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SECURITIES LAW DISCLOSURE

AFTER

SARBANES-OXLEY

APRIL 2004

By

Herbert S. Wander

Katten Muchin Zavis Rosenman

Chicago, Illinois

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I. INTRODUCTION

Disclosure has always been central to the federal securities laws. In the beginning, the thrust focused on disclosure in Securities Act of 1933 ("Securities Act") registration statements. Over time, current ongoing disclosure by public issuers has become an increasingly important topic for a number of reasons: the trading markets have grown exponentially and the Securities Exchange Act of 1934 ("Exchange Act") has been repeatedly strengthened, requiring more issuers to publicly report more frequently.

Once an issuer is public, it must file periodic and current reports with the Securities and Exchange Commission ("SEC" or "Commission") -- yearly, quarterly, upon the happening of a material event and when proxies are solicited. The trading markets, moreover, demand more frequent disclosure than the SEC mandated reports, namely, press releases, road shows, analyst calls and conferences. Not only does the market expect more current disclosure, it has also shown a great appetite for forward looking information which had been essentially "outlawed" until the 1970's. Corresponding to this growth in current disclosure has been the growth in class action securities fraud cases against issuers, their executives, directors, underwriters and analysts when the price of the stock falls precipitously. The $100 million jury verdict against Apple Computer executives in 1991 shocked Corporate America into an awareness that any arguable mistake in disclosure regarding a multitude of corporate developments could result in personal financial ruin. Although set aside, the verdict illustrated the perils of once-common promotional statements and disclosure practices.

When this article was originally written in the 1980s, its central emphasis was on the disclosures companies made outside filings with the SEC. As time went by, disclosures in quarterly and yearly reports became increasingly important, particularly Management's

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* Herbert S. Wander is a partner at Katten Muchin Zavis Rosenman in Chicago. The author thanks Aaron J. VanGetson, an associate at Katten Muchin Zavis Rosenman, for his help in the recent revisions to this article.

Discussion and Analysis (the "MD&A"). Beyond the MD&A, however, the periodic and current reports remained relatively unchanged. True, the SEC adopted Regulation FD in 2000 but that was designed to prohibit selective disclosure rather than dictate the content or timing of disclosure.

The securities world changed dramatically in the wake of the scandals prompted by Enron, WorldCom and similar debacles. The President, Congress, the SEC, the New York Stock Exchange ("NYSE"), Nasdaq, and others demanded improved, timely, transparent and honest disclosures. The cornerstone of these reforms was the Sarbanes-Oxley Act of 2002 ("S-O Act"). In July 2002 Congress (almost unanimously) adopted, and the President signed, the S-O Act of 2002. It is a multifaceted legislative act attacking many of the evils uncovered as a result of the financial scandals of Enron and WorldCom. The S-O Act became law on July 30, 2002. A number of the provisions became effective within 30 days of signing while others required the SEC to adopt implementing rules; in some instances, the S-O Act merely delegated authority to the SEC to adopt rules in the future at the SEC's discretion. Some of most notable provisions of the S-O Act include:

1. Certificate of CEO and CFO:

    - In August 2002, the SEC adopted rules implementing the certification provisions of Section 302(a) of S-O. These rules and the Criminal Code certification required by Section 906 of S-O are discussed below at Section II, A.1.

2. Audit Committee provisions:

    - Composition – all members must be independent (no consulting fees or other compensation) and the SEC requires disclosure of whether the audit committee has a member that is an "audit committee financial expert" (essentially someone with education or experience as a CPA, CFO or comptroller) or disclose why the audit committee does not have such a member.[1]

3. Dealings with auditors:

    - The audit committee must pre-approve all audit and non-audit services, unless the non-audit services satisfy certain limited exceptions; all non-audit services shall be publicly disclosed.

    - The auditors shall report to the audit committee all (i) critical accounting policies and practices (not defined), (ii) alternative treatments discussed with management and the auditor's preferred treatment and (iii) all material written communications with management including the management letter and schedules of unadjusted differences.

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[1] Sec. Act. Rel. No. 33-8177, Jan. 23, 2003.

- The audit committee "shall be directly responsible for the appointment, compensation, and oversight of the work of … [the auditor] (including resolution of disagreements between management and the auditor regarding financial reporting)".

- Receipt of complaints – the audit committee shall establish procedures (i) to receive and process complaints received by the Company concerning accounting, internal accounting controls or auditing matters and (ii) the confidential anonymous submission by employees of "concerns regarding questionable accounting or auditing matters".

4. SEC Reporting Procedures – Companies are required to establish procedures to capture and process information that must be publicly disclosed; a report will have to be included in the 10-K that (i) states it is management's responsibility to establish and maintain adequate internal controls and (ii) assesses the effectiveness of the internal controls. Moreover, the external auditor shall attest/report yearly on management's assessment.

5. Ethics for Financial Staff – Each public company must disclose whether it has a code of ethics for senior financial officers. If the company has no such code, it must explain the reason for its lack of code.[2]

6. Real Time Reporting – The SEC was given authority to promulgate rules that "disclose to the public on a rapid and current basis such additional information concerning material; changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations." The SEC furthered the goals of Section 409 of the S-O Act through its adoption of final rules (i) enlarging the events required to be disclosed, and (ii) shortening the Form 8-K filing deadline for most items to four business days after the occurrence of an event triggering the disclosure requirements of the form.[3]

7. Reports of Ownership Change – Reports of ownership change (Form 4s) must be filed within two business days by officers, directors and 10% stockholders. The SEC adopted rules implementing this provision on August 27, 2002.[4].

8. Loans – Personal loans to officers and directors are broadly prohibited except in very limited circumstances.

9. Other Provisions – The S-O Act contains a host of other major provisions, among them:

    - establishment of a Public Accounting Oversight Board;

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[2] Sec. Act. Rel. No. 33-8177, Jan. 23, 2003.

[3] Sec. Act. Rel. No. 33-8400, Mar. 16, 2004.

[4] Exch. Act. Rel. No. 34-46421, Aug. 27, 2002.

- substantially increased fines and jail terms for criminal violations of the S-O Act and the securities and mail fraud statutes;

- expanded authority for the SEC to bar persons from serving as officers and directors of public companies;

- requiring attorneys to report material violations of the securities law or breach of fiduciary duty by companies or their agents to the chief legal counsel or CEO and, if they do not appropriately respond, to the audit committee, a committee of independent directors, or the board of directors;[5]

- whistle blower protection;

- regulation of analyst conflict of interest;

- auditors will be prohibited from providing many kinds of non-audit services;

- a number of government agencies are directed to conduct studies of a number of the problems caused by Enron/Worldcom;

- the non-dischargeability in bankruptcy of debts incurred as a result of violations of the securities laws, common law fraud whether through judgment, settlement or administrative order;

- the statute of limitations for violations of the securities laws is lengthened;

- recapture of bonus paid to the CEO and CFO and any profits they may have realized from the sale of securities if the company is required to restate its financial statements because of material non-compliance of the company with the financial disclosure rules caused by misconduct;

- prohibitions on executive officers and directors selling stock during black out periods (in general, when employees cannot sell stock held in their IRAs); and

- restrictions on destroying records.

The SEC has made a number of major revisions to the disclosure reporting system as a result of the Congressional mandate under the S-O Act, including:

- Faster insider reporting under Section 16(a) – On August 27, 2002, the SEC adopted rules (as mandated by S-O Act) under Section 16(a) to require insiders to file Form 4s reporting changes in ownership within two business days of a transaction.[6]

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[5] Sec. Act. Rel. No. 33-8185, Jan. 29, 2003.

[6] Exch. Act Rel. No. 34-4621, Aug. 27, 2002.

- CEO and CFO Certification – Also on August 27, 2002, the SEC adopted rules requiring CEOs and CFOs to certify as to accuracy of the contents of Forms 10-Q and 10-K as well as to report on the issuer's internal controls and "disclosure controls and procedures" (a newly defined term). These changes had essentially been earlier proposed by the SEC and later required by the S-O Act. Additionally, under Section 404 of the S-O Act, the SEC has proposed requiring companies to report on their internal controls and procedures for financial reporting in their annual reports.

- Speedier filings of Forms 10-K and 10-Q – These rules were also adopted in August 2002 and are discussed below.

- Improvements to MD&A – In May 2002, the Commission proposed strengthening the MD&A disclosure by requiring a detailed discussion of critical accounting policies.[7] Further, in November 2002, the SEC proposed rules relating to the disclosure of off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments, which were adopted in January 2003.[8] The SEC also, in an effort to elicit more meaningful disclosure in MD&A in a number of areas, including the overall presentation and focus of MD&A, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates, issued an interpretative release in December 2003.[9]

- Changes to Form 8-K: Faster filings and more events to be covered – In an effort to provide more timely and comprehensive information in SEC filings, the Commission adopted substantial revisions to current report Form 8-K on March 16, 2004, namely, filings must be made within four business days of a larger universe of events.[10]

In November 2003, the NYSE and Nasdaq adopted substantially stronger listing standards focusing on improved corporate governance requiring listed companies to have a majority of independent directors and to have audit, compensation and corporate governance/nominating committees to be comprised solely of independent directors.[11]

This article identifies emerging trends in securities law disclosure, updates disclosure developments and provides guidance to issuers and their securities law advisors. Timely disclosure and materiality remain bitterly disputed in the courts, even long after the Supreme Court's landmark 1986 decision in Basic Inc. v. Levinson. Subsequent to Basic, the Supreme

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[7] Sec. Act Rel. No. 8098, May 10, 2002.

[8] Section IV, L, infra.

[9] Sec. Act. Rel. No. 33-8350, Dec. 19, 2003. See Section IV, infra.

[10] Sec. Act Rel. No. 33-8400, Mar. 16, 2004, discussed infra Section II.A.2.c.

[11] These are discussed infra, Section II.A.3.d.

Court decision in Virginia Bankshares confirmed that management statements of reasons, opinions or beliefs may be actionable as misstatements of material fact.

Attaining a completely safe disclosure policy is virtually impossible. Issuers may take some comfort from various post-Basic cases challenging the disclosure of merger negotiations and other business developments, which confirm the traditional rule that issuers have no general duty to disclose material information simply because it exists. Unfortunately, several cases erroneously suggest that issuers have a continual duty to update statements which, although accurate when made, may have become misleading due to subsequent developments. The courts and Congress, moreover, have recently assisted issuers in satisfying their disclosure obligations as discussed in more detail in this article.

A multitude of disclosure issues are involved, among them:

- Is there a duty to disclose outside of the SEC required filings?
- Are opinions or beliefs of management actionable?
- What information is "material," especially in light of the SEC SAB 99?
- What are the liabilities for publishing forward looking information that does not come true?
- Is there a duty to update previously disclosed information which was accurate when released?
- How does an issuer satisfy its obligations to provide meaningful MD&A?
- Is there an obligation to provide a list of risks factors in public releases and SEC filings and, if so, how are these to be crafted?
- What are the safe harbor boundaries of the Private Securities Litigation Reform Act of 1995 ("Reform Act") for forward looking information?
- How will Regulation FD (Fair Disclosure) impact the market generally, and how will it affect the relationship between issuers and market analysts?
- What changes will result as a consequence of the new rules regulating analyst conduct and reporting?
- What will be the result of the S-O Act and SEC rule changes in the aftermath of Enron/WorldCom?
- What will be the impact of the Congressional mandate that the SEC require more current, real time disclosure?

