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## Private Securities Litigation Reform Act of 1995: Do Issuers Still Get Soaked in the Safe Harbor?

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## COMMENT

### PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: DO ISSUERS STILL GET SOAKED IN THE SAFE HARBOR?

*[T]here appears to be a growing consensus in the courts, at the Securities and Exchange Commission and in Congress that, while private securities litigation serves a role in deterring law violations and compensating investors, the current system also imposes costs on issuers, on such professionals as accountants and attorneys who provide services to corporations, and ultimately, on investors.<sup>1</sup>*

#### I. INTRODUCTION

In an effort to restore investors' confidence in the securities market, Congress passed the Securities Act of 1933 (hereinafter the "Securities Act") and the Securities Exchange Act of 1934 (hereinafter the "Exchange Act").<sup>2</sup> The two primary goals of these Acts are to promote full disclosure of information necessary to make wise investment decisions and to enable corporations to raise capital.<sup>3</sup> Since much of the information the issuer discloses under these Acts deals with future projections, the issuer<sup>4</sup> is more susceptible to frivolous lawsuits.<sup>5</sup> Conse-

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1. Geoffrey F. Aronow & Martha L. Cochran, *Shaking the Foundation of Securities Suits*, THE RECORDER, Jan. 6, 1995, at 8.

2. S. REP. NO. 98, 104th Cong., 1st Sess. (1995), reprinted in Congressional Information Service, Inc., S 243-1, at 4.

3. 69 AM. JUR. 2D *Securities Regulation - Federal* § 64 (1993).

4. An issuer is a person who issues or proposes to issue any security, except for issuance of certificates of deposit for securities, voting-trust certificates, collateral-trust certificates, certificates of interest or share in an unincorporated invest-

quently, the issuer often must expend money to defend such lawsuits rather than to increase the value of, or capital in, the company.<sup>6</sup>

A significant conflict arising from the competing goals of the Securities Act and the Exchange Act centers on the disclosure of forward-looking information.<sup>7</sup> The United States Securities and Exchange Commission (hereinafter "SEC"), the courts and Congress have all made attempts to create a workable balance between promoting full disclosure and raising capital.<sup>8</sup> The SEC adopted Rule 175<sup>9</sup> and Rule 3b-6<sup>10</sup> to allow issuers to disclose forward-looking information without fear of defending strike suits.<sup>11</sup> However, these rules, as applied, have been ineffective in curtailing litigation.<sup>12</sup> In response, the courts developed the 'bespeaks caution' doctrine<sup>13</sup> to pro-

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ment trust without a board of directors or of a fixed, restricted management, or unit type. 15 U.S.C. § 78c(8) (1994).

5. The more information that an issuer discloses, the more susceptible they are to frivolous lawsuits.

6. J. Kenneth Blackwell, *Halting 'Strike Suits' Can Give Clinton a Solid Anchor in the Political Center*, THE BOND BUYER, Nov. 20, 1995, at 33, available in LEXIS, News Library, Bndbyr File. Providing full and fair disclosure often does not promote raising capital. 69 AM. JUR. 2D *Securities Regulation - Federal* § 301 (1993).

7. A forward-looking statement is a statement of economic projections, a statement of management's objective for future operations, a statement of future economic performance or any statement of the assumptions underlying or relating to any of the statements already described. 17 C.F.R. 230.175(c) (1996), 17 C.F.R. 240.3b-6(c) (1996).

8. See generally, *Safe Harbor For Forward-Looking Statements*, 59 FED. REG. 52723 (1994).

9. Securities Act of 1933, 17 C.F.R. § 230.175 (1996), see part II.B.2.

10. Securities Exchange Act of 1934, 17 C.F.R. § 240.3b-6 (1996), see part II.B.2.

11. A strike suit is a suit brought primarily for its nuisance value by a small shareholder whose interest in the corporation is insignificant and knowing the cost of defending such a suit is high, the shareholder sues hoping for a private settlement. BLACK'S LAW DICTIONARY 1267 (5th ed. 1979).

12. *Safe Harbor For Forward-Looking Statements*, supra note 8, at 52728.

13. Donald C. Langevoort, *Disclosure that "Bespeaks Caution,"* 49 BUS. LAW. 481 (1994) (hereinafter "Disclosure that 'Bespeaks Caution'"). In re Donald J. Trump Casino Secs. Litig., 7 F.3d 357 (3rd. Cir. 1993), cert. denied, \_\_\_ U.S. \_\_\_, 114 S.Ct. 1219 (March 7, 1994). Under the 'bespeaks caution' doctrine a plaintiff cannot base a securities fraud claim on forward-looking statements if such statements are accompanied with cautionary language. *Id.* at 371. This doctrine will apply to "both affirmative misrepresentations and omissions concerning soft information" and the "cautionary language must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus" that are chal-

protect issuers from frivolous anti-fraud suits.<sup>14</sup> In order for issuers to ensure protection under the 'bespeaks caution' doctrine they must include meaningful cautionary language with forward-looking information.<sup>15</sup> Finally, Congress acted by passing the Private Securities Litigation Act of 1995 (hereinafter "Reform Act").<sup>16</sup>

The Reform Act intends to strike a balance between controlling frivolous strike suits and safeguarding investors' rights by affording issuers a safe harbor protection<sup>17</sup> when disclosing forward-looking statements.<sup>18</sup> The potential for liability from private class actions under Rule 10b-5<sup>19</sup>, due to forward-look-

lenged. *Id.* at 371-72.

14. See generally, Disclosure that "Bespeaks Caution," *supra* note 8.

15. *In re Donald J. Trump Casino Secs. Litig.*, *supra* note 13, at 371.

16. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified as 15 U.S.C. §§ 77z-1, 78u-4 (Supp. 1995)).

17. The term "safe harbor" refers to the granting of relief from liability if the actor was acting in good faith when complying with the law. BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 498 (4th ed. 1995).

18. These statements include projection of revenue, income, earnings per share, capital expenditures, dividends, capital structure or other financial items; plans and objectives of management for future operations; future economic performance; assumptions underlying or relating to any statement concerning the above mentioned statements; any report by an outside reviewer retained by issuer that assesses a forward-looking statement made by issuer; or statement containing a projection or estimate of items specified by rule or regulation by the SEC. 15 U.S.C. §§ 77z-2(i)(1), 78u-5(i)(1) (Supp. 1995).

19. According to SEC Rule 10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1996).

According to the Exchange Act § 10b:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . (b) to use or employ, in connection with the purchase or sale of any security regis-

ing statements, often inhibits communication among management, analysts and investors thereby reducing the amount of information provided to the investing public.<sup>20</sup> Consequently, investing becomes riskier due to the lack of information and the cost of raising capital increases.<sup>21</sup>

This Comment will examine the background and development of protection for forward-looking statements through the SEC, the courts and Congress. Following this background examination, Part III will focus on the recently passed Reform Act. This discussion will consider the arguments made by opponents and proponents of the Reform Act, the effects of this act and whether it is encouraging disclosure by issuers and protecting the same issuers from frivolous lawsuits.

## II. BACKGROUND

The Securities Act in 1933 administered by the Federal Trade Commission was the first significant federal legislation regulating securities<sup>22</sup> The following year Congress passed the Exchange Act.<sup>23</sup> As part of the Exchange Act, Congress created the SEC,<sup>24</sup> which became responsible for administering both the Securities Act and the Exchange Act.<sup>25</sup> By enacting

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tered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1994).

20. S. REP. NO 98, *supra* note 2, at 5.

21. *Id.*

22. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994). A security includes articles such as any note, stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement, or in general, any instrument commonly known as a "security." 15 U.S.C. § 78c(a)(10) (1994). Although the definition of "security" in the Securities Act of 1933 (15 U.S.C. § 77b(1) (1994)) and the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(10) (1994)) are slightly different, the two definitions are considered practical equivalents. *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914 (8th Cir. 1976), *Untied Cal. Bank v. THC Financial Corp.*, 557 F.2d 1351, 1356 (9th Cir. 1977), *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977).

23. Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1994).

24. 15 U.S.C. § 78d(a) (1994).

