purpose of the safe harbor provisions, as articulated by Congress, which is to encourage the continued issuance of forward-looking statements. This article reviews these conflicting views.

What is the Meaning of “Meaningful”? 

The first safe harbor provision protects forward-looking statements that are “identified as forward-looking,” and “accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.” The only two Circuits to squarely address this safe harbor have reached conflicting conclusions on what kind of risks must be disclosed in order for the protection to apply. In essence, the question is: what does “meaningful” mean? The bookends are relatively clear. If the risk that ultimately materialized to cause a drop in the company’s share price was specifically disclosed as a risk factor, the safe harbor provision will typically apply, as the investor was made aware of the risk at the time the forward-looking statement was made. In contrast, risk disclosures that are overly broad or can be viewed as non-specific boilerplate have been found as lacking in sufficient clarity to be meaningful.

While agreeing on the outer bounds of what does and does not constitute meaningful risk disclosures, courts have not yet settled on a uniform standard to govern those cases that lie in between. In many cases, the cautionary statements accompanying a forward-looking statement will not identify the specific risk that ultimately leads to a share price decline, nor will they provide only overly broad cautionary language. Instead, companies often identify a number of specific risk factors, and the court is in the position of determining ex post whether such factors qualify as “meaningful” under the PSLRA. Thus, the question becomes, what standard appropriately advances the policy judgment made by Congress to encourage companies to continue to issue forward-looking statements without real fear of costly litigation if they predict incorrectly?

At one end is the Eleventh Circuit. In Harris v. Ivax Corporation, the plaintiffs alleged that Ivax Corp. deliberately failed to disclose the reduction in the carrying value of the goodwill ascribed to certain of the company’s business. This eventually caused the company to take a loss of $104 million. The company issued “detailed and informative” cautionary language, but did not mention “the possibility of a large goodwill writedown.” In affirming the district court’s dismissal of the complaint, the Eleventh Circuit held that the safe harbor “does not require a listing of all factors.” Instead, it concluded that “when an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.” Ultimately, the court found that Ivax Corp.’s risk disclosures were sufficiently “meaningful” to invoke the safe harbor protection.

The upshot of Harris is that companies are not required to have disclosed the precise risk that ultimately occurred in order for the safe harbor to apply, just those that are of “a significance similar” to what actually occurs. Other courts have followed the Harris formulation. For example, in the U.S. Interactive, Inc. Securities Litigation, the plaintiffs alleged that U.S. Interactive, Inc. (USIT) made false forward-looking statements regarding, among other things, its plan to use the proceeds from a secondary offering to pay off debt from acquiring a smaller company, and its ability to remain solvent. Arguing that USIT failed to warn that it forgave certain customers’ debts and had increased expenses, plaintiffs claimed that USIT’s cautionary statements were inadequate. Citing
The district court articulated the standard for “meaningful” as follows:

The issue is whether the cautionary language is sufficient to convey to an investor that the prediction in question is not a guarantee. Cautionary language is sufficient when an investor has been warned of risks similar to that actually realized so that the investor is on notice of the danger of the investment. In dismissing the complaint, the court found that because USIT disclosed a “host of factors,” the cautionary language accompanying USIT’s forward-looking statements was sufficient to warn investors that USIT’s future solvency was not guaranteed, even though it did not specifically caution that its solvency was at issue.

In contrast, the Seventh Circuit has suggested that to be sufficiently “meaningful,” cautionary statements must include the principal or important risks facing a company at the time it issues a forward-looking statement, and not just those that are of a significance similar to the issue that actually occurs. In Asher v. Baxter International Inc., medical products manufacturer Baxter issued financial projections with a number of cautionary statements disclosing general risks. When Baxter’s financial results fell short of these projections, shareholders filed suit alleging that in order to artificially inflate the price of its stock, Baxter had failed to disclose, among other things, that instability in Latin America affected its sales, it had closed certain plants, and that the market for one of its products was over-saturated. The district court concluded that the safe harbor applied and dismissed the complaint. The Seventh Circuit reversed, and stated:

