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Second Circuit Court of Appeals Sets Safe Harbor Guidance and Exacting Test for "Meaningful" Cautionary Statements

In a decision dated May 18, 2010, the U.S. Court of Appeals for the Second Circuit addressed in depth the requirements for "forward-looking statement" safe harbor protection under the Private Securities Litigation Reform Act (PSLRA) (*Slayton v. American Express Company, et al.*, 2010 U.S. App. LEXIS 10072).

One of the main issues on appeal before the Court was whether a particular "expectation" stated by the company in its Quarterly Report on Form 10-Q was appropriately accompanied by *"meaningful"* cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.

The Second Circuit ultimately determined that the company and the individually named defendants were *not* entitled to safe harbor protection under the "meaningful cautionary language" prong of the safe harbor, because, in the Court's view, the company's cautionary language was "vague." (The Court did determine, however, that plaintiffs had not sufficiently pled facts demonstrating that the company's statement of expectation in the Form 10-Q was made with "actual knowledge" that the statement was false or misleading and affirmed the district court's dismissal of the amended complaint on this basis.)

The case involved the substantial losses incurred by American Express in its high-yield debt investments.

The complaint, and question on appeal, related to a single forward-looking statement.

The forward-looking statement at issue related to the company's May 2001 Form 10-Q, in which the company announced a $182 million first-quarter loss from its high-yield debt investments. In that same Form 10-Q, the company added the following softening statements: "the high yield losses reflect the continued deterioration of the high-yield portfolio and losses associated with selling certain bonds" and ***"total losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter."***

Several pages later in the Form 10-Q the company expressly warned that the Form 10-Q contained "forward-looking statements" and ***"[f]actors that could cause actual results to differ materially from these forward-looking statements include... potential deterioration in the high-yield sector, which could result in further losses in [the company's] investment portfolio."***

The plaintiffs claimed that this forward-looking statement was fraudulent because, at the time the statement was made, the defendants knew that this statement was "misleading."

According to the complaint, shortly prior to filing its Form 10-Q, company management had been advised of significant and rapid deterioration in its high-yield debt portfolio, although the extent of that further deterioration was not then known.[1] In response, company management immediately initiated a detailed analysis of its portfolio. This analysis, completed approximately two months after the Form 10-Q was filed, apparently stunned company management with its magnitude and resulted in the company promptly issuing a press release announcing that it would be taking an additional $403 million loss related to investment-grade debt obligations, plus other losses from planned sales of high-yield and lower-grade debt, resulting in a total loss of approximately $826 million associated with the high-yield debt portfolio and rebalancing its portfolio toward lower-risk securities.

(1) The Court's forward-looking statement analysis

The Court first determined that a forward-looking statement included in an MD&A *is* entitled to forward-looking protection under the safe harbor, assuming all other required elements are present. The PSLRA specifically *excludes* from safe harbor protection a forward-looking statement that is included in a *financial statement prepared in accordance with GAAP*.?However, because an MD&A presents an analysis of a company's business as seen through the eyes of management, it was not intended to be included in the exception to safe harbor protection applicable to financial statements.

(2) Whether the statement at issue was properly "identified" as a forward-looking statement

The Court next looked at whether the company's statement of expectation was appropriately "identified" as a forward-looking statement within the meaning of the PSLRA.

The statement included in the Form 10-Q was the company's statement that its "expected" loss from high-yield investments would be substantially lower for the remainder of the year. The cautionary paragraph of the Form 10-Q also provided that "[t]he words 'believe', 'expect', 'anticipate', 'optimistic', 'intend', 'aim', 'will', 'should' and similar expressions are intended to identify such forward-looking statements."

The Court (with the support of the SEC as *amicus*) provided that the "facts and circumstances of the language" in a particular report will determine whether a statement is adequately "identified" as forward-looking. Quoting from the SEC brief, the Court noted that "'[t]he use of linguistic cues like "we expect" or "we believe", *when combined* with an explanatory description of the company's intention to thereby designate a statement as forward-looking, generally should be sufficient to put the reader on notice that the company is making a forward-looking statement.'"?(Italics supplied.)

(3) Whether the statement was accompanied by "meaningful" cautionary language

The Court next reviewed whether the forward-looking statement included in the Form 10-Q was accompanied by "meaningful" cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.

The plaintiffs (and the SEC) claimed that at the same time that the company was warning of *potential* deterioration in the high-yield sector that *could* result in further losses,[2] company management had been specifically warned of *actual* deterioration in that sector and that the risk factor only pointed out that additional losses could occur in high-yield debt based on *potential* deterioration and, as claimed by plaintiffs, did not meet the statutory test of appropriate meaningful cautionary language. In other words, plaintiffs and the SEC argued that cautionary language that is misleading in light of existing or historical facts known to the company cannot be "meaningful," with the SEC stating that by "historical facts" the SEC means facts that are established at the time the statement is made.

The Second Circuit agreed with this general framework for reviewing safe harbor protection-***risk factors that are misleading in light of historical fact cannot be "meaningful" under the safe harbor.***

In this case, the Court said that the defendants may not have clearly misstated a historical fact, but they apparently did know of a *specific risk*-that is, rising defaults on the bonds underlying the investment portfolio would cause deterioration in the portfolio at the time of the Form 10-Q-and they elected not to warn investors of this risk.

