When a Company's Forward-looking Statements Find No Safe Harbor: Bespeaks Caution Doctrine Provides Alternative Protection

Article contributed by:
Morris DeFeo, Jr., Amanda Paracuellos and Kelly Howard, Crowell & Moring LLP

A company has just entered into a consent decree with the SEC related to one or more antifraud provisions of the securities laws. As a result, for the next three years, the company cannot avail itself of the statutory safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995 (PSLRA).[1] Should the company release its next earnings forecast per its previous disclosure practice? Will forward-looking information in other disclosures need to be withheld or handled differently?

Fortunately, companies finding themselves without the PSLRA "safe harbor" can instead rely on the judicially created "bespeaks caution" doctrine, which provides generally parallel protection for forward-looking statements. While each regime has its specific nuances, both the bespeaks caution doctrine and the statutory safe harbor can render a forward-looking statement not actionable in a private securities fraud lawsuit if the statement is accompanied by cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. This article focuses on the key similarities and differences between the bespeaks caution doctrine and the statutory safe harbor to suggest the available strategies for companies facing situations in which the statutory safe harbor does not apply.

The Private Securities Litigation Reform Act of 1995

Aimed at reducing frivolous and baseless securities litigation, the PSLRA amended and created several new sections of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). Among other reforms, the PSLRA created a statutory safe harbor for certain forward-looking statements made by companies which are subject to the reporting requirements of Section 13(a) or 15(d) of the 1934 Act, persons acting on behalf of such companies, outside reviewers retained by such companies, and underwriters. If a forward-looking statement is immaterial or accompanied by meaningful cautionary language, or if a private securities fraud plaintiff cannot prove that the statement was made with actual knowledge that the statement was false or misleading, there is no liability in a private action for securities fraud for that statement. However, as noted above, the statutory safe harbor excludes forward-looking statements made in a number of situations, including, statements made by companies that are subject to consent decrees or cease and desist orders related to securities law antifraud provisions.[2]

The Bespeaks Caution Doctrine

The bespeaks caution doctrine is a judicially created rule providing that cautionary language meeting the standards of the rule can render forward-looking statements inactionable under securities fraud laws if such forward-looking statements later prove to be incorrect. The rationale is that the cautionary language negates the reasonableness of reliance on the forward-looking statements as well as the materiality of such statements.[3]

The doctrine has become firmly established as a defense to claims under the federal securities fraud laws, formally adopted by nine Circuit Courts of Appeals -- the First, Second, Third, Fifth, Sixth, Seventh, Eighth, Ninth and Eleventh.[4] It serves as a defense to claims under Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder, as well as Sections 11 and 12(2) of the 1933 Act.[5]

While the statutory safe harbor was modeled after the bespeaks caution doctrine, it is clear that the bespeaks caution doctrine survives the creation of the statutory safe harbor. Congress specifically acknowledged this survival in passing the PSLRA, stating that the safe harbor is not intended to "replace the judicial bespeaks caution doctrine or to foreclose further development of that doctrine by the courts."[6] Due to their many similarities, many courts have interpreted the statutory safe harbor using bespeaks caution decisions and standards as precedent. In addition, in many cases since the passage of the PSLRA, defendants have raised, and courts have applied, both the bespeaks caution doctrine and the safe harbor in tandem, finding the same result under both. Given the significant overlap between the two rules, it is possible that the safe harbor might similarly affect the development of the bespeaks caution doctrine; namely, a court in a future bespeaks caution case might look to the statutory safe harbor and practices related thereto as the appropriate standard required for protection under the bespeaks caution doctrine. We have not yet found any cases where this has occurred.

Where Cautionary Language is Well-Used, Scope of Protection is Similar

Both the statutory safe harbor and bespeaks caution doctrine require that meaningful risk disclosure qualify forward-looking statements. Cautionary language must meet similar requirements regarding content and placement vis-à-vis the forward-looking statements intended to be shielded. With respect to the content of cautionary language, the requirements of the safe harbor and bespeaks caution doctrine are virtually indistinguishable. Both require cautionary language to be precise and fact-specific, directly addressing the substance of each forward-looking statement. General or boilerplate statements of risk do not suffice.

However, with regard to the placement or location of the required cautionary language vis-à-vis the forward-looking statements to be qualified, the bespeaks caution doctrine has been more permissive with respect to both written and oral forward-looking statements. Courts typically have not required that cautionary language appear in the same document as a forward-looking statement; not even a cross-reference is necessary. Similarly for oral statements, no particular reference in the statements is required. Instead, the mere existence of cautionary language in another reasonably contemporaneous document available to the plaintiff generally has been deemed sufficient.[7]

As such, risk disclosure designed to meet the more stringent placement requirements of the statutory safe harbor should afford protection under the bespeaks caution doctrine. For written documents, the safe harbor requires that forward-looking statements be specifically identified as such and that cautionary language "accompany" any forward-looking statements. This latter rule generally is interpreted to require the cautionary language to appear somewhere in the same document as the forward-looking statement sought to be immunized. The safe harbor does not expressly permit cross-referencing or incorporation of other documents that contain the requisite cautions; however, some courts have permitted this practice.[8] For oral forward-looking statements, such as those made by companies at press conferences or in meetings with securities analysts, the speaker must both warn that actual results may differ and refer interested persons to a "readily available" disclosure document such as SEC-filed documents, annual reports, or other widely disseminated materials, such as press releases.