There is no reason to think—at least, no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery—that the items mentioned in Baxter’s cautionary language were those that at the time were the (or any of the) “important” sources of variance. The problem is not that what actually happened went unmentioned; issuers need not anticipate all sources of deviations from expectations. Rather, the problem is that there is no reason (on this record) to conclude that Baxter mentioned those sources of variance that (at the time of the projection) were the principal or important risks. For all we can tell, the major risks Baxter objectively faced when it made its forecasts were exactly those that, according to the complaint, came to pass, yet the cautionary statement mentioned none of them.

The Asher decision suggests a far more demanding standard for determining the sufficiency of cautionary language than the Harris decision. Read literally, rather than requiring the company to disclose risks of a significance similar to the risk actually realized, the Asher decision suggests that a company making projections is required to disclose all the principal or important risks. By importing a qualitative judgment into the analysis—determining “the principal or important risks”—this conclusion appears to be at odds with the language of the statute, which requires disclosure only of “meaningful” risks. If “meaningful” risks are disclosed, as the statute requires, that should be the end of the inquiry.

More problematic is the fact that the Seventh Circuit’s standard has been interpreted by some courts to offer plaintiffs the opportunity to take discovery to determine whether the cautionary statements omitted a risk that the company foresaw at the time it made the projection. The practical consequence of this is that the safe harbor protection cannot be invoked on a motion to dismiss. This has caused a rift in case law, as courts inside and outside the Seventh Circuit have begun to cite Asher for the proposition that it may be inappropriate to consider this safe harbor at the pleading stage.

This split remains nascent, as courts implementing the Asher standard are few; for now, the majority of decisions continue to follow Harris. No other Circuits have squarely reached the issue of exactly how to resolve the meaning of “meaningful.” Nonetheless, in suggesting that discovery is appropriate, the Seventh Circuit’s reasoning conflicts with the Congressional compromise reached in adopting the PSLRA. First, in a section titled...
“Dispositive Motion,” the PSLRA expressly requires the court to consider any cautionary statement “on any motion to dismiss based upon” the safe harbor provisions. Specifically, the statute mandates that “on any motion to dismiss based upon subsection (c)(1) of this section, the court shall consider . . . any cautionary statement accompanying the forward-looking statement . . . cited by the defendant.” Thus, the PSLRA itself makes clear that the first safe harbor should be considered at the pleading stage. Second, in discussing the safe harbor, the Conference Committee specified “that the cautionary statements identify ‘important’ factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.” Courts have similarly recognized the appropriateness of addressing the safe harbor on a motion to dismiss. Finally, not only was this result contemplated by Congress, but it best serves the underlying goal of the safe harbors, which is to “enhance market efficiency by encouraging companies to disclose forward-looking information.”

**Actual Knowledge as a Bar**

There has also been some inconsistency in the case law as to whether a company alleged to have actually known that its forward-looking statements were false or misleading may nonetheless claim safe harbor protection if it discloses meaningful cautionary language. Though not a majority, some courts have held that, even where meaningful cautionary language is disclosed, defendants will not be insulated from liability if the defendant knew that the forward-looking statement was false at the time it was made. Such an interpretation is problematic, because it, among other reasons, ignores the disjunctive nature—the use of the word “or”—of the safe harbor provisions, which operate independently. The safe harbor for meaningful cautionary language is one statutory tool for defendants to shield themselves from liability; the safe harbor requiring plaintiffs to plead and prove that a statement was made with actual knowledge of its falsity is a separate statutory hurdle. Courts that conflate these individual safe harbors are misconstruing the statute and frustrating the goals of the PSLRA.