25. 15 U.S.C. § 77s(a) (1994).

these Acts, Congress hoped to induce full and fair disclosure of necessary information and place capital in productive channels.<sup>26</sup>

**A. SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934: FEDERAL LEGISLATION AIMED AT FULL AND FAIR DISCLOSURE.**

The Securities Act primarily governs the initial issuance of securities,<sup>27</sup> while the Exchanges Act regulates trading in securities following their initial issuance and transactions by officers, directors and principal security holders.<sup>28</sup> The fundamental purpose of both Acts is to promote full disclosure of information necessary for investors to make informed investment decisions.<sup>29</sup>

The Securities Act affords protection to the naive or uninformed investor by deterring sellers of securities from reckless or fraudulent activities.<sup>30</sup> It attempts to ensure full and fair disclosure regarding securities sold in the initial offering to prevent fraud and misrepresentation.<sup>31</sup> Issuers of initial public offerings must file a registration statement with the SEC and provide a prospectus on the securities to every purchaser.<sup>32</sup>

Under the Securities Act, a registration statement and a prospectus must include: 1) information about the business of the issuer; 2) the value and number of shares offered; 3) net proceeds derived from any security sold by the issuer in the past two years; 4) a balance sheet showing all assets of the issuer; and 5) a profit and loss statement.<sup>33</sup> The Securities Act

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26. 69 AM. JUR. 2D *Securities Regulation - Federal* § 64 (1993).

27. *Id.*

28. 69 AM. JUR. 2D *Securities Regulation - Federal* § 301 (1993).

29. *Id.* at § 64. The Securities Act and the Exchange Act are the two principal federal statutes regulating the sale and distribution of securities. *Id.* at § 1.

30. *Id.* at §§ 64, 301.

31. *Id.* at § 2.

32. ROBERT CHARLES, *CORPORATE LAW* 719-720 (1986). Although this is the general rule, the Securities Act provides exemptions based on the type of security (15 U.S.C. § 77c (1994)) and the type of transaction initiated (15 U.S.C. § 77d (1994)).

33. 15 U.S.C. § 77aa (1994). Schedule A provides, in detail, the information re-

protects honest enterprise, helps bring available capital into productive channels and restores the confidence of the public in securities markets.<sup>34</sup> These purposes also form the foundation of the Exchange Act so that the two Acts work in harmony to protect the public investor.<sup>35</sup>

When an issuer discloses information it allows investors to make informed investment decisions, however, it also increases the risk of litigation for the issuers.<sup>36</sup> Recognizing this dilemma, the SEC, the courts and Congress each attempted to develop protection from litigation for issuers without unduly compromising the requirement for full and fair disclosure of pertinent information to investors.<sup>37</sup>

#### B. THE SEC'S APPROACH TO DISCLOSURE OF FORWARD-LOOKING STATEMENTS UNDER THE SECURITIES ACT AND EXCHANGE ACT

Initially, the SEC prohibited the disclosure of forward-looking information because it perceived the information as inherently unreliable.<sup>38</sup> Such information includes a statement of economic projections, a statement of management's objective for future operations, or a statement of future economic performance.<sup>39</sup>

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quired under 15 U.S.C. § 77g (1994) in a registration statement and under 15 U.S.C. § 77j (1994) in a prospectus. Information required in a prospectus is substantially the same as that required in the registration statement. For documents not required in a prospectus see 15 U.S.C. § 77j (1994).

34. 69 AM. JUR. 2D *Securities Regulation - Federal* § 64 (1993).

35. *Id.* If an act or transaction gives rise to civil action under both Acts, the person wronged may rely on the provisions of both Acts in seeking a remedy. *Id.*

36. 69 AM. JUR. 2D *Securities Regulation - Federal* § 64 (1993).

37. *See generally*, Safe Harbor For Forward-Looking Statements, *supra* note 8.

38. *Id.* at 52723.

39. 17 C.F.R. 230.175 (1996), 17 C.F.R. 240.3b-6 (1996). Forward-looking statement also included any statement of the assumptions underlying or relating to any of the statements already described. *Id.*

## 1. Prior to 1979: Disclosure of Forward-looking Information Prohibited

Until the passage of Rule 175 and Rule 3b-6 in 1979,<sup>40</sup> the SEC prohibited disclosure of forward-looking information.<sup>41</sup> It believed that, when investing, unsophisticated investors would rely too much on this inherently unreliable information.<sup>42</sup>

Notwithstanding its reservations about forward-looking statements, the SEC formed the Wheat Commission<sup>43</sup> to examine the benefits of such statements.<sup>44</sup> After studying the various disclosure issues, the Wheat Commission found estimates of future earnings were the basis of most investment decisions.<sup>45</sup> Since projections of future earnings could change rapidly, the Wheat Commission determined that forward-looking statements would increase the risk of undue reliance on such projections.<sup>46</sup>

Although the Wheat Commission advised keeping the ban, the Advisory Committee on Corporate Disclosure (hereinafter "Advisory Committee")<sup>47</sup> continued investigating possibilities of lifting the ban on disclosing forward-looking information.<sup>48</sup>

40. *Id.*

41. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52723.

42. *Id.* at 52723-24.

43. Upon recommendation of several securities analysts, the SEC formed a Disclosure Policy Group (Wheat Commission) in 1969, to study a variety of disclosure issues and whether projections should be permitted or mandated in SEC filings. *Id.* at 52724.

44. *Id.*

45. *Id.*

46. Safe Harbor For Forward-Looking Statements, *supra* note 8, 52724. Beyond the risks to the investor, such statements would increase the issuers exposure to litigation and the Wheat Commission determined that these factors outweighed the benefits of lifting the ban. *Id.*

47. Advisory Committee on Corporate Disclosure was formed by the SEC in 1976 to evaluate the Division of Corporation Finance's disclosure policies, including forward-looking statements. *Id.*

48. *Id.* The SEC considered the issues raised by the Wheat Commission and conducted hearings on the issue of lifting the ban on disclosure. Based on these hearing and other comments, primarily from issuers, in 1973 the SEC lifted the ban, but did not require disclosure of forward-looking information. By lifting the ban, the SEC intended to regulate the disclosure of forward-looking statements while protecting issuers from frivolous anti-fraud litigation. Although the SEC re-



In an effort to review the costs and benefits of disclosure of forward-looking statements, the Advisory Committee suggested that the SEC encourage voluntary disclosure.<sup>49</sup> After assessing these issues, the Advisory Committee recommended a safe harbor protecting forward-looking statements.<sup>50</sup> This safe harbor would protect statements made in good faith and with a reasonable basis.<sup>51</sup> Further, it recommended that cautionary language<sup>52</sup> accompany the forward-looking statement indicating the risks of the projections.<sup>53</sup> The Advisory Committee also recommended that the person claiming fraud have the burden of proving the issuer made the forward-looking statement without a reasonable basis or lacking good faith.<sup>54</sup>

## 2. Rule 175 and Rule 3b-6: SEC Safe Harbor Provisions for Forward-looking Statements

In 1979, the SEC enacted their safe harbor provision as Rule 175 for the Securities Act and Rule 3b-6 for the Exchange Act.<sup>55</sup> Rule 175 and Rule 3b-6 protect<sup>56</sup> issuers from lawsuits based on forward-looking statements made by or on behalf of an issuer or by an outside reviewer retained by the issuer.<sup>57</sup>

leased proposed guidelines, they were withdrawn due to opposition. *Id.*

49. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52724.

50. *Id.*

51. *Id.* at 52725. Purposed safe harbor rules covered all oral and written forward-looking information, not just those contained in the SEC filings. *Id.*

52. Cautionary language is language that explains in detail, sufficient to inform a reasonable person, both the approximate level of risk associated with the statement and the basis for the statement. *Id.* at 52730.

53. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52725. The Advisory Committee suggested the cautionary language "indicate clearly the nature of the projection and caution investors against ascribing undue weight thereto." *Id.*

54. *Id.* The Advisory Committee believe the burden of proving lack of good faith or reasonable basis should be placed on the person bringing the anti-fraud cause of action. *Id.*

55. 17 C.F.R. § 230.175 (1996); 17 C.F.R. § 240.3b-6 (1996).

