A Safe Harbor for Lying?

Warning Investors About Knowingly False Predictions

The day before a major public announcement the CEO of Widgets, Inc. is informed that the development of its highly anticipated new line of SuperWidgets has experienced a significant and unexpected setback: the supplier of a key component is about to go belly-up, and it will take months, if not more than a year, to provide suitable alternatives. She is told that, as such, it will take a minor miracle for Widgets, Inc. to actually meet its promised delivery date. The following day, however, the CEO of Widgets, Inc.—a woman of unsurpassed faith—boldly announces to investors: "Widgets, Inc. fully expects that the SuperWidget program will be completed on time!" Spurred by a gnawing of conscience and perhaps a fear of liability, however, she issues the following simultaneous warning: "Of course, there any number of things that could hypothetically cause delay. The economy could crash; our employees could go on strike; our suppliers could go out of business; our factories could be destroyed in an earthquake; who knows." Satisfied, she takes her leave.

Days later, news of the supplier's collapse—and the inevitable delay of SuperWidgets—reaches the market. Widgets, Inc.'s stock plummets in response, and investors sue.

Did the CEO's confident but clearly misleading prediction constitute securities fraud? Under the Private Securities Litigation Reform Act ("PSLRA"), predictions are deemed "forward-looking statements," and if they are "accompanied by meaningful cautionary statements" that disclose "important factors" that could cause the prediction to fail, then no matter how spectacularly wrong the prediction, it is protected from liability by a "safe harbor."

Here, the CEO *did* explicitly tell investors "our suppliers could go out of business," which "could hypothetically cause delay." And, of course, that is exactly what happened. Thus, she did disclose to investors an "important factor" that could cause, and did cause, her prediction to fail. Thus, the safe harbor would seem to apply.

And yet something feels wrong about this conclusion: the supplier had *already* gone out of business, and she *knew* it! Sure, she told investors that might happen—but that implies a non-zero probability it might *not* happen, as well. So, should the fact that she knew the supplier had already gone out of business affect our analysis of whether her warnings were adequate?

On this question, the courts are of two minds. On one side, the Sixth, Ninth, and Eleventh Circuits say no.[1] The Second and Seventh Circuits, meanwhile, say yes.[2] What do they base their positions on? The text of the statute itself, which uses the formless words “meaningful” and “important,” is not especially illuminating.

The courts that say no, it doesn’t matter that the CEO knew the supplier was already out of business, make two main arguments.

First, they cite legislative history—what Congress said when it passed the law. Legislative history is not controlling, but courts frequently consider it when trying to figure out what Congress intended the words of a statute to mean. In the case of the safe harbor, the most cited legislative history is the Conference Report, which is an agreement on legislation negotiated between the House and Senate. In this case, the Conference Report for the PSLRA included the following comment: “The use of the words ‘meaningful’ and ‘important factors’ are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor 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.” [3] This argument is relatively straightforward: Congress didn’t mean for courts to consider state of mind when analyzing cautionary statements, so we shouldn’t.

But the text of the statute, not the Conference Report, is the law, so these courts generally cite a second, more textual rationale for disregarding state of mind, based on the logic and structure of the statute itself. According to this rationale, taking state of mind into consideration when assessing cautionary language would make the cautionary language defense meaningless. This is so because the safe harbor creates at least two independent defenses for forward-looking statements. First, there is the meaningful cautionary language defense. Second, regardless of whether there is cautionary language, there is no liability if the defendant did not have “actual knowledge” that the forward-looking statement was false. Since lack of actual knowledge is a complete defense, if plaintiffs fail to allege that defendants knew of falsity, plaintiffs will lose, even if there is no cautionary language. Thus, plaintiffs always have to allege knowledge in a case involving forward-looking statements. But if having knowledge makes cautionary language less meaningful, the argument goes, that means that no defendant will ever be able to take advantage of the cautionary language defense, because the inevitable allegation of knowledge will

[1] *See, e.g.*, *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999); *Miller v. Champion Enters., Inc.*, 346 F.3d 660 (6th Cir. 2003); *In re Cutera Sec. Litig.*, 610 F.3d 1103 (9th Cir. 2010).