The manner of disclosing corporate developments is, as always, a much examined topic, as indicated by the passage of the Reform Act and its safe harbor for forward looking statements and the 2002 enactment of the S-O Act. Other potential pitfalls are presented by the duty not to mislead, the "Bespeaks Caution" doctrine and the duty to update. These topics are examined in this article in Section III.

MD&A is again a prime subject for improved and more comprehensive disclosure as a result of the SEC's 2002 proposals for expanding MD&A, the adoption of rules relating to the MD&A disclosures of off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments in January 2003, and the SEC's interpretative release on MD&A published in December 2003. The SEC's 1989 Management's Discussion and Analysis Interpretive Release and the enforcement actions against Caterpillar, Inc., Bank of Boston and Sony, analyzed in Section IV of the article, evidence the SEC's past concerns with disclosure matters and, more importantly, indicate that the SEC constantly construes the MD&A as a quarterly disclosure vehicle for all material trends and uncertainties affecting an issuer's results of operation and financial condition.

Financial analysts have taken on a central role in the public offerings of securities and the day-to-day operations of the capital markets. In particular, communications between issuers and analysts ensure that information is widely disseminated in the marketplace. With the 2000 adoption of Regulation FD, however, which seeks to eliminate the selective disclosure of material information by public companies, and the 2002 Self-Regulatory Organizations' ("SRO") rules regulating the conduct and reporting of analysts to prevent conflicts of interest and to provide more objective analyst reports, the analysts' role in the market may be minimized. The February 2003 adoption of Regulation AC,[12] which requires research analysts to certify the truthfulness of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to the specific recommendations or views expressed in those reports and appearances, will also undoubtedly impact an issuer's relationship with financial analysts. The interaction between an issuer and the financial analysts is fraught with risks and issuers should exercise care as described in Section V.

Other topics discussed in this article include road shows (Section VI), Plain English (Section VII), Regulation S (Section VIII), disclosure of management misconduct and government investigations (Section IX), disclosure of stock accumulation programs and "greenmail" negotiations (Section X), disclosure of environmental liabilities (Section XI), settlement in "T+3" (Section XII), and charges to the NASD's "free-riding" interpretation (Section XIII).

Before beginning a historical note is in order. In November 1998, the SEC published its long awaited "aircraft carrier" release[13] (proposing major changes in the way securities are

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[12] Regulation Analyst Certification, Securities Act Release No. 33-8193, Exchange Act Release No. 34-47384 (Feb. 20, 2003), available at http://www.sec.gov/rules/final/33-8193.htm (hereinafter "Regulation AC"). Regulation AC is effective as of April 14, 2003.

[13] SEC Release No. 33-7606 (November 3, 1998).

offered and sold under the Securities Act of 1933) and a companion release (proposing to update and simplify the rules applicable to tender offers, mergers and acquisitions, and other similar transactions) (the "M&A Release").[14] The M&A Release was universally applauded and was adopted in October, 1999, with an effective date of January 24, 2000.[15] The aircraft carrier release, had it been adopted as proposed, would have generated substantial changes to the registration and offerings process.

Brian Lane, the former Director of the Corporate Finance Division of the SEC, has argued that the benefits of the proposal have been overlooked or discounted, that the criticisms are unduly harsh and that the proposal fixes a number of existing serious problems under the Securities Act.[16] The proposal generated considerable controversy, and will not be adopted. Recognizing that the aircraft carrier release was in trouble, Brian Lane reemphasized in a farewell address to the ABA Committee on Federal Regulation of Securities just prior to retirement that broad reform, as proposed by the aircraft carrier release, is appropriate rather than patching the current system. He went on to suggest that perhaps a series of separate proposals might be more acceptable than the aircraft carrier release and suggested seven possible areas for achieving a possible consensus, namely, board certification, pre-sale delivery of prospectus, filing transactional information, filing written communications, secondary shelf registrations, Exxon Capital transactions and disqualifications for certain persons.[17] In time, many of the individual reforms will most likely be adopted. This article, however, does not discuss these releases in detail.

Many years ago, articles addressing disclosure obligations began with a discussion of formal line-item disclosure requirements. In later years, articles began with discussions of materiality as the emphasis shifted to court decisions and particularly to the Supreme Court's decision in Basic. Now in 2004 we have to analyze disclosure obligations under a number of regimes, namely, line item required disclosure (i.e., SEC filings), voluntary public disclosure (i.e., press releases, analyst calls, etc.) and court decisions interpreting the securities laws. This article thus opens with a discussion of the formal SEC line-item disclosure requirements and the SROs' disclosure requirements, moves to voluntary disclosure and court decisions and proceeds to discuss the issues described above.

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[14] SEC Release No. 33-7607 (November 3, 1998).

[15] SEC Release No. 33-7760 (October 22, 1999).

[16] See Remarks by Brian Lane at the Nineteenth Annual Ray Garrett, Jr., Corporate and Securities Law Institute/The Corporate Counsel Center of Northwestern University School of Law held April 22, 1999, entitled "The Securities Act Reform Project: Improving Capital Formation in Our Markets." (Web site http://www.sec.gov/news/speeches/spch275.htm).

[17] See "Views Into the Crystal Ball," by Brian Lane, given at the American Bar Association Committee on Federal Regulation of Securities on November 13, 1999.

II. DISCLOSURE 2004

An analysis of the case law reveals that there is neither a judicial nor a statutory requirement that issuers disclose material information simply because it exists.[18] There are three limited exceptions to the general rule that issuers have no affirmative duty to disclose. Issuers must disclose material facts only:

(1) as mandated by a line-item of an SEC periodic report;

(2) prior to trading in their own securities; and

(3) to correct a prior statement that remains viable in the market and was inaccurate at the time it was made.

Of course, Basic and the cases discussed below also teach that once an issuer chooses to make any public statement as to any material fact, it undertakes a duty to speak truthfully and not mislead. In addition, the SEC Staff Accounting Bulletin on materiality imposes on the company and its auditors the potentially onerous duty to look at the entirety of statements made together to determine whether or not misstatements are material.[19]

Time will tell whether this basic construct will change under the S-O Act's grant of authority to the SEC to provide for real time disclosure:

> Each issuer "shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest."[20]

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[18] See Basic v. Levinson, 479 U.S. 880 (1988); Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982); SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). A good faith decision by management to delay disclosure of material developments during the interim between periodic reports is protected by the business judgment rule. This rule is especially appropriate where the information has not been verified sufficiently to give management full confidence in its accuracy. See e.g., Financial Indus. Funds v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), cert. denied, 414 U.S. 874 (1973) (issuer's decision to delay announcement of steep drop in interim earnings was a reasonable exercise of business judgment).

[19] SEC SAB 99: Materiality August 12, 1999 (hereinafter referred to as "SAB 99"). In May 2003, the SEC codified a number of previously released Staff Accounting Bulletins, including SAB 99, in Staff Accounting Bulletin 103, "Update of Codification of Staff Accounting Bulletins," available at http://www.sec.gov/interps/account/sab103.htm (May 9, 2003). See also SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, available at http:// http://www.sec.gov/interps/account/sab103codet1.htm (May 14, 2003). The codification did not change the substance of SAB 99 in any way.

[20] S-O § 409.

Prior to adoption of S-O, Harvey Pitt, the former Chairman of the SEC, called for more current disclosures.[21] Both he and Alan Beller, the Director of the Division of Corporate Finance, differentiated this need for current disclosure from a continuous disclosure system which neither is advocating. More likely the SEC will push for more forward-looking and trend disclosure.[22]

Although the Securities Act and the Exchange Act do not impose general affirmative disclosure obligations, they do contain mandatory filing and reporting requirements. In addition to the periodic disclosure requirements promulgated by the SEC under the securities acts, there are three other general sources pertaining to disclosure obligations for a public company: (1) the antifraud provisions of the federal securities law (primarily Rule 10b-5); (2) the requirements of the various self-regulatory organizations (i.e., New York Stock Exchange, American Stock Exchange, Nasdaq); and (3) state law. The SEC periodic disclosure requirements and the requirements of the various self-regulatory organizations will be discussed below.

A. The "Line-Item" Duty to Disclose

Section 12 of the Exchange Act requires the registration of certain securities with the SEC. Once a company registers with the Commission under Section 12, the company is required thereafter to file a Form 10-K on an annual basis, a Form 10-Q on a quarterly basis, and a Form 8-K upon the occurrence of certain significant events. To augment periodic reporting disclosures, the SEC has adopted the MD&A, Item 303 of Regulation S-K, which requires issuers to provide information in the periodic reports on financial conditions, operations and prospects in light of recent corporate developments.[23]

1. SEC Certification Requirements

A major new element of SEC filings of quarterly and yearly reports is the new certification required of CEOs and CFOs.[24] Now under the rules adopted by the SEC (as compelled by S-O), each of the CEO and CFO will have to certify in 10-Qs and 10-Ks in the following prescribed form:

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[21] See infra n.429 and accompanying text.

[22] Based on the law prior to S-O, the Seventh Circuit rejected an argument that companies "have an absolute duty to disclose all information material to stock prices as soon as news comes into their possession . . . that is not the way the securities laws work. We do not have a system of continuous disclosure. Instead, firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose." Gallagher v. Abbott Labs., 269 F.3d 806, 808 (7th Cir. 2001).

[23] In 2002, the SEC proposed a number of amendments to the periodic reporting rules: basically to make the filings more current and to disclose quickly director and executive officer loans and transactions in the issuer's securities. Sec. Act Rel. No. 33-8089 (April 12, 2002); these have largely been superceded by the S-O Act and SEC rules adopted thereunder.

[24] Exch. Act Rel. No. 34-46427, Aug. 28, 2002 ("Certifying Release"); these new rules were directed by § 302(a) of S-O.

"(b) The certification included in each report specified in paragraph (a) of this section must be in the form specified in the report and consist of a statement of the certifying officer that:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;

(4) He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in paragraph (c) of this section) for the issuer and have:

(i) Designed such disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;

(ii) Evaluated the effectiveness of the issuer's disclosure controls and procedures as of the date within 90 days prior to the filing date of the report ("Evaluation Date"); and

(iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

(i) All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.[25]"

Not only do the officers have to certify as the material accuracy and completeness of the report, but they have to acknowledge responsibility for establishing and maintaining "disclosure controls and procedures" and essentially vouching for the effectiveness of these controls. Disclosure controls and procedures ("DC&P") are separately defined to mean controls that are designed to ensure that the required disclosed information is recorded, processed, summarized and reported timely.[26] This concept is expressly meant to be broader than "internal controls" which is related only to financial reporting; DC&P is crafted to "capture information that is relevant to an assessment of the need to disclose developments and risks that pertain to the issuer's business."[27]

Vast amounts of executive, legal and accounting time is being spent implementing these new requirements. The SEC has specifically avoided proscribing particular procedures for satisfying the DC&P requirements. It has, however, recognized that each issuer develop a process that "is consistent with its business and internal management and supervisory practices" and that a "committee [be established] with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis."[28] The Commission suggests that likely candidates for this committee are the "principal accounting officer (or controller), the general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel, the principal risk management officer, the chief investor relations officer (or an officer with equivalent responsibilities) and such other officers or employees, including individuals associated with the issuer's business units, as the issuer deems appropriate".[29]

On a substantive note, counsel should recognize that the required certification is not limited to certifying that the financial information is presented in accordance with GAAP; instead the officers must certify that both the financial statements and other financial information

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[25] Rule § 240-13a-14.