56. If an issuer makes a forward-looking statement within the parameters of Rule 175 or 3b-6, both rules provide that the statement is not a fraudulent statement and therefore cannot be a bases for liability under § 10(b) or Rule 10b-5 (anti-fraud provisions - *see supra* note 19). 17 C.F.R. § 230.175 (1995); 17 C.F.R. § 240.3b-6 (1995). If an investor alleges the issuers liability upon such a forward-looking statement they are subject to dismissal for failure to state a claim upon which relief can be granted. FED. R. CIV. P. 12(b)(6).

57. Neither the SEC nor Congress has defined "outside reviewed retained by the issuer," however, its usage in the securities industry refers to companies such as accounting firms. Interview with Steven R. Aaron, Vice President, Director of

In order to qualify for this protection the issuer must have a reasonable basis for making the statements or reaffirmations and the disclosure must be in good faith.<sup>58</sup> In addition, these statements must be included within a quarterly report filed with the SEC or in an annual report furnished to shareholders.<sup>59</sup>

Rule 175 and Rule 3b-6 cover four categories of forward-looking statements: 1) statements filed with the SEC in a quarterly report; 2) statements in an annual report to shareholders; 3) statements made to reaffirm a forward-looking statement subsequent to the date of the quarterly or annual report that is publicly available; and 4) statement made prior to the SEC filing or the shareholders annual report, if the issuer confirms the statements in the quarterly or annual report.<sup>60</sup>

As an additional condition for protection, these safe harbor provisions require compliance with other reporting or registration provisions of the Securities Act and Exchange Act.<sup>61</sup> Both of these Rules require that an issuer subject to the Exchange Act to also be in compliance with the reporting requirements of Section 13(a) or 15(d)<sup>62</sup> of the Exchange Act.<sup>63</sup> If the issuer is not subject to these reporting requirement, the issuer must make the statements in a registration statement filed under the Securities Act in the offering statement<sup>64</sup> or other solicita-

Compliance at Hambrecht & Quist LLC (November 26, 1995).

58. 17 C.F.R. § 230.175(a) (1996); 17 C.F.R. § 240.3b-6(a) (1996).

59. 17 C.F.R. § 230.175(b)(1) (1996); 17 C.F.R. § 240.3b-6(b)(1) (1996).

60. 17 C.F.R. § 230.175(b)(1) (1996); 17 C.F.R. § 240.3b-6(b)(1) (1996).

61. *Id.*

62. Issuers must file with the SEC information and documents to protect the investor such information to keep reasonably current information on documents required to be filed with an application for registration requirement and the issuer must file annual and quarterly reports. Exchange Act § 13(a) (15 U.S.C. § 78m (1994)). Issuer must also file supplementary and periodic information for reports required pursuant to section 13. Exchange Act § 15(d) (15 U.S.C. § 78o (1994)).

63. 17 C.F.R. § 230.175(b)(1)(i) (1996) and 17 C.F.R. § 240.3b-6(b)(1)(i) (1996). An issuer becomes subject to the Exchange Act after its initial issuance of its security.

64. Neither the SEC nor Congress has defined "offering statement," however, its usage in the securities industry refers to any prospectus, including a private placement memorandum, issued on behalf of the security. Interview with Steven R. Aaron, Vice President, Director of Compliance at Hambrecht & Quist LLC (November 26, 1995).

tion of interest.<sup>65</sup>

### 3. Infrequent Use of Safe Harbor Provisions

Contrary to the intent of the Commission, issuers do not regularly utilize the safe harbor provisions of Rule 175 and Rule 3b-6 to prevent litigation.<sup>66</sup> Some attribute this infrequent use to several problems with the provision itself.<sup>67</sup> These problems include limiting the safe harbor protection to only those documents filed with the SEC, which does not provide protection in most situations.<sup>68</sup> Furthermore, there is confusion over whether issuers have a duty to correct or update projections.<sup>69</sup> Consequently, issuers often refrain from making the forward-looking statements.<sup>70</sup> Additionally, uncertainty still exists regarding when issuers are liable for statements made by third parties.<sup>71</sup> Finally, the courts' application of the safe harbor provisions does not result in quick dismissal of frivolous cases, therefore defendants still incur the costs the

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65. 17 C.F.R. 240.3b-6(b)(1)(i) (1996). These statements must be made under Regulation A or pursuant to the Exchange Act § 12(b) or (g). Neither the SEC nor Congress has defined "solicitation of interest," however, its usage in the securities industry refers to any prospectus or other type of offering statement made by an underwriter. Interview with Steven R. Aaron, Vice President, Director of Compliance at Hambrecht & Quist LLC (November 26, 1995).

66. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52728.

67. *Id.*

68. Since the protected forward-looking statements are only those filed with the SEC, it does not provide protection in most situations involving disclosure of forward-looking information. Many issuers face analyst and institutional demands for predictive information and much of communication is informal and unpredictable. *Id.*

69. *Id.* at 52729.

70. To avoid this confusion and out of fear of assuming some duty to update the information when circumstances change, many issuers are advised to refrain from making forward-looking statements in SEC filings and when speaking to analysts. Harvey L. Pitt and Karl A. Groskaufmanis, *Selective Disclosure can be Perilous*, NAT'L L. J., Apr. 18, 1994, at B4. There is also the question as to when the information will need to be updated. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52729.

71. If a corporation reviews, corrects or otherwise provides impute on analysts' reports, it may become sufficiently involved imposing a duty upon the corporation to update the statements. *Elkind v. Liggett & Myers*, 635 F.2d 156, 163 (2nd Cir. 1980); Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52729. In addition, management can be subject to liability by making responses that an analyst's estimates are "too high," "in the ballpark," or "too low." Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52729 n. 79.

protection strives to avoid.<sup>72</sup> Due to these problems, commentators and organizations<sup>73</sup> alike submitted proposals to the SEC to amend the safe harbor provisions.<sup>74</sup>

Some proposals have suggested expanding the coverage of the safe harbor to cover all forward-looking statements, regardless of whether filed with the SEC.<sup>75</sup> This would extend the safe harbor protection to management's statements of future business.<sup>76</sup> A second proposal would require issuers to formally elect a specified safe harbor disclosure program.<sup>77</sup> The program would require an issuer to make forward-looking disclosures quarterly.<sup>78</sup> Finally, other proposals would protect forward-looking statements unless made recklessly or with an actual intent to deceive,<sup>79</sup> and protect statements made on a reasonable basis whether filed with the SEC or not.<sup>80</sup>

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72. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52728. The center criticism is that court will not refer to the safe harbor when applicable, unless raised by the defendant and a defendant will not general raise the issue. When the defendants raises the safe harbor provision it leads to judicial examination of reasonableness and good faith, a factual issue, which precludes pre-discovery dismissal. *Id.*

73. These commentators and organizations include Association of Publicly Traded Companies, Commission Beese, Business Roundtable and National Association of Manufacturers, Professor John Coffee, Mr. William Freeman, Professor Joseph A. Grundfest, Jonathan Cuneo on behalf of the National Association of Securities and Commercial Attorneys, Harvey Pitt, Karl Groskaufmanis and Gilbey Strub. *Id.* at 52729 - 31.

74. *Id.* at 52729. The SEC solicited public comment in their SEC release no. 33-7101 on October 13, 1994. This release is included within 59 FED. REG. 52723. However, prior to making the public solicitation the SEC received comments from various individuals and interest groups. These comments are those referred to in this article.

75. *Id.* at 52730. This "Heightened Definition" proposal was submitted jointly by the business Roundtable and the National Association of Manufacturers. *Id.*

76. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52730.