[2] *See, e.g.*, *Slayton v. Am. Exp. Co.*, 604 F.3d 758 (2d Cir. 2010); *Asher v. Baxter Int’l Inc.*, 377 F.3d 727 (7th Cir. 2004), *as amended* (Sept. 3, 2004).

[3] H.R. Rep. No. 104-369, at 44 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 743.

foreclose that possibility. Thus, for the statute to make sense, it must be that knowledge should not enter into the cautionary language analysis. Or so goes the argument anyway.

Meanwhile, the courts on the other side of the debate rely on a more diverse set of rationales. The fairest way to describe this side's reasoning is probably to say that considering state of mind is at least *consistent* with the safe harbor's text, if not required. Plus, it just seems wrong to say that a warning that doesn't reveal the full extent of the dangers of which you're aware can really be "meaningful." Indeed, as one district court has observed, Congress cannot have intended to grant safe harbor to defendants who knowingly lied to investors.[4]

Both sides' arguments have strengths and weaknesses. The side that eschews state of mind has the benefit of some pretty clear legislative history. Their main weakness is that their position grants safe harbor to some pretty bad behavior, such as the one described above. Additionally, their strongest textual argument, that taking state of mind into consideration would render the cautionary language defense superfluous, is probably wrong. A company could still find safe harbor protection for making knowingly false and misleading prediction if the company paired that prediction with something like a statement that the company doesn't have much faith in the prediction, or at least with disclosures that would allow the investing public to readily figure that out for themselves. For example, suppose the CEO had said "Widgets, Inc. fully expects that the SuperWidget program will be completed on time! Of course, any number of things might cause delay, including a key supplier going out of business. By the way, that just happened yesterday. But we're still projecting an on-time delivery!" In this scenario, the CEO has actual knowledge of falsity, so the complaint can't get dismissed on that basis. But the CEO also warned about the very fact that made her prediction false and misleading in the first place. Thus, even taking the CEO's state of mind into consideration, the complaint would still likely get dismissed because of there was meaningful cautionary language.

Of course, defendants will object that this is a crazy scenario—no company or executive would ever undermine or embarrass themselves that way, and it's unrealistic to expect as much. But even if that's true, the fact remains that the text and structure of the statute plainly doesn't preclude such a scenario. And perhaps more importantly, that criticism misses the point of the safe harbor, which is, after all, to avoid misleading investors by making sure companies disclose all relevant risk factors. So, if you want the protection of cautionary language, don't lie in your projections, and, if you do, hedge your predictions appropriately.

Meanwhile, the side that champions state of mind has the benefit of common sense. If you make a prediction to investors you know is unlikely to come true, issuing warnings that minimize the real

[4] *In re SeeBeyond Technologies Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1165 (C.D. Cal. 2003)

probability of failure shouldn't get you off the hook. The main weakness for this side is, of course, the legislative history. As far as legislative history goes, it doesn't get much more authoritative than a Conference Report. And the Conference Report makes pretty clear that when analyzing cautionary language, "[c]ourts should not examine the state of mind of the person making the statement."

Yet, as the Second Circuit pointed out, the Conference Report also required that "cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement." Surely, if a speaker knew that a risk had already materialized, that is "substantive information about [a] factor[] that realistically could cause results to differ materially from" the projection, no? Still, the more specific directive for courts not to consider state of mind is difficult to overcome, and the majority of the circuits have acted accordingly.

So who, if anyone, is right? The realistic answer is, it depends on the judge, the Circuit, and ultimately, the Supreme Court, should it decide to resolve this debate between the Circuits. Of course, Congress could also simply amend the statute to make it clearer—an unlikely scenario in this partisan climate to be sure.

But for the investing public, the *preferred* reading is obvious. If a company issues a prediction it knows is false because something bad has already happened, or will almost certainly happen, they should not be given safe harbor merely for offering cautionary hypotheticals that minimize the true extent of the risk. In the story outlined above, the CEO of Widgets, Inc. lied to investors by making a prediction she knew to be misleading, and her breezy warnings were a wholly inadequate substitute for the truth. Since the safe harbor can readily be interpreted to make her liable for harming investors with her bad behavior, it should be.