[26] Rule § 240 13a-14(c).

[27] Certifying Release at 10.

[28] Certifying Release at 8.

[29] Id. at n. 60.

"fairly present in all material respects the financial condition, results of operations and cash flows of the issuer." According to the SEC: "a 'fair presentation' of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows."[30]

On the liability issue, the SEC states that CEO and CFO are "already" responsible for their company's disclosures under the Exchange Act liability provisions.[31] Time will tell whether the certification rules will result in more liability exposure, but certainly the certification process itself, including DC&P, will produce more potential liability.

In addition to the foregoing certification, Section 906 of S-O adds to the Criminal Code another certification required of CEOs and CFOs. This is a rather curious provision because of its placement in the Criminal Code making it unclear as to whether the SEC or the Department of Justice (or both) has (have) the authority to interpret it. To comply, the CEO and CFO have to certify in each periodic report containing financial statements that "the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) … and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operation of the issuer.[32] Severe criminal penalties are imposed are those who certify "knowing" that the periodic report "does not comport" with all the requirements of Section 906. Although the criminal penalties portion of the Section contains a "knowing" requirement, the operative portion of the Section does not allow the officers to certify on the basis of their knowledge. Consequently, Forms 10-Q and 10-K will now include two separate certifications. My prediction is that the rules adopted by the SEC will be the focus of attention and that Section 906 will be used sparingly to support criminal sanctions in egregious cases.

2. SEC Periodic and Current Filing Requirements

In August 2002, the SEC adopted amendments to accelerate the filing deadlines for the Form 10-Q and the Form 10-K. The changes in the filing deadlines are to be phased in over three years with no change for the first year. The accelerated filing deadlines apply to domestic companies that: (1) have a public float of at least $75 million; (2) have been reporting for at least

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[30] Id. at 7.

[31] Id. at 9.

[32] S-O § 906. Section 906 does not apply to Form 8-K. See Sec. Act. Rel. No. 33-8400, Mar. 16, 2004.

12 months; (3) have previously filed one annual report; and (4) are not to use the SEC's special forms for small business issuers (all such companies, "accelerated filers").[33]

Furthermore, an accelerated filer is required to disclose on its Form 10-K, beginning with reports for fiscal years ending on or after December 15, 2002, whether the company makes its periodic and current reports available, free of charge, on its web site as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. The SEC interprets this requirement to mean that the report should be available on the website on the same day as filing, absent some unforeseen circumstances. The website access is to include all exhibits and supplemental schedules electronically filed with the reports or amendments. The SEC suggests that companies provide access to their previous reports for at least a 12-month period, although it would be desirable for companies to provide access to archived portions of their website for a longer timeframe. Finally, the Commission states in the adopting release that the new provisions are not antifraud rules and hence do not create new duties under the antifraud provisions of the securities laws or in the private rights of action.

The changes for accelerated filers are summarized in the following table:

For Fiscal Years Ending On or After	Form 10-K Deadline	Form 10-Q Deadline
December 15, 2002	90 days after fiscal year end	45 days after fiscal quarter end
December 15, 2003	75 days after fiscal year end	45 days after fiscal quarter end
December 15, 2004	60 days after fiscal year end	40 days after fiscal quarter end
December 15, 2005	60 days after fiscal year end	35 days after fiscal quarter end

a. Periodic Form 10-K

An issuer must file its annual report within 90 days after its fiscal year-end on Form 10-K. For the first year, an accelerated filer must also must file its annual report within 90 days after its fiscal year-end on Form 10-K. Starting in the second year, the annual report deadline changes for accelerated filers to 75 days and to 60 days in year

[33] Final Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Release Nos. 33-8128, 34-46464, (Sept. 5, 2002), available at http://www.sec.gov/rules/final/33-8128.htm.

three and thereafter. The first reduction to 75 days would occur for accelerated filers with fiscal years ending on or after December 15, 2003.[34]

Form 10-K includes full, audited financial statements. In addition, Item 1 of Form 10-K requires a description of the registrant's business in accordance with Item 101 of Regulation S-K. Item 3 requires, in accordance with Item 103 of Regulation S-K, a description of material pending legal proceedings outside the ordinary course of business, to which the issuer or subsidiary is a party. Item 7 requires the registrant to include an MD&A section, in accordance with Item 303(a) of regulation S-K. This includes a description of current and historical information, as well as trends and forward looking information (see discussion infra Section IV).

b. Periodic Form 10-Q

An issuer must file its quarterly reports within 45 days after the end of each of the first three quarters of the issuer's fiscal year on Form 10-Q. For the first year, an accelerated filer must also file its quarterly reports within 45 days after the end of each of the first three quarters of the issuer's fiscal year on Form 10-Q. Starting in the second year, the quarterly report deadline changes to 40 days and to 35 days in year three and thereafter for the accelerated filer. The first reduction to 40 days would occur for accelerated filers with fiscal years ending on or after December 15, 2003.[35] Form 10-Q, among other things, requires the issuer to disclose any material changes in the company's financial condition with respect to the most recent fiscal year-to-date period.

c. Current Form 8-K

Over one and one half years after the SEC proposed revisions to the current report on Form 8-K, in March 2004 the SEC adopted rule amendments to Form 8-K that:[36]

- Add eight new disclosure items to Form 8-K; and
- Transfer two items from the quarterly and annual reports to Form 8-K; and
- Shorten the Form 8-K filing deadline for most items to four business days after the occurrence of an event triggering the disclosure requirements of the form; and
- Expand the disclosures required under two existing Form 8-K items.

The SEC thought it appropriate, given the addition of a number of new items to the form, to organize the reportable items into nine topical categories.[37] The eight new disclosure items in Form 8-K are as follows:

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[34] Id.

[35] Id.

[36] Sec. Act. Rel. No. 33-8400, Mar. 16, 2004.

- Item 1.01 requires the disclosure of "material definitive agreements" entered into by a company that are not made in the ordinary course of business, including business combination agreements and other agreements that relate to extraordinary corporate transactions.[38] The SEC indicates that this item parallels Items 601(b)(10) of Regulation S-K with regard to the types of agreements that are material to a company. Under Item 1.01, a company must also disclose any material amendment to a material definitive agreement. Such material amendments may trigger a disclosure obligation even if the underlying agreement previously has not been disclosed by the company.[39]

- Item 1.02 requires disclosure if a material definitive agreement not made in the ordinary course of business to which a company is a party is terminated, other than by expiration of the agreement on a stated termination date or as a result of the parties completing their obligations under such agreement, and such termination of the agreement is material to the company. Disclosure is not required under this item unless and until the agreement has been terminated.

- Item 2.03 requires disclosure of certain information if the company becomes obligated under a "direct financial obligation," defined to include long-term debt obligations, capital lease obligations, operating lease obligations, and short-term debt obligations arising other than in the ordinary course of business. Moreover, if the company becomes directly or contingently liable for an obligation that is material to the company arising out of an "off-balance sheet arrangement,"[40] it must provide certain information, and may even have to provide the maximum potential amount of undiscounted future payments that the company may be required to make.

- Item 2.04 requires a company to file a Form 8-K report if a triggering event causing the increase or acceleration of a direct financial obligation of the

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[37] The nine topical categories are: Section 1 – Registrant's Business and Operations; Section 2 – Financial Information; Section 3 – Securities and Trading Markets; Section 4 – Matters Related to Accountants and Financial Statements; Section 5 – Corporate Governance and Management; Section 6 – [Reserved]; Section 7 – Regulation FD; Section 8 – Other Events; Section 9 – Financial Statements and Exhibits.

[38] The SEC notes that the filing of the Form 8-K may constitute the first "public announcement" for purposes of Rule 165 under the Securities Act and Rule 14d-2(b) or Rule 14a-12 under the Exchange Act and thereby trigger a filing obligation under those rules. The SEC amended Form 8-K to enable a company to check one or more boxes on the cover page of the form to indicate that it is simultaneously satisfying its filing obligations under such rules, provided that the Form 8-K contains all of the information required by those rules.

[39] The SEC notes that typically a company will report its entry into a material definitive agreement to acquire or dispose of assets under Item 1.01, and then later disclose the closing of the acquisition or disposition transaction under Item 2.01. However, Item 2.01, which, like former Item 2 of Form 8-K, requires disclosure if a company, or any of its majority-owned subsidiaries, has acquired or disposed of a significant amount of assets, otherwise than in the ordinary course of business, includes a bright-line reporting threshold that is not included in Item 1.01.

[40] As defined in Item 303(a)(4)(ii) of Regulation S-K.

company occurs and the consequences of the event are material to the company. Also, if a triggering event occurs causing a company's obligation under an off-balance sheet arrangement to increase or be accelerated, or causing a company's contingent obligation under such an arrangement to become a direct financial obligation of the company, and the consequences of such event are material, it must disclose certain information.

- Item 2.05 requires disclosure when the board of directors, a committee of the board of directors, or an authorized officer or officers if board action is not required, commits[41] the company to an exit or disposal plan or otherwise disposes of a long-lived asset or terminates employees under a plan of termination described in paragraph 8 of FASB Statement of Financial Accounting Standards No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146).[42] For each major type of cost associate with the course of action, an estimate of the total amount or range of amounts expected to be incurred in connection with action must be disclosed. If at the time of filing the company is unable to make a good faith estimate of the amount of the charges, the company need not disclose its estimate at that time, but nevertheless must file the Form 8-K report describing the company's commitment to a course of action. Within four business days after the company formulates an estimate, the company must amend its earlier Form 8-K to include the estimate.

- Item 2.06 requires disclosure when the board of directors, a committee of the board of directors, or an authorized officer or officers if board action is not required, concludes that a material charge for impairment of one or more of its assets, including, without limitation, an impairment of securities or goodwill, is required under GAAP. No Form 8-K disclosure is required, however, if the conclusion regarding the material charge is made in connection with the preparation, review or audit of financial statements at the end of a fiscal quarter or year and the plan is disclosed in the company's periodic report for that period.

- Item 3.01 requires that a company report is receipt of a notice from the national securities exchange or national securities association that maintains the principal listing of any class of the company's common equity, indicating that:

    - The company or such class of its securities does not satisfy a rule or standard for continued listing;

    - The exchange has submitted an application under Exchange Act Rule 12d2-2 to the SEC to delist such class of the company's securities; or

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[41] "Commitment" conveys the idea that a company has made a final determination regarding a course of action.

[42] The SEC notes that the disclosure requirements under this item closely track the disclosures required in the footnotes to the financial statements required by SFAS No. 146.

- The association has taken all necessary steps under its rules to delist the security from its automated inter-dealer quotation system.