77. *Id.* at 52731. This "opt-in" proposal, submitted by Harvey Pitt, Karl Groskaufmanis and Gilbey Strub, would allow an issuer to "opt-out" by giving 30 days notice and detail their reasons for opting out. *Id.*

78. *Id.*

79. *Id.* at 52730. Mr. William Freeman submitted this proposal and also place the burden of proving that when the statement was made, the issuer knew the projections were too high. Safe Harbor For Forward-Looking Statements, *supra* note 8, at 52730

80. *Id.* at 52731. Jonathan Cuneo on behalf of the National Association of Securities and Commercial Attorneys in submitting this proposal. *Id.*

### C. THE GROWING TREND TOWARD EXPANDING SAFE HARBOR PROVISIONS: JUDICIALLY CREATED 'BESPEAKS CAUTION' DOCTRINE

In addition to the efforts of the SEC in creating a safe harbor for forward-looking statements, the courts developed their own safe harbor provision. In doing so, the courts formulated the 'bespeaks caution' doctrine to protect issuers from frivolous anti-fraud suits.<sup>81</sup>

The courts first outlined the 'bespeaks caution' doctrine in *Luce v. Edelstein*.<sup>82</sup> This doctrine protects defendants against claims of securities fraud if the forward-looking statements contain adequate cautionary language or risk disclosure.<sup>83</sup> At least eight circuits embrace the protection of the 'bespeaks caution' doctrine.<sup>84</sup>

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81. See generally, Disclosure that "Bespeaks Caution," *supra* note 13.

82. 802 F.2d 49, 56 (2nd Cir. 1986). The challenged disclosure stated that the projections were "necessarily speculative," that "no assurance could be given that these projections would be realized," and that "actual results may vary from the predictions." *Id.* The court held that because the disclosures "clearly 'bespeak caution'" the disclosure was not actionable. *Id.* *Polin v. Conductron Corp.*, 552 F.2d 797 (8th Cir. 1977), *cert. denied*, 434 U.S. 857 (1977). The court held that the statements bespoke caution "in outlook and fell far short of the assurances required for a finding of falsity and fraud." *Luce*, at 806 n. 28.

83. Disclosure that "Bespeaks Caution," *supra* note 13, at 481. This doctrine protects forward-looking statements from being the basis of a lawsuit against an issuer under certain circumstances.

84. These eight circuits include the 11th, 9th, 5th, 3rd, 8th, 6th, 2nd, and 1st. *Saltzberg v. TM Sterling/Austin Assocs.*, 45 F.3d 399 (11th Cir. 1995) applied the "bespeaks caution" doctrine narrowly. Under this court's analysis, the cautionary language must be specifically related to the stated risks and boilerplate warnings are insufficient. *Id.*; *In re Worlds of Wonder Sec., Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994) found the cautionary language repeatedly addressed the specific risks of the forward-looking statements. *Id.* at 1415; *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994) considered whether under the circumstances, the omitted fact or unreasonable prediction altered the available public information in such a way that it became material to a reasonable investor in making an investment decision. *Id.* at 168.; *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-73 (3rd Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994) if accompanied with meaningful cautionary statements, forward-looking statements are not actionable as fraud if they do not affect the "total mix" of information. *Id.* at 371.; *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991) held that cautionary language accompanying the forward-looking statements were so repetitive and specific that plaintiff could not claim fraud based on these statements or underlying assumptions. *Id.* at 245.; *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991) a claim is insufficient if optimistic opinions

Courts espouse two rationales as to why cautionary language can justify dismissal of a cause of action.<sup>85</sup> One rationale stresses that when cautionary language acts to diminish the reliance upon such projections, no reasonable person could find the disclosures optimistic and, therefore, could not be misled.<sup>86</sup> The second rationale embraces the idea that an investor cannot rely on disclosures, optimistic or not, if accompanied by cautionary language.<sup>87</sup> Both rationales hinge on a determination regarding a reasonable person's perception of the forward-looking statements and how much weight is given to such statements.<sup>88</sup> As courts vary on the basis for applying the 'bespeaks caution' doctrine, they also vary in their judgment as to when the doctrine properly applies.<sup>89</sup>

Some courts apply the doctrine as long as some cautionary language accompanies the disclosure.<sup>90</sup> In *Luce*, the court found a simple disclaimer that projections were "necessarily speculative" and that "no assurance could be given that these projections would be realized," was sufficient to protect the defendant.<sup>91</sup> Other courts require the issuer to tailor the cautionary language to the specific disclosure.<sup>92</sup> This standard requires cautionary language to be "substantive and tailored to the specific future projections, estimates or opinions in the prospectus" which the plaintiffs challenge.<sup>93</sup> These courts reason that vague, boilerplate warnings of potential risks are not sufficient to protect investors against misinformation.<sup>94</sup>

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are accompanied with cautionary language. *Id.* at 1040; However, this use of the 'bespeaks caution' doctrine was limited in *Mayer v. Mylod*, 988 F.2d 635 (6th Cir. 1993) holding plaintiffs were allowed to offer proof that statements were neither true nor genuinely believed regardless if accompanied with cautionary language. *Id.* at 639; *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2nd Cir. 1991) refused to impose liability when statements in a prospectus clearly 'bespeaks caution.' *Id.* at 763; *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991) the issuer repeatedly warned the investor of the high risks associated with the investment and did not guarantee success. *Id.* at 879.

85. Disclosure that "Bespeaks Caution," *supra* note 13, at 487.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.* at 488.

90. *Luce*, 802 F.2d at 56.

91. *Id.*

92. Disclosure that "Bespeaks Caution," *supra* note 13, at 488.

93. *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d at 371-72; *In re Worlds of Wonder Sec., Litig.*, 35 F.3d at 1414.

94. *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d at 371. The cautionary

No matter how the courts apply the 'bespeaks caution' doctrine, it encourages disclosure of more information to investors.<sup>95</sup> Consequently, the 'bespeaks caution' doctrine allows an investor to make an informed investment decision and reduces the issuer's risk of litigation.

### III. DISCUSSION

Although the SEC and the courts made strides in balancing the needs of the investor and protecting the issuer, many believed they had not achieved a workable balance.<sup>96</sup> In an attempt to strike a workable balance between these two interests, Congress passed the Private Securities Litigation Reform Act of 1995 (hereinafter the "Reform Act").<sup>97</sup>

The Reform Act received both strong opposition and support, prior to and during its passage.<sup>98</sup> However, since its adoption issuers<sup>99</sup> have refrained from relying on the Reform Act or invoking it in litigation.<sup>100</sup> Consequently, few courts have had the opportunity to apply or interpret the Reform Act.<sup>101</sup>

#### A. PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: CONGRESSIONAL ATTEMPTS TO CREATE A NEW SAFE HARBOR PROVISION

The purpose of the Reform Act is to encourage meritorious

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language provided to investors included that the casino was not completed, had no operating history, no history of earnings and made no assurance of profitability. *Id.* at 370-71.

95. See generally, Disclosure that "Bespeaks Caution" *supra* note 13.

96. See *supra* part II.

97. 28 BNA Securities Regulation and Law Report 5 (January 5, 1996); Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified as 15 U.S.C. §§ 77z-1, 78u-4).

98. See *infra* accompanying text.

99. The Reform Act provides protection for statements made by or on behalf of an issuer or by an outside review retained by the issuer. A person acting or behalf of the issuer refers to a director, officer or employee of the issuer. 15 U.S.C.S. §§ 77z-2(i)(6), 78u-5(i)(4). However, in order to simply the discussion and explanation of the Reform Act I will refer to this class of people as the "issuer".

100. See *infra* text accompanying in part III.C.

101. *Id.*

cases while discouraging abusive litigation, and thus lowering the cost of raising capital.<sup>102</sup> The Reform Act amends the Securities Act as § 27A and the Exchange Act as § 21E.<sup>103</sup>

The Reform Act includes a new safe harbor provision.<sup>104</sup> Through this safe harbor provision Congress endeavors to protect forward-looking statements<sup>105</sup> that caution the investor that actual results may significantly differ from the stated

102. S. REP. NO. 98, *supra* note 2, at 4. By reforming securities litigation, the Senate hopes to encourage the voluntary disclosure of forward-looking information, put investors in control of their litigation and encourage and issuers to defend abusive claims. *Id.* at 4-6.

103. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as 15 U.S.C. §§ 77z-1, 78u-4). On December 22, 1996, Congress voted to override President William J. Clinton's veto and passed the Reform Act into law. 28 BNA Securities Regulation and Law Report 3 (Jan. 5, 1996). On December 6, 1995, the Senate passed the proposed Private Securities Litigation Reform Act of 1995 by a vote of 65 to 30. 27 BNA Securities Regulation and Law Report 1899 (Dec. 8, 1995). The following day the House approved the same bill by a vote of 320 to 102, sending the bill to President Clinton for his approval or vetoed. *Id.* After reviewing the proposed bill, President Clinton vetoed the Private Securities Litigation Reform Act of 1995 on December 19, 1995. H.R. Doc. No. 150, 104th Cong., 1st Sess. (1995), *reprinted in Congressional Information Service, Inc.*, H270-1. Following President Clinton's veto, on December 20, 1995, the House voted to override the veto by a vote of 319-100. 28 BNA Securities Regulation and Law Report 5 (Jan. 5, 1996). Two days later the Senate voted 68-30 to override the veto, thereby passing the Act into law. *Id.*

104. 15 U.S.C. § 77u-2(c), 15 U.S.C. § 78u-5(c) (Supp. 1995) in pertinent part:

(1) [A]ny private action arising under this title that is based on a untrue statement of material fact or omission of a statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) 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) if made by a natural person, was made with actual knowledge by the person that the statement was false or misleading. . . .

105. *See supra* note 18.



projections.<sup>106</sup>

One of the motivating factors behind the Reform Act was the substantial testimony regarding the high number of frivolous strike suits filed in hopes of a quick settlement.<sup>107</sup> Defending these frivolous lawsuits unnecessarily increases the cost of raising capital.<sup>108</sup> The Senate report found that plaintiffs often base these strike suits on nothing more than bad news concerning the company, not on fraud.<sup>109</sup> This apprehension of prosecution inhibits disclosure of forward-looking statements thereby depriving investors of necessary information to make wise investment decisions.<sup>110</sup>

Under the Reform Act, the safe harbor provision protects forward-looking statements, written or oral,<sup>111</sup> if the issuer identifies the statement as forward-looking and accompanies the statement with meaningful cautionary language.<sup>112</sup> The issuer must tailor the meaningful cautionary language to the

106. Congress hopes to protect "projections or estimates that are identified as forward-looking statements and that refer clearly and proximately to the risk that actual results may differ materially from the projection or estimate." S. REP. NO. 98, *supra* note 2, at 5. According to the Senate Report, private actions brought under Rule 10b-5 based on forward-looking information chills communication among management, analysts and investors. *Id.* Therefore, investors receive less forward-looking information from corporate management about the companies. *Id.*

107. *Id.* at 4. Various Congressmen, corporations and interest groups testified before the senate committee at various times during 1993 to 1995. Senate Report No. 98 outlines the various witnesses and the dates on which they testified. S. REP. NO. 98, *supra* note 2, at 1-3.

108. *Id.*

109. *Id.* at 4.

110. *Id.*

111. 15 U.S.C. §§ 77z-2(c)(2), 78u-5(c)(2) (Supp. 1995). To qualify for protection the oral statement must be accompanied by cautionary language identifying the statement as forward-looking and warns that "actual results could differ materially from those projected." 15 U.S.C. § 77z-2(c)(2)(A) (i), (ii), 78u-5(c)(2)(A)(i),(ii) (Supp. 1995). In addition, the issuer must inform the investor that information concerning risk factors or other warning as to the forward-looking statements is available in a publicly available written document. 15 U.S.C. §§ 77z-2(c)(2)(B), 78u-5(c)(2)(B) (Supp. 1995).

112. 15 U.S.C. §§ 77z-2(c), 78u-5(c) (Supp. 1995). If an action is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading, the issuer will not be liable if the issuer characterizes the disclosure as forward-looking information and accompanies such disclosure with meaningful cautionary language. This cautionary language must identify the "substantive factors that could cause actual results to differ materially" from those projected in the forward-looking statement. *Id.*

forward-looking statement, thereby specifically disclosing the risks associated with the security.<sup>113</sup> In addition, issuers must disclose any assumptions upon which they base the forward-looking statement and make the cautionary language prominent.<sup>114</sup> If the issuer fails to do so, and does not qualify for the safe harbor protection, plaintiffs in § 10(b) and Rule 10b-5 suits against issuers must nevertheless prove that the issuer had actual knowledge that the statement was false.<sup>115</sup>

## 1. Exceptions to the Safe Harbor Provisions

Protection under the Reform Act, however, is not without exception.<sup>116</sup> One exception denies protection to issuers convicted of certain felonies or misdemeanors<sup>117</sup> or other judicial

113. Harvey L. Pitt and Karl A. Groskaufmanis, *Securities Reform Act Offers Limited Safe Harbor*, Jan. 15, 1996, at B4, available in LEXIS, News Library, Ntlawj File. In this article, the authors developed a four part analysis in creating "meaningful cautionary language." The first step requires the issuer to tailor the cautionary language specifically to the forward-looking statement avoiding boilerplate warnings. *Id.* at B4, B6.

The second step requires the issuer to provide sufficient information on the risks involved in purchasing the security (so as to "present a complete picture" for the investor). *Id.* at B6.

The third and fourth steps require these warnings be prominent and if based on any assumptions, the issuer must disclose these assumptions as well. *Id.*

114. 15 U.S.C. §§ 77z-2(i)(D), 78u-5(i)(D) (Supp. 1995).

115. 15 U.S.C. §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B) (Supp. 1995). The protection of forward-looking statements only applies if they are made by: 1) an issuer, who at the time of making the statement, is subject to reporting requirements of § 13(a) or § 15(d) of the Exchange Act; 2) a person acting on behalf of issuer; 3) an outside reviewer retained by such issuer making a statement on issuer's behalf; and 4) an underwriter with respect to information provided by such issuer. 15 U.S.C. §§ 77z-2(a), 78u-5(a) (Supp. 1995). An underwriter is defined as any person who purchases from an issuer "with a view to, or offers or sells from an issuer in connection with, the distribution of any security" or directly or indirectly participates in such an undertaking or participates in underwriting such an undertaking. *Id.* Liability is avoided if the plaintiff cannot prove that the forward-looking statement was made with actual knowledge by that person that it was "an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading." 15 U.S.C. §§ 77z-2(c)(1)(B)(i), 78u-5(c)(1)(B)(i) (Supp. 1995). If the forward-looking statement was made by a business entity, it was "made by or with the approval of an executive officer of that entity and made or approved by such officer with actual knowledge "that the "statement was materially false or misleading. 15 U.S.C. §§ 77z-2(c)(1)(B)(ii), 78u-5(c)(1)(B)(ii) (Supp. 1995).

116. 15 U.S.C. §§ 77z-2(b), 78u-5(b) (Supp. 1995).

117. Any felony or misdemeanor within subdivisions (i) - (iv) of § 15(b)(4)(B) under the Exchange Act. 15 U.S.C. §§ 77z-2(b)(1)(A)(i), 78u-5(b)(1)(A)(i) Supp. 1995). These include under (I) the "taking of a false oath, making a false report,

or administrative judgement<sup>118</sup> rendered against them in the three years preceding the forward-looking information.<sup>119</sup> In addition, the safe harbor protection does not apply to certain transactions, including issuance of penny stock,<sup>120</sup> offerings of securities by a blank check company<sup>121</sup> or issuances in connection with a tender offer.<sup>122</sup>

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bribery, perjury, burglary, any substantially equivalent activity"; under (ii) offenses arising out of conduct of the "broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, foreign person performing a function substantially equivalent" or "entity or person required to be registered under the Commodity Exchange Act" or substantial equivalent; under (iii) offenses of "larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, securities, or substantially equivalent activity"; or under (iv) offense involving "violation of §§ 152, 1341, 1342 or 1343 or chapter 25 or 47 of title 18 of the United States Code," or substantial equivalent. 15 U.S.C. § 78o(b)(4)(B) (1994).

118. A judicial or administrative judgement prohibiting future violations of the anti-fraud provision, or a cease and desist order from violating the anti-fraud provision or determines that the issuer violated the anti fraud provision of the securities laws. 15 U.S.C. §§ 77z-2(b)(1)(A)(ii), 78u-5(b)(1)(A)(ii) (Supp. 1995).

119. 15 U.S.C. §§ 77z-2(b)(1)(A), 78u-5(b)(1)(A) (Supp. 1995).