For example, in *Primavera Investors v. Liquidmetal Technologies, Inc.*, the district court denied the defendants’ motion to dismiss, even though the forward-looking statement at issue was accompanied by cautionary language, because the plaintiff pled that the defendants knew at the time that it was false and misleading. The court held that “[a] defendant remains liable, even for a forward-looking statement, if the plaintiff shows that the defendant knew at the time of the statement of false and misleading content and thus lacked a reasonable basis for making the statement.” The Third Circuit reached a similar conclusion in *Advanta Corp. Securities Litigation*. While ultimately dismissing the claims for failure to plead that the statements were made with actual knowledge of their falsity, the court noted that the first safe harbor would not apply “if the statement was made with ‘actual knowledge’ that the statement was false or misleading.”

This reading of the safe harbor is troublesome for several reasons. First, as noted above, the disjunctive language of the statute renders the defendant’s state of mind irrelevant if the first safe harbor (for meaningful cautionary statements) is invoked. The statute reads:

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(c) Safe harbor
(1) In general
   . . . [I]n any private action arising under this chapter that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person . . . shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that—
   (A) the forward-looking statement is—
      i. identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
      ii. immaterial; or
   (B) the plaintiff fails to prove that the forward-looking statement—
      i. . . . was made with actual knowledge . . . that the statement was false or misleading.
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Though the second safe harbor provision—requiring the plaintiff to plead and prove that the forward-looking statement was made with actual knowledge of falsity—does incorporate a state of mind component, the safe harbor provisions operate independently, and each, on its own, is sufficient to preclude liability. As noted above, the weight of authority follows this disjunctive reading of the safe harbors.

Second, requiring an inquiry into the defendant’s state of mind would render the first safe harbor redundant and mere drafting surplusage. Under this reading, the first safe harbor would only apply in those situations where the plaintiff is unable to plead that the defendant had actual knowledge of the falsity of the forward-looking statement (and, of course, where the defendant had accompanied the forward-looking statement with meaningful cautionary statements). However, where a plaintiff cannot show actual knowledge of falsity, the second safe harbor, standing alone, would protect the defendant from liability. Thus, this approach effectively renders the first safe harbor provision irrelevant, an outcome Congress could not have intended.

Third, interpreting the first safe harbor without regard to state of mind is the only reading that is faithful to Congress’ explicit intent. The original proposal containing the statutory safe harbor did contain a state of mind requirement, but was deleted as adopted by Congress. The Conference Report (detailing the negotiated language of the legislation) states that the first safe harbor provision “requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.” Also, the Conference Report later states: “the applicability of the safe harbor provisions . . . shall be based on the sufficiency of the cautionary language . . . and does not depend on the state of mind of the defendant.”

Thus, any reading of the statute which imports a knowledge component into an application of the cautionary language safe harbor is inconsistent with the text of the PSLRA and Congressional intent.

Conclusion

In theory, the PSLRA’s safe harbor provisions are a valuable tool to encourage companies to continue to make forward-looking statements, which are, by their very nature, speculative and subject to risk, and to protect companies from costly litigation if those forward-looking statements ultimately turn out to be incorrect. But until courts can apply the safe harbors with sufficient uniformity, issuers should be wary of just how “safe” they really are.

NOTES

2. 15 U.S.C.A. §§ 77z-2, 78u-5 (2006). Section 77z-2 pertains to statements covered by the Securities Act of 1933, and section 78u-5 pertains to statements covered by the Securities Exchange Act of 1934. The two sections are identical in all significant respects, so the remainder of this article will cite only to the latter.
3. Id. § 78u-5(c)(1)(A)(i).
4. Id. § 78u-5(c)(1)(B).
7. § 78u-5(c)(1)(A)(i).
8. See, e.g., Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co., 353 F.3d 1125, 1133 (9th Cir. 2004) (holding that where cautionary statements specifically mentioned the risk that trade-loading would slow the growth of its new business, which ultimately was the cause of the stock price drop, safe harbor required dismissal); In re Alamosa Holdings, Inc., 8 F. Supp. 2d 832, 844, Fed. Sec. L. Rep. (CCH) P 93215 (N.D. Tex. 2005) (applying the safe harbor where a separate disclosure “expressly addressed the very risk that Plaintiffs allege was not disclosed”).
than boilerplate and should ‘convey substantive information about factors that could cause results to differ materially from those projected in the forward-looking statements, such as, for example, information about the issuer’s business’”).