- Item 4.02 requires a company to file a Form 8-K if and when its board of directors, a committee of the board of directors, or an authorized officer or officers if board action is not required, concludes that any of the company's previously issued financial statements covering one or more years or interim periods no longer should be relied upon because of an error in such financial statements as addressed in Accounting Principles Board Opinion No. 20 (APB Opinion No. 20).

The rule amendments transfer two items from periodic reports to Form 8-K: (i) unregistered sales of equity securities by the company,[43] and (ii) material modifications to rights of security holders.[44] Moreover, the new rules expand the disclosure requirements concerning the departure of directors or principal officers, election of directors and the appointment of principal officers, amendments to articles of incorporation or bylaws, and a change in the company's fiscal year.[45]

The SEC also adopted a limited safe harbor from public and private claims under Exchange Act Section 10(b) and Rule 10b-5 for a failure to timely file a Form 8-K for seven items. Material misstatements or omissions in a Form 8-K, however, remain subject to Section 10(b) and Rule 10b-5 liability. In addition, the safe harbor extends only until the due date of the company's next periodic report. Failure to make such disclosure in the periodic report will subject a company to potential liability under Section 10(b) and Rule 10b-5, in addition to potential liability under Exchange Act Section 13(a) or 15(d).

3. Self-Regulatory Organizations' Disclosure Obligations

The timely disclosure policies of the stock exchanges and NASD probably provide the most definite expression of an affirmative duty to disclose. These policies are stated below.

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[43] New Item 3.02 requires a company to disclose the information specified in paragraphs (a) and (c) through (e) of Item 701 of Regulation S-K. This information is currently required in Item 2(c) of Forms 10-Q and 10-QSB and Item 5(a) of Forms 10-K and 10-KSB.

[44] New Item 3.03 requires a company to disclose material modifications to the rights of the holders of any class of the company's registered securities and to briefly describe the general effect of such modifications on such rights. The substance of the disclosure is the same as previously required by Items 2(a) and (b) of Forms 10-Q and 10-QSB.

[45] See new Items 5.02 and 5.03 of Form 8-K.

a. The New York Stock Exchange

The New York Stock Exchange ("NYSE") Listed Company Manual states that listed companies are "expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."[46] This duty is not absolute, however. Under certain circumstances, there may be valid business reasons to delay certain disclosures. In these cases, the company should "weigh the fairness to both present and potential shareholders who at any given moment may be considering buying or selling the company's stock."[47]

b. The American Stock Exchange

The American Stock Exchange ("AMEX") similarly provides for a timely disclosure obligation and a business judgment exception. As noted in the AMEX Company Guide: "A listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances."[48] "Unusual circumstances" may include instances "[w]hen immediate disclosure would prejudice the ability of the company to pursue its corporate objectives" or when the facts of a situation are in a "state of flux and a more appropriate moment for disclosure is imminent."[49]

c. Nasdaq National Market

The Nasdaq National Market ("Nasdaq") requires companies whose securities are registered with it to "make prompt disclosure to the public through the news media of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions . . ."[50]

The SEC, however, has approved an amendment to these requirements. As of April 15, 1994, issuers need not make public disclosure of material events "where it is possible to maintain confidentiality of those events and immediate disclosure would prejudice the ability of the issuer to pursue its objectives."[51]

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[46] NYSE Listed Company Manual § 202.05.

[47] Id. at § 202.06(A).

[48] ASE Company Guide § 401(a).

[49] Id. at § 402, 4-3 to 4-4.

[50] NASD Manual, Rule 4310(c)(16).

[51] Rel. No. 34-33510 (Jan. 24, 1994), 59 Fed. Reg. 4736 (Feb. 1, 1994).

d. Corporate Governance Listing Standards

Each of the SROs has adopted new corporate governance standards.[52]

i) NYSE

The principal rule changes include:[53]

- The board consists of a majority of "independent" directors.
- A strengthened definition of independence.
- Non-management directors must meet at regularly scheduled executive sessions without management. There must also be at least one executive session at which only independent directors attend.
- Require that each company have an audit committee consisting of at least three members, all of whom satisfy the board independence requirements and Rule 10A-3(b)(1) under the Exchange Act.
- Require that each company adopt a written audit committee charter that addresses the audit committee's purpose, the preparation of the audit committee report to be included in the company's annual proxy statement, the annual performance evaluation of the audit committee, and the duties and responsibilities of the audit committee.
- Increased role of the audit committee, whereby the audit committee is, among other things, directly responsible for the appointment, compensation, retention and oversight of the work of the company's independent auditors.
- Require that each company have a nominating/corporate governance committee and compensation committee comprised solely of independent directors, and for which the company adopts formal written charters that address the

[52] See Rel. No. 34-48745 (Nov. 4, 2003), 68 Fed. Reg. 218 (Nov. 12, 2003).

[53] See http://www.nyse.com/listed/p1020656067970.html?displayPage=%2Fabout%2F1045516490394.html

committees' purpose and responsibilities of committee members.

- Require each company to have an internal audit function, although it may choose to outsource this function to a third party service provider other than its independent auditor.

- Require that each company's CEO certify annually that he or she is not aware of any violation by the company of NYSE governance listing standards, and promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of the NYSE corporate governance listing standards.

- Require that the company adopt and include on its website corporate governance guidelines as well as the charters of the most important committees.

- Require companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, promptly disclose any waivers of the code for directors or executive officers, and publish such code on their websites.

ii) Nasdaq

The principal rule changes include:[54]

- Increased board independence by requiring that a majority of board members be independent (under a strengthened definition) and that regular meetings consisting of only independent directors be held.

- Increased role of the audit committee, whereby the audit committee is, among other things, directly responsible for the appointment, compensation, retention and oversight of the work of the company's independent auditors.

- All director nominations must be approved by an independent nominations committee or by a majority of

[54] See http://www.nasdaqnews.com/about/Reports/NDQ_Corporate_Governance0503.pdf.

the independent directors. Moreover, the listed company is required to adopt a board resolution or a formal written charter which addresses the nominations process.

- Require that executive compensation be approved by a compensation committee comprised solely of independent directors or by a majority of independent directors (one non-independent director may serve on the compensation and nominating committees under certain disclosed circumstances).

- Require listed companies to develop and disclose codes of conduct for all directors and employees.

iii) American Stock Exchange

The American Stock Exchange Board of Governors has also approved new corporate governance measures.[55] In general, the American Stock Exchange corporate governance rules track those of the NYSE and Nasdaq.

B. Informal Disclosures -- What the Courts Are Saying

The Supreme Court's decision in Basic Inc. v. Levinson[56] remains the most important decision on materiality and timely disclosure since 1988. The Basic decision confirmed that issuers may refuse to comment on pending merger negotiations, but may not deny the existence of, or otherwise affirmatively mislead investors regarding the terms of, any existing negotiations. Because the decision also adopted the "fraud-on-the-market" theory as a substitute for proof of direct reliance, it is especially important that issuers and their counsel understand the Basic opinion and formulate a coherent policy regarding the timing and content of corporate disclosure. The Basic decision and the Supreme Court's subsequent decision in Virginia Bankshares are summarized below, together with several Court of Appeals decisions which apply the Supreme Court's rulings on materiality and timely disclosure in a preliminary merger or takeover context.

1. Basic Inc. v. Levinson

In Basic, plaintiffs, who had sold their Basic stock in the open market shortly before Basic's merger with Combustion Engineering, Inc. was announced, claimed that Basic's failure to disclose the existence of preliminary merger negotiations with

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[55] See http://wallstreet.cch.com/AmericanStockExchangeAMEX/AmexCompanyGuide/PART8/default.asp

[56] 108 S. Ct. 978 (1988). For a detailed analysis of the Basic decision, see Herbert Wander & Russell Pallesen, Timely Disclosure After Basic, 21 Sec. & Com. Reg. 109 (1988).

Combustion Engineering violated Rule 10b-5. The plaintiffs also alleged that Basic had defrauded them by making public "no corporate developments" statements while actually engaged in merger talks. Basic maintained that the merger discussions were not material and that the company was not subject to a duty to disclose because it was not trading in its securities.

a. Materiality

With respect to materiality under Rule 10b-5, the Supreme Court in Basic:

- Rejected the notion that merger negotiations are not, as a matter of law, material until the parties reach an agreement-in-principle on price and structure.[57]

- Determined that the materiality of contingent or speculative events, such as merger negotiations, must be determined on a case-by-case basis and "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[58]

- Confirmed that an omitted fact is material if there is a substantial likelihood that a reasonable investor would have considered it important "as having significantly altered the total mix of information made available."[59]

b. Duty to Disclose

Although the Supreme Court specifically elected not to address what it described as "the rubric of an issuer's duty to disclose," properly interpreted, the Basic decision does provide considerable guidance regarding appropriate disclosure conduct. More specifically, the Supreme Court in Basic:

- Indicated in a footnote that issuers may refuse comment regarding impending mergers.

- Noted that "no comment" statements are generally the functional equivalent of silence and, absent a duty to disclose, are not misleading under Rule 10b-5.

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[57] But see infra Section IV.B.2.

[58] 108 S. Ct. at 987 (citing SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968)).

[59] Id. at 983 (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

- Left undisturbed the general rule that, absent insider trading or prior inaccurate disclosures, issuers need not make interim disclosure regarding corporate events, even if material.[60]

- Determined that an issuer which voluntarily chooses to make any public statement as to a material fact, such as a "no corporate developments" statement, undertakes a duty to speak truthfully and not mislead.

- The Supreme Court held that Basic's "no corporate developments" statements may have violated the duty not to mislead, and remanded the case to the district court for a determination whether the merger discussions were material under the probability/magnitude balancing test, based upon all the facts and circumstances.

2. The Progeny of Basic

The Supreme Court's Basic decision, as expanded by Virginia Bankshares, discussed below, obligates lower courts to undertake a fact-intensive, case-by-case inquiry to determine the materiality of contingent corporate developments such as merger negotiations. Commentators feared that the Supreme Court's fact-specific materiality analysis would preclude dismissal of many Rule 10b-5 actions on a motion for summary judgment. Coupled with the Supreme Court's adoption of the fraud-on-the-market theory of reliance, which facilitates certification of securities fraud class actions, it was suggested that the decision would flood the federal courts with a wave of securities fraud lawsuits.

Clearly, there has been a significant increase in the number of cases filed challenging corporate disclosure practices since Basic. However, in the takeover context, the lower courts generally have applied the Basic analysis to alleged omissions relating to merger negotiations in a manner consistent with traditional concepts of materiality and timely disclosure.

a. No Duty to Disclose

i) Taylor v. First Union Corporation of South Carolina

The Fourth Circuit determined in Taylor v. First Union Corporation of South Carolina[61] that defendants First Union

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[60] Since the right to deny comment regarding material corporate developments presumes that issuers have no initial duty to disclose, the Supreme Court implicitly rejected the notion of a general duty to disclose by sanctioning the "no comment" response to merger inquiries. In October 2001, the Seventh Circuit reiterated that there is no duty to disclose during interim periods. The court stated that the federal securities laws do not provide for a system of "continuous disclosure," but require only the filing of annual reports with periodic updates of certain information. Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001).

[61] 857 F.2d 240 (4th Cir. 1988), cert. denied, 489 U.S. 1080 (1989).