120. A penny stock is defined as

[A]ny equity security other than one that is: 1) registered or approved for registration and traded on a national securities exchange that meets SEC criteria; 2) authorized for quotation on an automated quotation system sponsored by a registered securities association if the system was established and in operation before 1/1/90 and meets SEC criteria; 3) issued by an investment company registered under the Investment Company Act of 1940; 4) excluded, on the basis of exceeding a minimum price, net tangible assets of the issuer, or other relevant criteria, from the definition of such term by the Commission; and 5) exempted conditionally or unconditionally, from the definition by rule, regulation or order of the SEC.

15 U.S.C. § 78c (51) (1994).

121. A blank check company is one that has not yet determined type of business activities it will perform. Securities offered by such a company are speculative. BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 51 (4th ed. 1995).

122. 15 U.S.C. §§ 77z-2(b)(1)(B)-(E), (b)(2), 78u-5(b)(1)(B)-(E), (b)(2) (Supp. 1995). Other exemptions include forward-looking statement made with respect to the business or the issuer makes the statement in connection with a rollup transaction or a going private transaction. *Id.* In addition, the safe harbor does not protect statements that are included in a financial statement. *Id.* Other exemptions include: 1) statements contained in a registration statement of an investment company; 2) in connection with an initial public offering; 3) made in a disclosure of beneficial ownership pursuant to the Exchange Act § 13(d); 5) or those made by or in connection with an offering by a partnership, limited liability corporation or a direct participation investment program. *Id.* A rollup transaction is when one closes out an option position and moves another one with a higher exercise price.

## 2. Stay of Discovery upon Motion to Dismiss

Prior to the passage of the Reform Act a court would dismiss a case finding the statements in question fell within the safe harbor provision, but only after the company incurred the costs of discovery.<sup>123</sup> In order to prevent costly discovery and litigation, companies reduced the amount of forward-looking information given to prospective investors.<sup>124</sup> To combat this problem, the Reform Act provides a stay of discovery upon a motion to dismiss.<sup>125</sup> With a stay on discovery, the issuer does not have to carry out unnecessary and costly discovery. It is this cost of complying with discovery that motivates many settlements of anti-fraud cases based on forward-looking information.<sup>126</sup> The stay of discovery remains in force until the court decides whether the issuer falls within the protection of the safe harbor.<sup>127</sup> Consequently, issuers do not incur the expense of discovery for cases the court deems frivolous. By providing this stay of discovery followed by an early dismissal procedure, investors will retain the right to bring suit, but innocent companies will not have to defend costly frivolous litigation.<sup>128</sup>

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BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 494 (4th ed. 1995). A going private transaction is when a public company becomes a private company. This is effectuated either by a repurchase of the company's share or when an outside private investor purchases all the shares. *Id.* at 222. Financial statements include a balance sheet and income statements reflecting the financial status of the business organization. *Id.* at 190. Initial Public Offering is the first time a corporation offers its stock to the public. *Id.* at 260. Beneficial ownership is when a person has the benefit of ownership although title is not in their name. *Id.* at 46. The Exchange Act § 13(d)(1) (15 U.S.C. § 78m(d)(1) (1994)) requires disclosure if a person is the beneficial owner of more than 5% of a class of securities.

123. Christi Harlan, *SEC Seeks to Beef Up 'Safe Harbor' Provision*, WALL ST. J., May 17, 1994, available in 1994 WL-WSJ 292188.

124. *Id.*

125. 15 U.S.C. §§ 77z-2(f), 78u-5(f) (Supp. 1995). The court will stay discovery during the pendency of any motion by a defendant for summary judgment that is based on the grounds that the statement or omission is a forward-looking statement and the exemption precludes a claim for relief. *Id.*

126. S. REP. NO. 98, *supra* note 2, at 6-7.

127. 15 U.S.C. §§ 77z-2(f), 78u-5(f) (Supp. 1995).

128. SEC Seeks to Beef Up 'Safe Harbor' Provision, *supra* note 123, quoting Mr. Brent Thompson Director of Corporate Finance for the National Association of Manufacturers.

## B. THE DEBATE OVER THE REFORM ACT

The concern of costly litigation of frivolous suits and the chilling effect it has on the disclosure of information are precisely the problems Congress hopes to alleviate with the safe harbor provision of the Reform Act.<sup>129</sup> However, opponents of the Reform Act criticized Congress for going too far in protecting corporations, meanwhile proponents argued Congress did not go far enough.<sup>130</sup> The Reform Act sparked much debate between the competing views of investor and issuer protection.

## 1. Strong Opposition to Safe Harbors: Investors Pay the Price for Reform by Giving Issuers a License to Lie

Opponents of the Reform Act voiced their opposition to both the President and Congress.<sup>131</sup> Many opponents believed the Reform Act restricts citizens from bringing lawsuits against dishonest investment advisors and allows "swindlers" to escape liability.<sup>132</sup> Public Citizen, a consumer advocacy group headed by Ralph Nader, characterized the Reform Act as the "Crooks and Swindlers Protection Act" saying the Reform Act gives executives a "license to lie."<sup>133</sup> Even those who agree that frivolous lawsuits occur, find the safe harbor provision goes beyond that necessary to curb strike suits.<sup>134</sup> Aside

129. See generally, S. REP. NO. 98, *supra* note 2.

130. See *infra* text accompanying part III.B.1.

131. A coalition of five government groups urged their members to send letters to President Clinton and Congress in opposition to the compromise bill. This coalition is comprised of Government Finance Officers Association, the National Association of Counties, the National League of Cities, the U.S. Conference of Mayors, and the Municipal Treasurers' Association. Lynn Stevens Hume, *Groups Send Letters Against Reform Bill*, THE BOND BUYER, Nov. 9, 1995, at 2, available in LEXIS, News Library, Bndbyr File.

132. Editorial Desk, *Securities Bill Helps Swindlers Prey on Elderly*, N. Y. TIMES, Nov. 18, 1995, § 1, at 2, available in LEXIS, News Library, Nyt File .

133. Nancy J. Kim, *Proposal A License to Lie?; Foes Blast Reform of Securities Law*, THE RECORD, Nov. 12, 1995, at B01, available in LEXIS, News Library, Njrec File.

134. *Securities Reform Act Goes Too Far*, WIS. ST. J., Nov. 9, 1995, at 13a, available in LEXIS, News Library, Wistjl File. The writer agrees that there are "whining" investors who use the courts and "unscrupulous lawyers" to indemnify them for their own bad investment decisions, but the bill reduces investors rights and allows the deceitful issuers and those connected to them to "thumb their noses at the justice system." *Id.*

from this fear of a rise in fraud, opponents also feared that the Reform Act would unduly frustrate investors efforts to have their case heard.<sup>135</sup>

In addition to private interest groups, some members of Congress also voiced opposition to the Reform Act. Representative John D. Dingell (D-Mich.) and Representative Edward J. Markey (D-Mass.) expressed their fear that the safe harbor provision would reduce effective deterrents against fraud and result in a chilling effect on the investing.<sup>136</sup> They found that the safe harbor provision, by merely requiring general cautionary language, would result in the possible protection of intentional fraud.<sup>137</sup> Rep. Dingell and Rep. Markey further argued that this diminished deterrence, inherent in the safe harbor provision, would lead to an increase in fraud against the investor.<sup>138</sup>

## 2. Urging Passage of Safe Harbors: A Balance Struck to Protect both Investors and Issuers

In response to the opposition, proponents defended the safe harbor provision as balanced legislation. Both SEC Chairman Arthur Levitt and SEC Commissioner Steven Wallman

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135. Anne Kates Smith, *Some Call it Securities Reform*, U.S. NEWS & WORLD REPORT, Nov. 13, 1995, at 117, available in LEXIS, News Library, Usnews File. Opponents include American Association of Retired Persons, Conference of Mayors to Consumers Union and National Association of Securities and Commercial Law Attorneys. *Id.*

136. *Dingell, Markey Knock Securities Litigation Bill Deal*, NAT'L J. CONG. DAILY, Nov. 7, 1995, available in LEXIS, News Library, Cngdly File. They also argued that without effective deterrence against fraud, the reputation of American markets as fair and honest would be undermined. *Id.*

137. William Taggart, *SEC Seeks Compromise to Move Securities Litigation Reform Bill*, WALL STREET LETTER, Nov. 13, 1995, at 1, available in LEXIS, News Library, Nwltrs File.