While it may be tempting to rely on the more permissive aspects of the bespeaks caution doctrine, particularly in shorter documents such as press releases, the best practice *in all cases* is to comply with the more detailed requirements of the safe harbor. Some courts have imposed such requirements in bespeaks caution cases of their own accord and, as noted above, there is some possibility that a court could incorporate the more stringent standards of the safe harbor into the bespeaks caution doctrine.[9]

Ending Cases Before Trial

If adequate cautionary language (meeting the standards described above) accompanies forward-looking statements, the likelihood of obtaining a pre-trial dismissal of fraud allegations under the bespeaks caution doctrine is likely to be similar to that under the statutory safe harbor. Under both regimes, such a dismissal is grounded in the basic proposition that even if there were a misstatement or omission, the cautionary language renders that misstatement or omission immaterial.[10]

However, if there are allegations that a forward-looking statement was untrue, or not genuinely believed by the speaker when made, the likelihood of a successful motion to dismiss is reduced under bespeaks caution. Case law under both regimes is mixed as to whether cautionary language is a *per se* bar to liability even where it is alleged that a forward-looking statement was known to be false when made. A majority of decisions under the bespeaks caution doctrine have rejected cautionary language as a *per se* bar to liability, while a majority of decisions under the statutory safe harbor recognize a *per se* bar where there is meaningful cautionary language. Ultimately, however, the applicable rule appears to be in flux and may depend on the particular venue in which any given case is decided.

Courts finding that the bespeaks caution doctrine does not insulate forward-looking statements known to be false when made, no matter whether accompanied by otherwise stringent disclaimers, include the Fifth, Sixth and Ninth Circuits.[11] One rationale for such decisions has been that to allow protection for knowingly made false statements would destroy the intent of the bespeaks caution doctrine. Other courts have found the cautionary language itself to contain the misrepresentations – for example, where cautionary language warned of risks that had already become reality. In the oft-quoted decision of *In re* Prudential Sec. Inc. Ltd. Partnerships Litigation, the court stated that the "doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away."[12]

On the other hand, other courts, including the Third and Eighth Circuits, disagree and have refused to consider allegations of fraud where adequate disclaimers have been used, reasoning that if a statement has been rendered immaterial by cautionary language, it remains immaterial, even if known to be false when made.[13]

A majority of courts that have considered this same issue under the statutory safe harbor have rejected inquiring into a defendant's state of mind if meaningful cautionary language was used. Indeed, the safe harbor is drafted with two distinct prongs separated by an "or," and thus provides that statements are immunized if *either*: (A) accompanied by meaningful cautionary statements; or (B) the plaintiff fails to prove the statements were known to be false when made.[14] Some courts have acknowledged this disjunctive structure in distinguishing the safe harbor from the bespeaks caution doctrine where actual knowledge is alleged.[15] Other courts, including the Third, Sixth and Eleventh Circuits have stated simply, without analysis, that where a forward-looking statement is accompanied by meaningful cautionary language, state of mind is irrelevant.[16]

Conversely, the Ninth Circuit stated in dicta that despite meaningful cautionary statements, "a person may be held liable if the forward-looking statement is made with actual knowledge . . . that the statement was false or misleading (internal quotations omitted)."[17] In addition, a California district court reached a similar result by reasoning that where a forward-looking statement is made and the speaker has actual knowledge that it is false, "cautionary language can only be meaningful if it either states the belief of the speaker that it is false or misleading, or at the very least, clearly articulates the reasons why it is false or misleading."[18]

Decisions in the Second Circuit, which is currently the most popular venue for securities fraud class actions given its permissive interpretation of the PSLRA's pleading standards, serve as an interesting illustration of differing viewpoints on this issue. As noted above, the Southern District of New York decided the Prudential case under the bespeaks caution doctrine in 1996 and has since cited that case in refusing to grant motions to dismiss under the statutory safe harbor as well – often referring to both doctrines in tandem and concluding that they lead to the same result where forward-looking statements are accompanied by meaningful cautionary language, but the plaintiffs allege actual knowledge of falsity.[19] However, other courts in the Second Circuit have held to the contrary. For example, the Eastern District of New York, in its 2005 decision *In re* Gilat Satellite Networks, Ltd., criticized a number of other courts for relying on bespeaks caution precedent while failing to analyze the language of the statutory safe harbor, which that court found to lead to the opposite result.[20] Also compare the Second Circuit's own decision under the statutory safe harbor in which the court, in dicta, quoted with approval the Prudential decision.[21]