Corporation and Southern Bancorporation, Inc. had no obligation under Rule 10b-5 to disclose highly tentative merger discussions prior to plaintiffs' sale of their Southern stock to First Union. The Fourth Circuit reversed a jury verdict and entered judgment for the defendant banks after determining that discussions between the two banks regarding the possibility of a merger were too preliminary, contingent and speculative to be considered material under the probability/magnitude balancing test adopted in Basic.

In February 1984, after a bitter dispute, Southern forced Bennie Taylor to resign as a director and agreed to repurchase the Taylors' Southern stock. However, after Southern refused to repurchase the Taylors' shares above the market price, the Taylors initiated negotiations with First Union and eventually sold their Southern stock to First Union for $18 per share. First Union neglected to advise the Taylors that First Union had previously approached Southern to discuss a merger between the two banks if interstate banking ever became legal in South Carolina. Sixteen months later, after interstate banking was declared constitutional, First Union renewed its discussions with Southern and eventually purchased all outstanding stock of Southern for $33 per share. The Taylors sued both Southern and First Union, claiming that the banks had conspired to withhold from them information regarding the potential merger in order to acquire their shares at less than true value.

This case is not typical of disclosure disputes. It did not involve alleged omissions or misrepresentations by an issuer repurchasing its own shares; rather, the issue was whether one company could purchase shares of a second company from the second company's shareholders without disclosing that it had contacted the second company regarding a possible merger. The court determined that First Union had no general duty to disclose material facts, under either South Carolina state fiduciary laws or federal securities laws, prior to purchasing stock of Southern from a Southern shareholder.[62] Although the Fourth Circuit recognized that a merger is of unique significance in the life of a corporation, the court stated:

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[62] See also Holstein v. Armstrong, 751 F. Supp. 746 (N.D. Ill. 1990), where the court held that officers and directors of UAL did not violate Rule 10b-5 by failing to publicly disclose a takeover proposal by Marvin Davis because defendants had not traded UAL stock and had not made misleading statements regarding the takeover proposal. The court noted that Basic had held that material information need not always be disclosed and that, absent a separate duty to disclose, silence could not be considered "misleading" in and of itself.

> Those in business routinely discuss and exchange information on matters which may or may not eventuate in some future agreement. Not every such business conversation gives rise to legal obligations.[63]

The court also noted that First Union had made no prior statements to the Taylors that would have been rendered misleading by First Union's failure to disclose the merger contacts.

> The Fourth Circuit also held that the merger discussions were not material under the Basic standard. The court noted that not only had there been no agreement on price and structure, but there was no evidence of board resolutions, actual negotiations, or instructions to investment bankers to facilitate a merger. Furthermore, the merger was contingent upon a change of banking laws beyond the control of the parties. The court concluded that the discussions, at most, resulted in a vague agreement to establish a relationship.[64]

ii) Jackvony v. RIHT Financial Corporation

> The First Circuit applied the Basic analysis in a more traditional manner in Jackvony v. RIHT Financial Corporation,[65] a case arising from the stock/cash election merger of Columbus National Bank into Hospital Trust. Mr. Jackvony, a shareholder of Columbus, claimed that Hospital Trust should have disclosed its "general interest" in facilitating a future merger with a larger bank prior to closing the acquisition/merger with Columbus. He alleged that had he known that Hospital Trust considered itself a potential takeover target at the time of the merger he would have elected to take more Hospital Trust shares instead of cash for his Columbus stock. Hospital Trust eventually was acquired at a premium by another bank.
>
> The First Circuit affirmed a directed verdict for Hospital Trust, holding that a company's "general interest" in a merger

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[63] 857 F.2d at 244.

[64] Had the Taylors sold their stock to Southern, as initially intended, Southern may have had a duty to disclose material information because it would have been trading in its own securities. See SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (insiders must disclose material information or abstain from trading). The Fourth Circuit's materiality analysis would then have been more critical to the outcome of the decision.

[65] 873 F.2d 411 (1st Cir. 1989).

could not be considered material information absent specific "pre-merger" events. Hospital Trust did consider itself a potential takeover target and officers and directors of Hospital Trust had discussed amongst themselves the possibility of seeking a merger with another bank as a defensive tactic. However, unlike the situation in Basic, Hospital Trust had not received any concrete offers and had not engaged in specific discussions with a potential suitor. Rather, Hospital Trust directors and officers had merely expressed concern internally about being acquired in the broader context of considering various options for the future. In addition, due to the environment of deregulation and uncertainty regarding interstate banking, the informed public was aware of the general possibility of mergers and acquisitions in the banking industry. Therefore, the court concluded that Hospital Trusts' alleged omissions could not have altered the "total mix" of information available to investors.

iii) Hartford Fire Insurance Company v. Federated Department Stores, Inc.

In the celebrated decision of Hartford Fire Insurance Company v. Federated Department Stores, Inc.,[66] the District Court for the Southern District of New York confirmed that under the Basic approach, pre-negotiation merger prospects or hypothetical takeover possibilities would not be considered material for Rule 10b-5 purposes. In Hartford, bondholders of Federated Department Stores sued, claiming that Federated had failed to disclose in the bond offering the possibility that Federated could be acquired in a highly leveraged takeover which would increase the risk of the bonds. Federated had considered itself a takeover candidate for some time before the issuance of the bonds, and was eventually acquired by Campeau U.S. in a highly leveraged hostile transaction. Shortly thereafter the investment grade of the bonds plummeted from low-risk to "junk" status.

The district court noted the novelty of the factual context in Hartford, but determined that the inquiry was still quite "basic" — was the omitted information material in light of the totality of facts and circumstances? The district court first examined the probability that a takeover of Federated would occur. Because Federated had shown no interest in being acquired and had even implemented defensive measures to thwart a potential bidder, the court found a low probability that another company would acquire

[66] 723 F. Supp. 976 (S.D.N.Y. 1989).

Federated. At the time Federated issued the bonds, no bidder had been identified and no discussions had occurred. Furthermore, as in Taylor, the court found that the consummation of a takeover was ultimately beyond Federated's control. In sum, a takeover of Federated was speculative and contingent.

As for the potential magnitude of any future takeover of Federated, the court noted that Federated could not have determined the structure of a takeover, the amount of debt an acquirer would cause Federated to incur, or the effect of any transaction on the investment grade of the bonds. Finally, the court found that the omitted information would not have altered the "total mix" of information available to investors because Federated had long been considered an attractive takeover candidate, both in the press and in the financial community.

The district court quoted Jackvony at length and concluded that its decision was on "all fours" with Jackvony. In both cases a general concern about possible acquisitions existed, but was not disclosed, no specific pre-merger events had occurred, and the investing public was aware of the takeover environment of the industry.[67] In response to plaintiff's argument that the fact-intensive nature of the Basic inquiry precluded summary judgment, the district court noted that the Supreme Court in Basic specifically stated that summary judgment would be appropriate where a prospective merger was too inchoate to be material.

b. The Duty Not to Mislead

i) Columbia Securities Litigation

The case of Columbia[68] is a misguided decision that, nonetheless, illustrates that the right to remain silent is not a license to mislead. Former Columbia shareholders who sold their shares in the open market prior to the merger of Columbia and Sony sued Sony and its Chairman and President challenging that Sony defrauded them by falsely denying the existence of ongoing merger discussions with Columbia. The plaintiff's case was based

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[67] 723 F. Supp. at 988-89; See also Savage v. Federated Department Stores, Inc. Retirement Income & Thrift Incentive, Civ. Act. No. 88-4444 (D.N.J.), aff'd, 893 F.2d 1331 (3d Cir. 1989) (omitted information cannot be considered misleading, and thus give rise to a duty to disclose, if that information is already available in the marketplace). For a detailed analysis of this proposition in fraud-on-the-market cases, see Apple Securities Litigation, 886 F.2d 1109 (9th Cir. 1989), cert. denied, Schneider v. Apple Computer, Inc., 110 S. Ct. 3229 (1990), discussed infra Section III.B.1.

[68] 747 F. Supp. 237 (S.D.N.Y. 1990).

on three separate public statements made by Sony in Forbes, The New York Times, and in a Reuters dispatch which specifically and affirmatively denied that any merger negotiations with Columbia had occurred. The district court denied the defendant's motion to dismiss, finding that the statements made by Sony were potentially misleading.[69] Additionally, the court rejected Sony's argument that the merger discussions were immaterial as a matter of law because the possibility of completing the merger had not reached a "more likely than not" status.

The most disturbing aspect of this case is the absence of any basis for finding that Sony owed any fiduciary duties whatsoever to the shareholders of Columbia. This case is similar to the Taylor case, discussed above, where the court correctly held that an acquiring company owes no general duty to disclose to the shareholders of a target company. The only difference is that in Taylor the acquiring company remained silent regarding merger discussions, while in this case, Sony made voluntary statements falsely denying the existence of discussions.

Courts have found a duty not to mislead in the private context where parties sit down in face-to-face negotiations for the purchase of securities.[70] Columbia represents the first decision where such obligations would be imposed in the public context through the fraud on the market theory — even though Sony and the plaintiffs never were party to a securities purchase transaction. Given that tender offer rules impose specific and strict guidelines of conduct in the public arena, the decision in Columbia appears an unwarranted extension of the fraud on the market theory.

ii) SEC v. Borman

In 1991, the SEC initiated proceedings against the former Chairman and CEO of Borman's alleging that he violated the securities laws by causing the company to issue a "no corporate developments" press release while actually engaged in acquisition negotiations with Great Atlantic & Pacific Tea Company. The

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[69] In a later opinion in this litigation, Fed. Sec. L. Rep. (CCH) ¶98,238 (S.D.N.Y. 1994), the District Court once again rejected Sony's arguments and denied its motion for summary judgment on the same grounds.

[70] See e.g., Rowe v. Maremont Corp., 850 F.2d 1226 (7th Cir. 1988); Folger Adam Co. v. PMI Indus. Inc., Fed. Sec. L. Rep. (CCH) ¶ 96,131 (2d Cir. 1991). For a discussion of disclosure obligations in the private context, see Herbert Wander & Russell Pallesen, Securities Law Disclosure by Public and Private Companies, 4 The Corp. Analyst 1, 9 (1991).

press release challenged in SEC v. Borman[71] was made in response to an inquiry by the New York Stock Exchange. The company denied knowing the reason for increased activity in the company's stock when, in fact, it was pursuing merger talks with A&P. Although the company did not affirmatively deny that it might seek an acquisition in the future, by abandoning a strict "no comment" approach the company provided the SEC with a basis to initiate a civil action proceeding. The case reaffirms the importance of consistently maintaining a "no comment" posture while in the midst of merger talks.

c. Slips of the Tongue and Pen Are Dangerous

As the following cases demonstrate, one or two line statements in live interviews can result in serious consequences for the issuer when its officials respond to questions regarding merger discussions and plans. The same is true for short written statements that are basically true and are probably not meant to deceive, but can be interpreted in more than one manner. The Buxbaum and MCI cases illustrate the pitfalls of oral answers in an interview. The Quaker decision on remand, however, involves written statements concerning the company's "guideline" for its debt to capitalization ratio.[72]

i) Buxbaum, et al. v. Deutsche Bank, A.G., et al.