138. *Dingell, Markey Knock Securities Litigation Bill Deal*, *supra* note 136. (reporting on a letter released by House Commerce ranking member Rep. John D. Dingell (D-Mich), ranking minority member of the Commerce Committee and Rep. Edward J. Markey (D-mass) alerting Congress members that the compromise is "extreme and radical"); *Some Call it Securities Reform*, *supra* note 135, at 117 (Within the article Michael Calabrese of Public Citizen, a consumer-advocacy group, believe investors will once again be faced with the old maxim of caveat emptor); *Securities Reform Act Goes Too Far*, *supra* note 134, at 13a. (the writer would change the name of the Securities Litigation Reform Act to White-Collar Criminals Freedom to Prey Act).

supported the Reform Act as a “workable balance” that “should encourage companies to provide forward-looking information to investors” while protecting issuers from frivolous suits.<sup>139</sup> The SEC stated that the safe harbor provision would allow for disclosure of forward-looking information along with safeguards to prevent abuse of the safe harbor.<sup>140</sup>

Proponents of the safe harbor provision argued that without adequate information investors and those acting on their behalf cannot invest wisely.<sup>141</sup> Prior to the Reform Act issuers refrained from providing such necessary information.<sup>142</sup> Due to the potential exposure to litigation many companies have been hesitant to disclose forward-looking information.<sup>143</sup> The disclosure of such information would leave companies vulnerable to defending frivolous suits that results in a downward movement in the security thereby a loss in capital for the small investor.<sup>144</sup> In addition, money spent fighting these frivolous lawsuits hurts the investor by devaluing public companies.<sup>145</sup>

Proponents supported the Reform Act not because it would prevent investors from filing lawsuits, thereby allowing issuers to act in a fraudulently without liability, but because it would

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139. Jeffrey Taylor, *Bill Curbing Investors' Lawsuits Wins SEC Support of 'Safe-Harbor' Provision*, WALL ST. J., Nov. 17, 1995, at A16. The SEC supported this provision only after Congress agreed to exclude statements covering initial public offering, financial statements, limited partnership, partnership “roll-up” transactions and penny stocks from eligibility for safe harbor. Genne Ramos, *SEC Backs Key Provision in Securities Litigation Bill*, THE REUTER BUS. REP., Nov. 17, 1995, available in LEXIS, News Library, Reubus File.

140. *Id.*

141. Halting ‘Strike Suits’ Can give Clinton Solid Anchor in the Political Center, *supra* note 6, at 33.

142. *Id.*

143. Some Call it Securities Reform, *supra* note 135. National Association of Investors Corporation, who represent more than 17,000 investors clubs and over 340,000 individual investors. *Id.* Securities Reform Act Offers Limited Safe Harbor, *supra* note 113, at B4.

144. *See generally*, S. REP. NO. 98, *supra* note 2. Some Call it Securities Reform, *supra* note 135.

145. *Id.* The Information Technology Association of America found that frivolous suits “increases pressure on capital sources, retards industry growth and shrinks the creation rate of both jobs and innovations.” *ITAA Backs Compromise on Securities Litigation*, BUS. WIRE, Oct. 27, 1995, available in LEXIS, News Library, Bwire File.

prevent lawyers from creating and filing strike suits for their own financial benefit.<sup>146</sup> Attorneys often selected corporations to sue based on how much their stock dropped on a given day.<sup>147</sup> Many of these firms has neither broken the law nor committed fraud, yet settled such suits because defending the suit exceeded the cost of settlement.<sup>148</sup> According to some proponents this "legalized extortion" cost U.S. companies more than \$2.5 billion in settlements in the last four years.<sup>149</sup> Meanwhile, this money could have flowed to more productive channels.<sup>150</sup>

Those that supported the Reform Act viewed it as both controlling frivolous suits and safeguarding investors' rights.<sup>151</sup> Proponents considered the Reform Act a responsible compromise, that would protect both companies and their

146. Some Call it Securities Reform, *supra* note 135, quoting Betty Sinnock, treasurer of the renowned Beardstown Ladies Investment Club.

147. Penni Crabtree, *Look Out, Little Guy Demons Abound in Battle Over Shareholder Suits*, SAN DIEGO UNION-TRIBUNE, Oct. 29, 1995, at I-1, available in LEXIS, News Library, Sdut File. According in to Lynn Zempel, spokeswoman for the Coalition to Eliminate Abusive Securities Suits, attorneys target a company for lawsuits if its stock price falls ten percent or more in a single day, especially high-technology and biotech firms. *Id.* Further, Rep. Peter Deutsch (D-Fl) stated that many of America's most innovative growth companies are targeted for meritless securities suits by "professional plaintiffs." *Statement from U.S. Rep. Peter Deutsch (D-Fl, 20th) Member of House Committee on Commerce, on Securities Litigation Reform Bill*, BUS. WIRE, Oct. 30, 1995, available in LEXIS, News Library, Bwire File.

148. *Look Out, Little Guy Demons Abound in Battle Over Shareholder Suits*, *supra* note 147, at I-1. Rep. Peter Deutsch (D-Fl) further stated that companies find it too costly to fight unjust allegations so investors in many growth companies see their investment value driven down unfairly. *Statement from U.S. Rep. Peter Deutsch (D-Fl, 20th) Member of House Committee on Commerce, on Securities Litigation Reform Bill*, *supra* note 147.

149. Halting 'Strike Suits' Can give Clinton Solid Anchor in the Political Center, *supra* note 6, at 33.

150. *Id.* Ninety percent of strike suits settle at an average of \$11 million per company, but in most settlements investors receive \$.15 on the dollar and the lawyers keep the rest. Joseph Perkins, *Bill Would Lessen Threats of Litigation Predators*, ROCKY MOUNTAIN NEWS, Nov. 23, 1995, at 74A, available in LEXIS, News Library, Rmtnew File.

151. Statement from U.S. Rep. Peter Deutsch (D-Fl, 20th) Member of House Committee on Commerce, on Securities Litigation Reform Bill, *supra* note 147. Information Technology Association of America, representing 6,700 direct and affiliate members, expressed support for the compromise bill stating it affording companies adequate protection (safe harbor) to make forward-looking statements about their firms, while giving investors legal remedies in those cases which are truly fraudulent. ITAA Backs Compromise on Securities Litigation, *supra* note 145.



shareholders.<sup>152</sup> Furthermore, without a "strong, clear safe harbor protection, reform efforts would be virtually meaningless."<sup>153</sup>

### C. THE RESPONSES AND EFFECTS OF THE REFORM ACT

Since the passage of the Reform Act, there appears to have been a reduction in the number of cases filed against issuers of securities.<sup>154</sup> According to the SEC's Consumer Affairs Advisory Committee, forty federal class action suits have been filed in contrast to 150 in a similar time period.<sup>155</sup> However, this figure represents a decrease in lawsuits only within the federal court system.<sup>156</sup> Instead investors are filing lawsuits against the issuers in state court.<sup>157</sup> According to one account, the number of cases filed in California state courts for securities violations since the passage of the Reform Act increased by 500%.<sup>158</sup>

In addition to the change in forum, disclosure of forward-looking statements has not increased as proponents hoped.<sup>159</sup> An analysis of written statements made by issuers since the passage of the Reform Act reveals that issuers are not making any new predictive statements concerning operations, future earning and the like.<sup>160</sup> Issuers still refrain from making for-

152. *Id.*

153. *Execs Press Clinton on Safe Harbor Provision*, NEW TECHNOLOGY WEEK, Oct. 23, 1995, available in 1994 WL 9015564. CEOs from 200 Silicone Valley high technology companies, including Intel, Silicon Graphics, Apple, Hewlett-Packard, Sun Microsystems, Oracle, Varian, Quantum and 3COM, have urges Clinton to sign the compromise bill. *Id.*

154. Vincent R. Cappucci, *Must Reliance Be Proven to Certify a Class*, N. Y. J., Aug. 30, 1996, § Outside Counsel, at 1, available in LEXIS, LegNew Library, Nylawj File.; 28 BNA Securities Regulation and Law Report 914 (July 26, 1996), available in LEXIS, FedSec Library, Secreg File. Although there has been a drop in the number of federal class action suits filed in federal court, many more cases were filed in California state courts. *Id.*

155. *Id.*

156. *Id.*

157. *Must Reliance Be Proven to Certify a Class*, *supra* note 154.