Inadequate or Absent Cautionary Language Increases Risk

As described in the preceding sections of this article, if a company follows disclosure practices carefully designed to comply with the requirements of the statutory safe harbor, forward-looking statements made pursuant to such practices are unlikely to greatly increase such company's risk of liability, even in the absence of safe harbor protection. However, if such disclosure practices are not carefully followed (or mistakes are made), a company without safe harbor coverage will be at a disadvantage under the bespeaks caution doctrine with respect to the type of scienter that a plaintiff must prove.

If there is no available cautionary language or if cautionary language is offered but not meaningful, the bespeaks caution doctrine simply does not apply. In such cases, the forward-looking statement at issue would be evaluated under the standards of the rules applicable to the securities fraud alleged (for example, under the Rule 10b-5 scienter standard). Under the statutory safe harbor, however, the applicable standard is "actual knowledge" by the person making the forward-looking statement that the statement was false and misleading when made. This is a heightened standard, providing more protection for those who make forward-looking statements than that of Rule 10b-5, under which a merely reckless or grossly negligent material misstatement or omission gives rise to liability. Put another way, reckless and grossly negligent projections are shielded from liability under the PSLRA safe harbor in the absence of the speaker's actual knowledge that they are false or misleading. An additional protection, and hurdle for plaintiffs, under the safe harbor is that if the statement is made by the issuer (for example, in a prospectus) the plaintiff must show both that: (1) such statement was approved by an executive officer of the issuer; and (2) that such officer actually knew the statement was false or misleading.

Procedural Benefits of PSLRA Remain Available

The PSLRA and related laws offer issuers a number of procedural benefits in securities fraud lawsuits. These benefits include: (1) automatic stay of discovery pending any motion to dismiss; (2) preemption of most state class action lawsuits for securities fraud; and (3) heightened pleading standards.

These procedural provisions apply to any securities fraud class action brought under the 1933 Act or the 1934 Act. As such, even if a company is not protected by the statutory safe harbor, a class action brought with respect to an allegedly fraudulent forward-looking statement would be brought under the 1933 Act or 1934 Act and the PSLRA's procedural benefits would apply. For example, in the context of a fraud claim brought against securities analysts (to whom the statutory safe harbor does not apply), the court applied the PSLRA's pleading standards alongside the bespeaks caution doctrine based on predictions and opinions contained in research reports.[22]

Protecting Forward-Looking Statements: A Practical Note

Companies which cannot avail themselves of the safe harbor of the PSLRA can obtain similar protections under the bespeaks caution doctrine in virtually any situation by following a careful disclosure policy relating to forward-looking statements.

The following guidelines may be helpful in retaining as much protection as possible:

- Identify your forward-looking statements as such. If you are not currently covered by the safe-harbor, make sure that you do not identify statements as being made or protected “pursuant to” the statutory safe harbor;
- Ensure predictions and other forward-looking statements have a reasonable basis in fact and are made in good faith;
- Where possible, accompany predictions and forward-looking statements with accurate facts regarding present and/or historical performance and describe any assumptions in detail (Note, however, that statements of present or historical facts are not covered by the statutory safe harbor or the bespeaks caution doctrine because they are not forward-looking statements.);
- Include cautionary language in the same document, in close proximity if possible, as the forward-looking statement it qualifies. For oral statements, provide listeners with a reference to appropriate written cautionary language;
- Tailor cautionary language to the specific risks and uncertainties of the forward-looking information on which investors may rely. Avoid boilerplate cautionary language, as it is insufficient to garner the protections of the bespeaks caution doctrine. (For example, it is usually better to specify risks that are unique to a particular product or the company about which a forward-looking statement is made, as opposed to risks common to the industry.);
- Review cautionary language often and keep it updated – especially where risk disclosure in a quarterly or annual statement will be referenced to qualify oral statements; and
- Draft cautionary language clearly, as less protection is available if special financial expertise would be required to assess the risk disclosed in regard to the forward-looking statement.

Morris DeFeo, Jr. is a partner and Kelly Howard is an associate in Crowell & Moring LLP’s Washington, D.C. office. Amanda Paracuellos is a counsel in the firm’s California office. As members of Crowell & Moring’s Corporate Group, their practices encompass a wide range of corporate and securities counseling and transactions, including corporate finance, securities reporting and compliance, corporate governance and mergers and acquisitions. With more than 300 attorneys, Crowell & Moring LLP is a nationally recognized, full service law firm based in Washington, D.C. with offices in California, London and Brussels.