The U.S. District Court in the Southern District of New York broadly interpreted Basic as protecting shareholders from offhand remarks given in any interview in Buxbaum v. Deutsche Bank, A.G.[73] In an interview with a foreign publication, the CEO of Deutsche Bank denied talks of a takeover of Bankers Trust, following which the stock of Bankers Trust fell by approximately 10%. When Deutsche Bank did takeover Bankers Trust one month later, accusations of misrepresentation and fraud on behalf of Deutsche Bank surfaced, and this lawsuit alleged that the statement had been given in a direct attempt to lower the stock price, thus lowering the ultimate purchase price paid by Deutsche Bank by nearly $7 million. Declining to accept Deutsche Bank's response that, given its understanding of "takeover discussions" to mean

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[71] Civ. Act. 91-0567 (D.D.C. 1991).

[72] Weiner v. The Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000). The Quaker case is discussed in more detail at III. F. 6, infra.

[73] Fed. Sec. L. Rep. (CCH) ¶ 90,969 (S.D.N.Y. 2000).

that the talks being held were not yet material or substantive, the court found the CEO's remarks to be materially misleading and it denied a motion to dismiss the claim.

In distinguishing this case from a Fourth Circuit case in which the Circuit Court affirmed a District Court dismissal[74], the court in Deutsche Bank made it clear that the specific wording is of the utmost importance and stressed the necessity of using extreme caution in giving any information that may later be interpreted by the market. LCI involved a situation in which an officer of the defendant company stated it was not for sale, but soon thereafter merged with another company

ii) MCI Worldcom, Inc. Securities Litigation

In response to a question regarding the possibility of a merger following the registration of the domain name "skytelworldcom.com" that was linked back to MCI, MCI responded that "the action is not an indication of official company intention."[75] The stock price of SkyTel dropped immediately, and MCI soon thereafter acquired SkyTel. Ruling that this statement went beyond the permissible "no comment," the District Court for the Eastern District of New York found that the market's interpretation of the remark as meaning that MCI had no intention of acquiring SkyTel was reasonable. The court therefore denied MCI's motion to dismiss.[76]

Distinguishing MCI from LCI, the District Court found the timing and specific language and the remarks to be important. The court found MCI more akin to Deutsche Bank and, like the District

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[74] Phillips v. LCI, International, Inc., 190 F.3d 609 (4th Cir. 1999). In LCI, as opposed to Deutsche Bank, the officer at LCI that stated LCI was not for sale was technically speaking the whole truth, as when it merged soon thereafter, it remained as the surviving corporation, thereby avoiding having been "for sale."

[75] Fed. Sec. L. Rep. (CCH) ¶ 90,950 (April 13, 2000). For a more detailed discussion of the Buxbaum and MCI Worldcom, Inc. cases, see Maryann A. Waryjas, "Disclosure Without Fear," Shareholder Value Magazine, Oct/Nov 2000, p. 64-67.

[76] Contra Elliot Assocs. v. Covance, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,269 (S.D.N.Y. 2000) (holding that defendant company's statement regarding the status of a proposed merger as "on track" were not actionable after the merger was not completed and defendant's motion to dismiss was granted because there is no duty to update optimistic opinions). But cf Eisenstadt v. Centel Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,458 (7th Cir. 1997) (noting that after the Private Securities Litigation Reform Act of 1995 there may be no more legal duty to update prior statements).

Court in Deutsche Bank, determined that the statements were false or misleading as well as being material.[77]

iii) Weiner v. The Quaker Oats Co.

The central issue in the Quaker cases is the duty to update.[78] The cases, however, also provide a good lesson on how to disclose company guidelines and avoid misinterpretation. Quaker repeatedly stated that its "guideline [for debt-to-capitalization ratio] will be in the upper-60 percent range."[79] Quaker also disclosed that "[w]e continually seek opportunities to acquire businesses that offer profitable future growth."[80] When Quaker announced the acquisition of Snapple, the market reacted negatively because, it is alleged, Quaker used debt to finance the acquisition and exceeded its publicly announced debt-to-capitalization ratio.[81] Quaker's internal analysis of the Snapple acquisition also included plans to divest other assets to reduce any debt incurred in a leveraged acquisition of Snapple.[82] In fact, within six months after the announcement of the Snapple acquisition, Quaker sold two businesses for $1.425 billion and its leverage ratio returned to the upper-60 percent range.[83] On these facts, Quaker may prevail before a jury but, in hindsight, it would have been preferable to expressly state that the leverage guideline

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77 The SEC announced that the reach of the US securities laws is not confined to the borders of the US. On September 28, 2000, the SEC brought and settled its first enforcement action against a foreign issuer for intentionally making a series of false statements regarding merger negotiations. The SEC charged E.ON AG, a German company, with making materially false denials regarding merger discussions with Viag AG, another German company, when in fact it was engaged in merger negotiations with Viag. Because E.ON has American Depositary Shares listed on the NYSE, the SEC applied the same antifraud rules and standards to the foreign issuer that it does to US issuers. The SEC reasoned that false statements made overseas can impact US investors as much as statements issued in the US. Though the E.ON situation represents more than a mere "slip of the tongue" because the company made multiple denials of merger negotiations and many of E.ON's senior management knowingly approved the false public statements, foreign issuers must be aware that overseas statements may now result in liability under the US securities laws. Mark S. Bergman, Securities Enforcement: Non-US Company Sued for False Public Statements Made During Merger Negotiations, Insights, Volume 14, Number 11, pg. 13, November 2000.

78 Fed. Sec. L. Rep. (CCH) ¶ 91,266 (N. D. Ill. 2000). The Quaker case is discussed in more detail at III. F. 6, infra.

79 Id.

80 Id.

81 Id.

82 Id.

83 Id.

> was a long term goal that could be exceeded temporarily. Also in hindsight, this omission was not probably meant to mislead but rather was an oversight or the authors believed the omitted information was implicit in the statements made. Moreover, the negative market reaction to the Snapple announcement could be attributed to other factors. Nevertheless, this case emphasizes the need to fully consider the market reaction – even if irrational – to public disclosures or omissions and the need to consider whether in light of the possible negative market response the statements should be expanded.[84]

C. Statements of Reasons, Opinions, or Beliefs: Virginia Bankshares, Inc. v. Sandberg

The Supreme Court's decision in Virginia Bankshares, Inc. v. Sandberg[85] builds upon the foundation of materiality analysis established in Basic. Plaintiffs successfully maintained that statements by management in a proxy statement that a proposed "freeze-out" merger would provide a "high value" and a "fair" price may have been false and deceptive statements of material facts. The Supreme Court held that statements by management of reasons, opinions or beliefs — even though conclusory in form — may be material facts that could give rise to misstatement liability under the federal securities laws.

The Court rejected the bank's defense that the statements regarding fairness were too indefinite to constitute material facts. Instead, Justice Souter concluded that "such conclusory terms in the commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." He also dismissed the defendants' "federalization" argument, concluding that:

> Although a corporate transaction's "fairness" is not, as such, a federal concern, a proxy statement's claim of fairness presupposes a factual integrity that federal law is expressly concerned to preserve.[86]

To be actionable, opinions, beliefs and forecasts must be both wrong and deceptive. In a concurring opinion, Justice Scalia described this two-analysis as follows:

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[84] The statements made in the Virginia Bankshares decision, discussed in the next section, are also relevant to this issue. There, the statements that the freeze out merger would provide "high value" and a "fair price" were held to be misstatements. In the context of a complex proxy statement, these statements, probably written by the lawyers, were most likely not meant to mislead: they were just insufficiently vetted.

[85] 111 S. Ct. 2749 (1991). The Supreme Court also held that shareholders whose vote was not required by law to approve the transaction cannot establish causation of damages and therefore lack standing to sue.

[86] Id. at n.6. Several courts have construed Virginia Bankshares and discussed the federalization of state law issue. See e.g., Mendell v. Greenberg, 938 F.2d 1528 (2d Cir. 1991); PHLCORP, Fed. Sec. L. Rep. (CCH) ¶ 96,808 (S.D.N.Y. 1992).

> As I understand the court's opinion, the statements "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the Directors honestly believed otherwise.

Although the holding spoke only to liability under Rule 14a-9, the Supreme Court's analysis already has had an impact in Rule 10b-5 cases involving projections and other forward looking statements.[87]

D. Is Materiality Still Alive?

Disclosure requirements have traditionally been limited by a materiality standard. The understanding of materiality taken from the Basic and Virginia Bankshares courts thrived, allowing registrants to disclose only those things that fell within a seemingly clear definition of "material." Statements, and even misstatements, not thought to be of material importance to the average investor, have not historically required correction or raised an inference of improper or unethical disclosure.[88] Materiality was often thought of as a quantitative standard, whereby a misstatement or omission that did not result in an excess of a 5% mistake in the financial statements was not deemed "material." Very few courts analyzed each statement qualitatively, preferring a more mechanical process.[89]

The use of an elastic materiality standard has generally worked well. The SEC, however, was not content with the state of affairs and has launched two assaults on materiality as we have known the concept for decades. First, in 1999 the staff issued its famous SAB 99 and, in 2000, the Commission redefined materiality in its Release adopting Regulation FD.

The SEC staff in 1999 gave materiality a new definition that requires each item or statement to be looked at as material if, *in the light of all the surrounding circumstances*, the magnitude of the item is such that it is probable that the judgment of a reasonable person would be changed or influenced by the inclusion or correction of the item.[90] The SEC has clouded the meaning of materiality by rejecting bright line quantitative standards and substituting qualitative standards, including the following, before determining whether or not something is material:

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87 Hanon v. Dataproducts Corp., Fed. Sec. L. Rep. (CCH) ¶ 96,808 (S.D.N.Y. 1992), discussed infra Section III.B.2. See also William O. Fisher, "Opinions and Predictions: Remembering Objective Falsity", Insights, Vol. 15, No.9, September 2001.

88 John M. Fedders. Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard, Catholic University L. Rev., Vol. 48, Fall 1998, for an overall discussion of the history of materiality in SEC disclosure requirements.

89 See e.g., SEC v. Joseph Schlitz Brewing Co., 452 F.Supp. 824 (E.D. Wis. 1978).

90 SAB Release No. 99. The staff argues that SAB 99 is limited to accounting matters and does not alter the definition of materiality. As we shall see, the courts are following SAB 99 in anti-fraud civil liability cases and most commentators believe that it does at least expand the definition of materiality.

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;

- whether the misstatement masks a change in earnings or other trends;

- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;

- whether the misstatement affects the registrant's compliance with regulatory requirements; and

- whether the misstatement involves concealment of an unlawful transaction.[91]

Requiring a registrant and its auditors to look at an overview of all surrounding circumstances is demanding, mainly because it may erase the materiality standard and force registrants to disclose items seen by them as entirely immaterial for fear of a potentially subjective qualitative analysis and hindsight analysis.[92] The SAB also suggests that potential market reaction to the misstatement is another factor to be considered in determining materiality supporting the fear of a look-back analysis.[93] This analysis, "although tricky, would be highly fact-driven and would rely heavily on whether a 'reasonable person' - or investor, on this point - would consider the item important."[94] While "'there's no one ... that wouldn't like bright lines'... it is just not a feasible standard where materiality is concerned."[95]

Accounting firms have also incorporated the 1999 Release in the representation letter it requires clients to deliver by removing from the letter any reference to specific amount thresholds in defining materiality. While in previous years, the representation generally included a definition of "material" as "any items referred to in this letter, either individually or collectively in the aggregate, involving potential amounts of more than $250,000," the representation in 1999 reads:

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91 Id.