158. *Id.* "More than 20 securities fraud cases have been filed in California state courts." *Id.*

159. Merrill B. Stone, *SEC, Congress Clarify Security Disclosure Issues*, NAT'L L. J., June 24, 1996, at B8, available in LEXIS, News Library, Ntlawj File.

160. *New 'Safe Harbor' Is not Being Well Utilized*, LEGAL TIMES, July 1, 1996, §

ward-looking statements and their cautionary language provided is "fairly generic."<sup>161</sup> Issuers apparently do not feel comfortable disclosing forward-looking information, and therefore the safe harbor provision of the Reform Act is not being utilized.<sup>162</sup>

Due to the reluctance of issuers to utilize the safe harbor provision of the Reform Act, few courts have had the opportunity to apply or interpret the new legislation.<sup>163</sup> Only two U.S. District Court judges have had the opportunity to apply the Reform Act's safe harbor provision for forward-looking statements.<sup>164</sup> With such little application and interpretation, there is little guidance for an issuer or those acting on their behalf as to where the safe harbor boundaries lie.

### 1. Strawbridge Sale

The Strawbridge Sale case outlined two alternatives by which a plaintiff could obtain a preliminary injunction based on estimated contained in a proxy statements.<sup>165</sup> In this case a shareholder, the plaintiff, filed a motion for a preliminary injunction to prevent Strawbridge from holding a shareholder meeting.<sup>166</sup> The plaintiff filed for the preliminary injunction alleging the company distributed misleading proxy statements undervaluing the company's liabilities.<sup>167</sup> In order to prevail

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Special Report, Focus on Securities Law, at S29, available in LEXIS, Legnew Library, Lgltime File. Not only are the issuers continuing to release the same type of information prior to the passing of the Reform Act, but these statements do not conform with the requirements for safe harbor protection. *Id.*

161. SEC, Congress Clarify Security Disclosure Issues, *supra* note 159, at B8. The SEC is considering issuing an interpretive release. *Id.*

162. New 'Safe Harbor' Is not Being Well Utilized, *supra* note 160, at S29.

163. NLJ Staff and Associate Press reports, *Defendant Seeks Refuge in Act's Safe Harbor*, NAT'L L. J., June 24, 1996, at B2, available in LEXIS, LegNew Library, Ntlawj File; Richenya A. Shepherd, *Judge Turns Down Bid to Halt Strawbridge Sale*, THE LEGAL INTELLIGENCER, July 17, 1996, at § Business Law, at 9, available in LEXIS, Legnew Library, Lglint File.

164. *Id.*; *In re Silicon Graphics Inc. Securities Litigation*, 1996 U.S. Dist. LEXIS 16989; Fed. Sec. L. Rep. (CCH) P99,325 (Sept. 26, 1996).

165. Judge Turns Down Bid to Halt Strawbridge Sale, *supra* note 163, at 9.

166. *Id.* Strawbridge sent the proxy statements and called a shareholders meeting to vote on the proposed sale of Strawbridge & Clothier to sell their stores to the May Department Store Co. for \$600 million. *Id.* Lee Hoffman owned ten shares of Strawbridge & Clothier stock valued at \$160.00. *Id.*

167. *Id.* Hoffman claimed that the liability (warehouse leases) was \$52 million

on this motion, the plaintiff had two alternatives.<sup>168</sup> The first alternative required the plaintiff to prove that the estimates in the proxy statement were not forward-looking statements and, therefore, not protected by the safe harbor provision.<sup>169</sup> Alternatively, the plaintiff would have to prove that the estimates were forward-looking statements unaccompanied by "meaningful cautionary language."<sup>170</sup> Furthermore, the plaintiff would have to show that the company had actual knowledge that the estimates were false or misleading, thereby losing the protection of the safe harbor provision.<sup>171</sup>

The plaintiff in this case was unable to prove either alternative.<sup>172</sup> The judge based his denial of the motion for a preliminary injunction on three findings.<sup>173</sup> First, the judge found that the plaintiff did not prove the "likelihood" that the estimates were not forward-looking statements.<sup>174</sup> Second, the judge found that the plaintiff failed to prove the estimates did not have the requisite cautionary language required for the safe harbor protection.<sup>175</sup> Lastly, the plaintiff did not allege or prove that the company had actual knowledge that the estimates were false or misleading.<sup>176</sup> By denying the motion for a preliminary injunction, the plaintiff could not stop the shareholder's meeting.<sup>177</sup>

## 2. *In re Silicon Graphics Inc. Securities Litigation*

The U.S. District Court for the Northern District of California held that in ruling on a motion to dismiss based on the protection of the safe harbor provision, the Reform Act limits the court's review to statements within the complaint and

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verses \$14.5 million as reported by Strawbridge in its proxy statement. *Id.*

168. Judge Turns Down Bid to Halt Strawbridge Sale, *supra* note 164.

169. *Id.*

170. 15 U.S.C. §§ 77z-2, 78u-5 (Supp. 1995).

171. Judge Turns Down Bid to Halt Strawbridge Sale, *supra* note 163, at 9.

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. Judge Turns Down Bid to Halt Strawbridge Sale, *supra* note 163, at § Business Law, at 9.

177. *Id.*

cautionary language not of material dispute.<sup>178</sup> In doing so, the court must first determine if the cautionary language protecting the defendant from liability is in material dispute.<sup>179</sup> Only after making this determination can the court consider whether the safe harbor will protect the defendant from liability.<sup>180</sup>

In this class action case the plaintiffs alleged that Silicon Graphics violated § 10(b)<sup>181</sup> by making material misrepresentations regarding the defendant's growth prospects and financial condition, and failing to disclose other adverse facts concerning the company.<sup>182</sup> In response, the defendant made a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).<sup>183</sup> The defendant's basis for the motion was that the Reform Act's safe harbor provision protected the statements.

In deciding whether the safe harbor provision applied, the court had to consider whether there was cautionary language accompanying the forward-looking statements. The court found that the cautionary language proffered by the defendant was not contained within the complaint.<sup>184</sup> Thus, this evidence was extrinsic, offered by an interested party and could be of material dispute.<sup>185</sup> Therefore, the court could not consider the statements in ruling on a motion to dismiss.<sup>186</sup> Since the defendant could not show, on the face of the pleadings, there was cautionary language accompanying the forward-looking statements, the court denied the motion to dismiss based on

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178. *In re Silicon Graphics Inc.*, *supra* note 164, at P99,325. The court entered its decision on September 26, 1996. 15 U.S.C. §§ 77z-2(e), 78u-5(e) (Supp. 1995).

179. *In re Silicon Graphics Inc.*, *supra* note 164.

180. *Id.*

181. 15 U.S.C. § 78j(b), *supra* note 19.

182. *In re Silicon Graphics Inc.*, *supra* note 164.

183. *Id.* FED. R. CIV. P. 12(b)(6) is a motion to dismiss for a failure to state a cause of action.

184. *Id.* The statements offered by the defendant were warning given by the company's CFO before two conference calls. The defendant offered a declaration by the CFO stating that he did read the warnings. *Id.*

185. *Id.*

186. 15 U.S.C. §§ 77z-2(e), 78u-5(e) (Supp. 1995). *In re Silicon Graphics Inc.*, *supra* note 164. However, the court said the defendant could argue the safe harbor provision as grounds for a summary judgment. The court dismissed the case on other grounds. *Id.*

the safe harbor provision.<sup>187</sup>

#### IV. CONCLUSION

The Reform Act expands the protection of forward-looking statements from those previously provided under Rule 175 and Rule 3b-6, and the 'bespeaks caution' doctrine. However, issuers are not changing the information they disclose in reliance on this new safe harbor. Since issuers are not increasing disclosure of forward-looking information, investors are not experiencing an increase in fraud, as many opponents feared. However, this lack of reliance also results in investors not having all the necessary information they may require when investing wisely, a concern many proponents had hoped this legislation would have corrected.

*Noelle Matteson\**

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187. *Id.*

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