The question asked by the Court was whether this particular specific risk needed to be detailed in the Form 10-Q in order for the cautionary language to be "meaningful." In other words, the Court asked whether an issuer should be protected by the meaningful cautionary language prong of the safe harbor ***even where the cautionary statement omitted a major risk that company management knew about at the time they made the statement*.**

However, the Court did not have to decide that question, because, in its view, the company's actual risk factor/warning of "potential deterioration in the high-yield sector, which could result in further losses in [the company's] investment portfolio" was too "vague" to meet the test of a "meaningful" cautionary statement.

In reviewing this, the Court noted a number of things:

- **"Boilerplate" warnings do not suffice.**
- **To be "meaningful," cautionary statements must convey "substantive" company-specific information.**

- **While a company is not expected to identify all factors, Congress intended that a cautionary statement must "convey substantive information about factors that realistically could cause results to differ materially from those projected."**
- **"To suffice," cautionary statements must be "'substantive and tailored to the specific future projections, estimates or opinions.'"**

In the Court's view, the company had, at the time of filing of its Form 10-Q, been presented with a major, specific risk that, due to rising defaults then being experienced, the investment portfolio could likely deteriorate, *but they did not warn of this specific risk*. According to the Court, a warning that essentially says, "if our portfolio deteriorates, then there will be losses in our portfolio" verges on mere boilerplate.

The Court also noted that the company's cautionary language and risk factors "remained the same even while the problem changed" and that the same cautionary language and ***risk factors had been included, without change or addition, in numerous reports over the preceding five months, even as the risk itself had changed during this same time period.***?

The Court's finding provides all the more reason for a public company to carefully consider, and regularly update, its cautionary statements on an ongoing basis-to carefully review and consider the types of major "risks" then being faced by the company in connection with any forward-looking statement and whether the company's description of its risks needs to be modified or updated to "substantively" address the specific risks then faced by the company in a "meaningful" way.

(4) Whether American Express made its statement of expectation with "actual knowledge" that it was misleading

The Second Circuit also determined that the safe harbor is written in the "disjunctive." That is, a defendant is not liable if the forward-looking statement is identified and accompanied by meaningful cautionary language (this standard was not found here) *or* if it is immaterial (no one argued in this case that the forward-looking statement was not material) *or* if the plaintiff fails to prove that it was made with "actual knowledge" that it was false or misleading.

In looking at whether the statement was made with actual knowledge that it was misleading, the Court was required to accept as true all the facts alleged by the plaintiff for purposes of the motion, and then it looked to apply applicable law to the alleged facts.

In doing so, the Court essentially looked at whether:

1. the defendants did not "genuinely believe" the forward-looking statement, *or*
2. the defendants actually knew that they had no reasonable basis for making the statement, *or*
3. the defendants were aware of undisclosed facts tending to seriously undermine the accuracy of the statement.

The Court noted that its analysis was very fact-specific and, calling it a close call, ruled that the plaintiffs had not sufficiently pled facts to meet this "actual knowledge" standard and, as a result, the Court could not conclude that the defendants had acted with actual knowledge that the statement was misleading.

Finally, it was particularly important that the company, promptly upon learning of the materially adverse results of its analysis of the investment portfolio, timely released this very negative information by press release rather than waiting until its next Form 10-Q or earnings release.

This Second Circuit opinion is likely to be closely scrutinized and used by potential plaintiffs and their counsel, and the issue of whether a company's cautionary statements are "meaningful" and substantively tailored to the particular forward-looking statement, projection or outlook is likely to be litigated going forward. (It is important to note, in our view, that many company executives, and their counsel, likely would have said that this particular cautionary language used by the company was specific and adequately warned of the specific "risk"-the Second Circuit disagreed.)

The learning and guidance for public companies from this decision is to look carefully at all forward-looking statements; to consider and appropriately identify, and carefully and specifically describe, the major risks associated with that expectation; and to craft and regularly update the company's risk factors accordingly.

The opportunity to obtain dismissal of costly (and very public) securities class action litigation at a motion-to-dismiss stage is not to be overstated. However, that opportunity may only be realized if, in the planning stage, when forward-looking disclosures are being made, company management:

- is aware of what is legally required under the safe harbor for cautionary statements to be "meaningful";
- carefully considers the potential significant risks associated with that estimate, outlook, expectation or other forward-looking statement; and
- Carefully, realistically and substantively tailors its risk factors and cautionary language accordingly.

This process requires discipline and a willingness to identify and describe potential risks to a forward-looking statement. The potential benefits to be realized by this process, however, far outweigh the accompanying time and commitment.

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[1]According to the complaint, shortly prior to filing its Form 10-Q, company management was told that the "deterioration of the high-yield debt portfolio was so bad that 'even the investment-grade CDOs held by [the company] showed potential deterioration' because defaults on the underlying bonds had risen so sharply."

[2]As noted above, the particular "risk" included by the company in its cautionary statement paragraph of the Form 10-Q was "...*potential* deterioration in the high-yield sector, which *could* result in further losses in AEFA's investment portfolio.