92 On August 5, 2001, Securities and Exchange Commission General Counsel David Becker disseminated his belief that SAB 99 did not change the meaning of materiality under section 10(b) of the 1934 Securities and Exchange Act when he was quoted as saying "SAB 99 did not lower the bar for materiality."

93 See, e.g., Ganino v. Citizens Utilities Company, Fed. Sec. L. Rep. (CCH) ¶ 90,535 (1999); See also Buxbaum v. Deutsche Bank, supra note 56, in which the District Court in the Southern District of New York looked carefully at the reaction in the press and in the market in finding a statement given in an interview could be material.

94 SEC Legal Chief Tries to Clarify Guidance on Materiality of Misstated Income Figures, Securities Regulation & Law Report, Vol. 31, No. 42. p. 1444. See also Media General v. Tomlin, Fed. Sec. L. Rep. (CCH) ¶ 91,517 (August 9, 2001) (ruling that a fraud action would not be dismissed on materiality grounds because a "reasonable" investor could find the fact that the acquired company was subject to multiple multi-million dollar lawsuits, rather than an isolated claim for $139,000, to be material).

95 Id.

> Certain representations in this letter are described as being limited to those matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Importantly, clients are being asked to also represent that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Courts will find it difficult to interpret this standard because the SEC requires an exactitude that is probably impossible to meet and invites one to find creative ways to distinguish their facts from the SEC's SAB. Indeed, in a case decided shortly before the SAB (but published at just about the same time), the court held that a 1.7% misstatement in amount of revenues was immaterial, although the court also did look at movements in stock price, as an indicator of market reaction, following a correction of the misstatement.[96] On appeal, however, the Second Circuit ruled that the district court erred in finding that a misstatement of an amount equaling 1.7% of pre-tax revenues was immaterial as a matter of law.[97] The Second Circuit reasoned that materiality determinations depend on "all relevant circumstances of the particular case," as it invoked the reasoning of Basic, which rejected the determination of materiality based on numerical formulas as a bright line rule.[98] In conclusion, though the court noted that SAB 99 is not the law, it did indicate that the SAB is consistent with the Basic analysis and is accordingly a persuasive guide in determining the materiality of misstatements and omissions.[99]

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[96] Ganino at ¶ 92,687.

[97] Ganino v. Citizens Utilities, Fed. Sec. L. Rep. (CCH) ¶ 91,210 (2d Cir. 2000); compare Shuster v. Symmetricon, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,206 (2000). In Shuster, a post-SAB 99 decision, the district court appears to have disregarded SAB 99 by adopting a quantitative materiality standard by ruling that the recording of a contingent contract as a sale would be immaterial as a matter of law because such sale represented only 2% of the quarterly revenues. In this case, the court relied upon the lower court decision in Ganino, which adopted the quantitative materiality standard before being reversed on appeal. The ultimate ruling of immateriality in Shuster is probably correct even under SAB 99 materiality standards, which take into consideration both quantitative and qualitative factors. The court, however, should have considered the application of SAB 99 to lend support to the finding of immateriality based on a small percentage of revenues.

[98] Id.

[99] Id.

Similarly, the trend rejecting a mathematical basis for materiality determinations continued in a September 2000 federal district court decision.[100] In this case, plaintiffs alleged that defendant Unisys knowingly made misleading statements about long term contracts with British Telecommunications and the United States Government in violation of section 10(b).[101] Unisys defended its position on the ground that the contracts were not material since each contract represented less than .6% of Unisys' annual revenue.[102] The court, however, rejected the idea that materiality determinations should be based on mathematical formulas and thresholds.[103] Though the two contracts at issue in this case each represented less than 1% of the defendant's revenues, the court reasoned that information regarding the contracts may be important to a reasonable investor and such information may significantly alter the "total mix" of information available to the investor.[104] Accordingly, the court ruled that misleading statements regarding the revocability of the contracts may be material despite the contracts' low value.[105] Even accepting the idea that materiality depends on all the relevant circumstances, the courts at some point should take cases away from juries.[106]

Not all courts, however, have been reluctant to dismiss cases because of alleged materiality. The Fifth Circuit in 2002 upheld the dismissal of a Rule 10b-5 complaint on the grounds, among others, that the alleged misrepresentations were immaterial.[107] The court held that Alcatel's alleged overstatement of 125 million French francs, while large, was nonetheless insufficient as a matter of law to materially affect Alcatel on a consolidated basis. The court did not, however, quantify the overstatement as compared to Alcatel's consolidated financials.

Regulation FD has also added to the materiality confusion.[108] The release adopting FD lists a number of rather standard, non-controversial, non-exclusive items

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100 Unisys Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,218 (2000).

101 Id.

102 Id.

103 Id.

104 Id.

105 Id.

106 Even in 2001, two years after the release of SAB 99, Courts still have difficulty understanding and applying the qualitative materiality standard set forth in SAB 99. Allscripts, Fed. Sec. L. Rep. (CCH) ¶ 91,481 (N.D. Ill. 2001) (ruling that plaintiffs' claim was not actionable because the defendant's alleged violation of accounting standards was immaterial as a matter of law since the amount in controversy constituted only 4% of the defendant's quarterly revenues).

107 ABC Arbitrage Plaintiffs Group v. Tchuruk, Fed. Sec. L. Rep (CCH) ¶ 91, 915 (5th Cir. 2002). See also Anderson v. Abbott Labs., 140 F. Supp. 2d 894 (N.D. Ill. 2001), aff'd, Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001) (holding that the company's omission of certain FDA demands was not material or misleading).

108 See infra Section V.

that are often, but not always, considered material, such as mergers, bankruptcies, stock splits and changes in management. The release, however, in its most controversial paragraph cautions issuers to avoid providing selective information concerning anticipated earnings—higher, lower or the same as has been forecasted. This take on materiality places insiders in an awkward position. They will almost always have more information than is publicly disclosed about anticipated earnings, and if as FD argues this is material, when will they ever be allowed to buy or sell securities? Perhaps Rule 10b-5-1 is the solution.

These recent developments concerning materiality are also causing the courts to focus on "when" the determination of materiality is to be made. In Ganino, the Second Circuit ruled that the relevant time period for assessing the materiality of a misstatement is the time the alleged misstatement occurred.[109] The court reasoned that the "determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event."[110] In contrast, the Third Circuit has ruled that materiality determinations are best made in the context of an efficient securities market.[111] As a result, important information regarding the company is immediately reflected in the price of the company's stock, and the materiality of such information may be assessed "post hoc" by studying the movement in the price of such stock during the period following the disclosure of the information.[112] Under this approach, if the price of the stock is altered after the disclosure of information, it is presumed that such information is material, conversely, if the disclosure has no effect on the price of the stock, such information is deemed immaterial as a matter of law.[113]

However, the Ninth Circuit declined to adopt the Oran bright-line rule requiring an immediate market reaction; instead, it opted for a fact-specific inquiry. The Ninth Circuit reasoned that the "market is subject to distortions that prevent the ideal of a 'free and open public market' from occurring . . . [and] [a]s recognized by the Supreme Court [in Basic], these distortions may not be corrected immediately."[114] The bright-line rule adopted by the Third Circuit, the Ninth Circuit continued, fails to address the "realities of

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[109] Ganino, Fed. Sec. L. Rep. (CCH) ¶ 91,210.

[110] Id.

[111] Oran v. Stafford, Fed. Sec. L. Rep. (CCH) ¶ 91,205 (2000). The court relied on the reasoning set forth in Burlington as it stated that "information important to reasonable investors…is immediately incorporated into the stock price." Id. (citing 114 F.3d at 1425). See also ABC Arbitrage Plaintiffs Group v. Tchuruk, Fed. Sec. L. Rep. (CCH) ¶ 91,915 (5th Cir. 2002) (indicating that the Fifth Circuit approved the Third Circuit's Burlington and Oran after the fact standard but believes it is more related to reliance than materiality).

[112] Id.

[113] Id.

[114] No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holdings Corp., Fed. Sec. L. Rep. (CCH) 92,278 (9th Cir. 2003), cert. denied, 2003 WL 2161436 (2003).

the market."[115] For now, the question of whether materiality determinations are best made in the context of an efficient market or a market "subject to distortions" will remain unanswered by the Supreme Court, which denied certiorari in America West on October 20, 2003.[116]

It is also clear that the court in Buxbaum v. Deutsche Bank was heavily influenced by the stock price decline when it determined that a statement denying the existence of merger discussions was material.[117] Moreover, the implementation of Regulation FD may well result in more stock price volatility as material information hits the market all at once. As qualitative factors become more important, it is unavoidable that courts will be influenced by a stock price reaction when deciding materiality issues.

Finally, are all these developments causing "loss causation" to become a surrogate for materiality? In other words, if an allegedly false announcement does not cause the stock to move and, therefore, security holders are not injured, is this another way to say the announcement is not material? This is illustrated in a 2000 federal district court opinion, Northern Telecom Ltd. Securities Litigation.[118] There, the plaintiffs purchased Nortel stock during a time when defendant Nortel issued statements and press releases regarding the strength of its products, its use of advanced technologies, its ability to obtain long-term contracts and its projected growth in earnings.[119] Subsequent to the making of these statements, the defendant reported projected shortfalls and restructuring plans.[120] Nortel's share price then dropped.[121] As a result, plaintiffs brought suit alleging that the previous statements were material misrepresentations, which inflated, or maintained, the share price.[122] Both plaintiffs and defendants agreed that to support a 10b-5 action, the plaintiffs were required to prove that the allegedly false statements inflated Nortel's share price—loss causation.[123] The court, on a motion for summary judgment, examined the analysis of each party's expert and concluded the plaintiffs failed to raise a disputed issue of fact as to causation.[124] The court also ruled that the statements

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[115] Id.

[116] Id.

[117] Fed. Sec. L. Rep. (CCH) ¶ 90,969 (2000).

[118] Fed. Sec. L. Rep. (CCH) ¶ 91,228 (2000).

[119] Id.

[120] Id.

[121] Id.

[122] Id.

[123] Id.

[124] Id.

at issue were either immaterial or reasonably based.[125] To this court, at least, the market reaction to the disclosures was largely determinative of both loss causation and materiality.[126]

A 2001 Fifth Circuit decision continues to demonstrate how the courts are having difficulty in isolating the various elements of a securities fraud claim, while differentiating between reliance, loss causation, fraud on the market and materiality.[127] In Nathenson, the Fifth Circuit held that because the market did not react to the defendants' alleged misstatements, the plaintiffs could not argue that they were entitled to a presumption of reliance based on a fraud on the market theory.[128] Such presumption of

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125 Id.