---

[1] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended within 15 U.S.C. 77, 78 (1994 & Supp. 1998)).
[2] The exclusions from the safe harbor may be found at 15 U.S.C. 77z-2(b). Other exclusions include IPOs, partnership offerings, tender offers, and "going private" transactions.
[3] *See In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir. 1994), *cert. denied*, 516 U.S. 868 (1995) *and cert. denied*, 516 U.S. 909 (1995).
[4] *See, e.g.,* Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991); Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986); Goldman v. Belden, 754 F.2d 1059, 1068 (2d Cir. 1985); I. Meyer Pincus & Assocs. v. Oppenheimer & Co., 936 F.2d 759, 763 (2d Cir. 1991); *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 371-73 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); Kline v. First Western Gov't Sec., Inc., 24 F.3d 480, 489 (3d Cir. 1994), *cert. denied*, 513 U.S. 1032 (1994); Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 204 (5th Cir. 1988), *cert. denied*, 488 U.S. 926 (1988); Stavroff v. Meyo, 1997 WL 720475 (6th Cir. 1997); Harden v. Raffenspurger, Hughes & Co., 65 F.3d 1392, 1404-06 (7th Cir. 1994); Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 949 F.2d 243, 245 (8th Cir. 1991); Warshaw v. Xoma Corp., 74 F.3d 955, 959 (9th Cir. 1996); Fecht v. Price Co., 70 F.3d 1078, 1081-82 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996); *In re* VeriFone Sec. Litig., 11 F.3d 865, 867-68 (9th Cir. 1993); *In re* Convergent Technologies Sec. Litig., 948 F.2d 507, 513 (9th Cir. 1991); Saltzberg v. TM Sterling/Austin Assocs., Ltd., 45 F.3d 399, 400 (11th Cir. 1995). *But see* Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993).

[5] Trump, 7 F.3d at 368, fn.10; Worlds of Wonder, 35 F.3d at 1415, fn.3.
[6] H.R. CONF. REP. NO. 104-369 (1995).
[7] *See, e.g.,* Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997).
[8] *See* Stavros v. Exelon Corp., 266 F. Supp. 2d 833 (N.D. Ill. 2003).
[9] *See, e.g.,* EP Medsystems, Inc. v. Echocath, 235 F.3d 845, 877 (3rd Cir. 2000).
[10] *See* I. Meyer Pincus, 936 F.2d at 763 (granting motion to dismiss); Romani, 929 F.2d at 879 (granting motion to dismiss); Saltzberg, 45 F.3d at 400 (granting summary judgment); Moorhead, 949 F.2d at 245-246 (granting summary judgment).
[11] *See* Rubinstein v. Collins, 20 F.3d 160, 168 (5th Cir. 1994), Mayer, 988 F.2d at 639; Worlds of Wonder, 35 F.3d at 1425.
[12] 930 F. Supp. 68, 72 (S.D.N.Y. 1996).
[13] *See, e.g.,* Trump, 7 F.3d at 371-73; Moorhead, 949 F.2d at 245-6 (8th Cir. 1991).
[14] Pub. L. No. 104-67, 109 Stat. 737 (1995).
[15] *See, e.g., In re* Gilat Satellite Networks, Ltd., No. CV-02-1510, 2005 WL 2277476 (E.D.N.Y. 2005).
[16] *See* GSC Partners CDO Fund v. Washington, 368 F.3d 228, 243 (3rd Cir. 2004); Miller v. Champion Enterprises, Inc., 346 F.3d 660, 672 (6th Cir. 2003); Harris v. IVAX Corporation, 182 F.3d 799, 803 (11th Cir. 1999), *reh'g denied*, 209 F.3d 1275 (11th Cir. 2000).
[17] No. 84 Employer Teamster Joint Council Pension Trust Fund v. America West, 320 F.3d 920, 936 (9th Cir. 2003), *cert. denied*, 540 U.S. 966 (2003) (stating in dicta that "it is arguable that a strong inference of actual knowledge has been raised, thus, excepting these statements from the safe harbor rule altogether").
[18] *In re* SeeBeyond Technologies, 266 F. Supp. 2d 1150, 1165 fn.8 (C.D. Cal. 2003).
[19] *See, e.g., In re* Alliance Pharmaceutical Corp. Securities Litigation, 279 F. Supp. 2d 171 (S.D.N.Y. 2003) ("neither the bespeaks caution doctrine nor the Safe Harbor provision of the PSLRA protects a defendant from liability if a statement was knowingly false when made").
[20] No. CV-02-1510, 2005 WL 2277476 (E.D.N.Y. 2005).
[21] Rombach v. Chang, 355 F.3d 164, 170 (2d Cir. 2004).
[22] *In re* Salomon Analyst AT&T Litigation, 350 F. Supp. 2d 455, 468 (S.D.N.Y. 2004).