11. Id. at 807.
12. Id. (emphasis in original).
13. Id.
14. Id. at 813–14.
16. Id. at *5.
17. Id. at *9.
18. Id.
21. Id. at 734.
22. See, e.g., Central Laborers’ Pension Fund v. SIRVA, Inc., 2006 WL 2787520, *23 (N.D. Ill. 2006) (“a caution falls within the safe harbor only if it includes those sources of variance that at the time of the projection were the principal or important risks”) (citing Asher); Selbst v. McDonald’s Corp., Fed. Sec. L. Rep. (CCH) P 93360, 2005 WL 2319936, *18 (N.D. Ill. 2005) (“even if this Court were to find that the above warnings were not boilerplate, at this time the Court cannot determine if the potential ‘sources of variance’ mentioned in the cautionary language were the ‘major risks [the company] faced when it made its forecasts’”) (quoting Asher).
23. See, e.g., In re Spectrum Brands, Inc. Securities Litigation, 461 F. Supp. 2d 1297, 1320 n.9 (N.D. Ga. 2006) (“Determining whether a statement contains sufficiently ‘meaningful’ cautionary language and is thus entitled to a PSLRA safe harbor . . . can be a fact-intensive question inappropriate for a decision on the pleadings”); The WU Group v. Synopsys, Inc., 2005 WL 1926626, *11 (N.D. Cal. 2005) (“The Court additionally notes that in the context of a 12(b)(6) motion, it is too early in the litigation to reach a conclusion on whether the cautionary statements included in the earnings releases at issue are sufficiently meaningful to invoke the safe harbor provision”); Selbst, 2005 WL 2319936 at *16 (“Exactly what constitutes ‘meaningful cautionary language’ is ‘difficult if not impossible’ to decipher, particularly ‘at the pleading stage, before plaintiffs have access to discovery’”) (quoting Asher).
24. See note 19, supra.
26. Id.
30. See, e.g., Southland Securities Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 371, Fed. Sec. L. Rep. (CCH) P 92803 (5th Cir. 2004) (“The safe harbor has two independent prongs: one focusing on the defendant’s cautionary statements and the other on the defendant’s state of mind”); Miller v. Champion Enterprises Inc., 346 F.3d 660, 671-72, 56 Fed. R. Serv. 3d 1177, 2003 FED App. 0359P (6th Cir. 2003) (stating that “if the statement qualifies as ‘forward-looking,’ and is accompanied by sufficient cautionary language, a defendant’s statement is protected regardless of the actual state of mind”); Helwig, 251 F.3d at 555 n.2 (“This formulation [of the safe harbor provisions] is drawn from the statutory text, which is written in the negative disjunctive”); Harris, 182 F.3d at 803 (“[W]e need not in this case enter the thicket of the PSLRA’s new pleading requirements for scienter; if a statement is accompanied by ‘meaningful cautionary language,’ the defendants’ state of mind is irrelevant”); Greebel v. FTP Software, Inc., 194 F.3d 185, 201, Fed. Sec. L. Rep. (CCH) P 90658 (1st Cir. 1999) (“The safe harbor has two alternative inlets”).
32. Id. at 1159.
33. Id.
35. Id. at 536. In a footnote, the First Circuit noted a similar understanding of the statute. See, e.g., Baron v. Smith, 380 F.3d 49, 55 n.3, Fed. Sec. L. Rep. (CCH) P 92896 (1st Cir. 2004) (suggesting, in dicta, that forward-looking statements with meaningful cautionary language would be protected by the statutory safe harbor unless the person making the statement had actual knowledge of their falsity).
37. See note 30, supra.
38. S. 240, 104th Cong. § 105 (1995) (“The exemption from liability . . . does not apply to a forward-looking statement that is . . . knowingly made with the expectation, purpose, and actual intent of misleading investors . . . ”) (not enacted as written).
40. Id. at 47.