126 For more information regarding loss causation, see Semernko v. Cendant Corp., 223 F.3d165 (3d Cir. 2000); Greenwold v. Orb Communications, Fed. L. Sec. Rep. (CCH) ¶ 91,762 (S.D.N.Y 2002) (dismissing plaintiff's 10(b) and 10b-5 claim because there was no allegation that the defendant's misrepresentations caused the plaintiff's economic loss); Ramp Networks, Fed. L. Sec. Rep. (CCH) ¶ 91,753 (N.D. Cal. 2002) (holding that if damage is a foreseeable consequence of a misrepresentation, then the element of loss causation is satisfied); DamilerChrysler AG, Fed. L. Sec. Rep. (CCH) ¶ 91,776 (D. Del. 2002) (holding that plaintiffs adequately pleaded loss causation by claiming that plaintiffs were induced to sell their shares without receiving a premium that they would have been aware of but for the defendant's misrepresentations); Castellano v. Young & Rubicam, 2001 WL 815572 (2d Cir.) (holding that summary judgment was improperly granted in favor of defendant Young & Rubicam where a jury could find that its failure to disclose failed merger negotiations to a selling shareholder caused the shareholder's loss when the shares sold for twice after the subsequent recapitalization of Young & Rubicam); Polaroid Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,369 (D. Mass. 2001) (holding that plaintiffs failed to show loss causation because the drop in the defendant's stock price was unrelated to its early recognition of revenue in the company financials). The District Court of New Jersey followed these holdings in CyberShop.com, Fed. Sec. L. Rep. (CCH) ¶ 91,726 (D.N.J. 2002). The court dismissed the plaintiff's 10b-5 claim because there lacked a "causal nexus" between the issuer's allegedly misleading conduct and a measureable decrease in price. Id. See also Nike, Fed. Sec. L. Rep. (CCH) ¶ 91,698 (D. Or. 2002) (holding that the cautionary language following company officials' statements did not warn about important factors which could result in revenue losses, so that the statements were not within PSLRA's safe harbor); Rent-Way, Fed. Sec. L. Rep (CCH) ¶ 91,946 (W.D. Pa. 2002) (holding that stock decline was caused by revelation of fraudulent conduct).

See also In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,480 (S.D.N.Y. 2003) (holding that plaintiffs failed to adequately plead facts from which the court could conclude (i) that the alleged nondisclosures of conflicts of interest would cause the harm allegedly suffered by plaintiffs as a result of the bursting of the Internet bubble, or (ii) that the decline in the prices of stock was caused by any or all of the alleged omissions from the analyst reports); Kirwin v. Price Communications Corp., Fed. Sec. L. Rep. (CCH) ¶ 92,490 (M.D. Ala. 2003) (holding that plaintiffs failed to adequately plead that the allegedly misleading statements contained in an information statement sent to minority shareholders after the completion of a short-form merger perfected under Delaware law caused them to lose their minority interest in that same merger). Cf. Demarco v. Robertson Stephens, Inc., No. 03 Civ. 590 (GEL), 2004 WL 51231 (S.D.N.Y. Jan. 9, 2004) (holding that Robertson Stephens' publication of false research reports that allegedly distorted the market price of stock "contained the seeds of loss causation" and satisfied that requirement).

127 Nathenson v. Zonagen, Fed. Sec. L. Rep. (CCH) ¶ 91,548 (5th Cir. 2001). See also Crossroads Systems, Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 92,272 (W.D. Tex. 2002) (investors were not entitled to a presumption of reliance under a "fraud on the market theory" because the alleged misrepresentations were not shown to have any market impact on the company's stock price).

128 Id.

reliance may be rebutted where evidence shows that the market did not react to the alleged statements, as was the case here.[129] Note, however, that the court goes on to say that when the market does not react to the alleged statements, such statements are not material.[130] This decision is a classic example of how the courts are blurring the lines between causation, reliance and materiality.

In February 2003, the Ninth Circuit held that alleged misrepresentations were material despite the fact that the stock of the air carrier did not change immediately upon the disclosure of the company's problems.[131] Although the company's disclosure had no immediate impact, the stock price dropped 31% when the full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed. The court considered it significant that the company provided the market with false statements about the company's outlook, launching a campaign to secure favorable recommendations from analysts by misinforming them that the operations problems had been fixed, and representing that the improved financial returns were due to exceptionally efficient management, rather than unsafe maintenance practices. It also appeared as though the company overstated its operating income by underreporting maintenance and repairs expenses.[132] The court reasoned that as required under the PSLRA, the plaintiffs set forth adequate "corroborating details" and facts to support their allegations and adequately alleged scienter. The dissenting judge argued that the plaintiffs did not meet the stringent standards of the PSLRA and could not claim reliance because the lack of significant change on the stock price at the time of disclosure meant that the information disclosed was immaterial. The dissenting judge took issue with the majority opinion's statement, "In this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious to raise the bar of the PSLRA any higher than that which is required under its mandates," by writing, "There is no doubt that in this post-Enron era suspicions have been raised regarding corporate malfeasance and insider trading. But the law is the law. Under the [PSLRA], the burden to plead facts with particularity establishing a required element of materiality remains squarely on plaintiffs. Plaintiffs also maintain the burden to plead detrimental reliance."[133]

A number of decisions in late 2003 have added to an emerging split among the Circuits regarding the "loss causation" element of a securities fraud claim. In September 2003, the Second Circuit joined the Third and Eleventh Circuits in holding that loss causation requires the pleading of a causal nexus between the statements alleged to be

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129 Id.

130 Id. – See also the ABC Arbitrage decision discussed at nn. 89 and 93 and accompanying text.

131 No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., Fed. Sec. L. Rep. (CCH) ¶ 92,278 (9th Cir. 2003).

132 Id.

133 Id.

misleading and a decline in the value of a security.[134] In Emergent, the plaintiffs contended that defendant's misrepresentations concerning the size of another investor's stake in defendant, coupled with defendant's omissions concerning its CEO's ban from the securities industry, "induced a disparity between the price paid by plaintiff and for the [defendant's] shares and their true investment quality."[135] In other words, the plaintiffs plead a price disparity theory of loss causation. The Second Circuit, however, held that while misstatements and omissions artificially inflating plaintiffs purchase price may be sufficient to plead transaction causation, they are not alone sufficient to plead loss causation.[136]

The Second Circuit's decision in Emergent runs counter to decisions in the Eighth and Ninth Circuits, which addressed the issue of the price disparity theory of loss causation earlier in 2003.[137] Because the split among the Circuits concerns one of the core elements of a securities fraud claim, it is likely that the Supreme Court will eventually have to resolve this question.[138]

E. Summary of Disclosure Obligations

The cases summarized above demonstrate that the Supreme Court's adoption of a flexible and fact-specific approach to materiality in Basic affirms the traditional concepts of disclosure obligations under the federal securities laws. Plaintiffs still bear the burden of proving first, that the issuer had a duty to disclose, because it was either trading in its securities or had made prior inaccurate disclosures, and second, that the information allegedly misrepresented or omitted was material. Moreover, these decisions illustrate that Basic does not stand for the proposition that materiality is automatically a question

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134 Emergent Capital Investment Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003). See also Semerenko v. Cendant Corp., 223 F.3d 165 (3d Cir. 2000); Robbins v. Kroger Properties, Inc., 116 F.3d 1441 (11th Cir. 1997); In re DaimlerChrysler AG Securities Litig., ¶ 92,621 (Dist. Del. 2003) (denying defendants' motion for summary judgment after plaintiff offered sufficient evidence that as a result defendants' allegedly false characterization of a merger between Daimler and Chrysler as a "merger of equals," defendants avoided paying the control premium that would have been due for an acquisition of Chrysler); Druskin v. Answerthink, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92, 663 (S.D. Fl. 2004).

135 Emergent at 198.

136 Emergent at 199. See also Hon. Kenneth Conboy & Jeff G. Hammel, "Second Circuit Has Latest Word on Pleading 'Loss Causation,'" Sec. Litig. & Prof. Liability Practice 12 (4th Qtr. 2003).

137 See Gebhardt v. ConAgra Foods, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,445 (8th Cir. 2003) (finding that an allegation that plaintiffs "[paid] more for something than it is worth" is sufficient to plead loss causation); Broudo v. Dura Pharmaceuticals, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,474 (9th Cir. 2003) (The Ninth Circuit concluded that "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction. It is at that time that damages are to be measured. Thus, loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that a price at the time of the purchase was overstated and sufficient identification of the cause").

138 See Conboy at 14. For a thoughtful article concerning the developing split among the circuits, see Richard A. Rosen & Vanessa Richards, "A Defendant's Guide to Loss Causation," INSIGHTS, Feb. 2004.

for the jury. Courts have in the past removed the issue of materiality from the domain of the jury.[139] Some of the more recent decisions and the issuance of SAB 99, however, have prompted the courts to lean towards letting juries decide the materiality question.

The timing of "when" materiality should be determined has evolved into a central issue and a moving target for courts' differing views regarding this subject. It is time to revisit the role and definition of materiality.

III. DISCLOSURE OF GENERAL BUSINESS DEVELOPMENTS AND RISKS

A. Introduction

The principles of timely disclosure and materiality derived from Basic and the merger cases are equally applicable to other corporate developments, such as the onset of financial instability, difficulties with product introductions and transitions, and the potential need to write down major assets. The celebrated $100 million securities fraud verdict against two executives of Apple Computer, arising out of a controversial promotional program for two new products in 1982, served as a wake-up call to corporate officials. The message: decisions as to the timing and content of disclosure for all manner of corporate developments are fraught with risks which could result in personal financial liability.

Some of the important developments, discussed in detail below, include:

- Duty Not to Mislead. The Apple Computer case is illustrative of a number of federal cases in which plaintiffs have challenged issuers' disclosure of general business developments in executive news interviews, press conferences and releases, as well as annual reports, registration statements and the various periodic reports required under the Exchange Act. In several of these cases plaintiffs allege that management intentionally misled investors by failing to disclose difficulties, such as problems with new products or excessive inventory levels, when promoting these new products or making predictions or general optimistic statements about a company's future performance. Other cases allege a failure to adequately explain the financial significance of identified problems such as plant deterioration or obsolete products.

  As in the Basic progeny cases, the issue before the courts in these "duty not to mislead" cases generally is whether the defendants are entitled to an order of dismissal or summary judgment. Certain of these decisions suggest that, in

[139] As discussed below, some cases involving other business developments, such as product obsolescence or the difficulties of new product development, may reflect a tendency by the lower courts to leave questions of materiality for a jury. The issue in these decisions is whether omissions of negative developments could render other affirmative statements made by the defendants materially misleading.

light of the fact-intensive materiality analysis advocated by the Supreme Court in Basic, lower courts may be more hesitant to grant summary judgment or dismissal, especially where the issue is whether the alleged omissions would render other statements misleading. The Ninth Circuit's decision in the Convergent Technologies case, discussed below, proves that issuers can prevail in duty not to mislead and omissions class actions. It is still difficult, however, to provide clients with specific bullet-proof advice when preparing disclosure documents because there are so many cases in this area with such different results. More recently, the "Bespeaks Caution" cases, discussed below, indicate that issuers are successful in defeating such class actions if they have included specific cautionary language in their disclosure documents. The Reform Act, discussed below, attempted to even the playing field by restricting early stage discovery, revising the class-action rules by requiring stricter pleading and a higher degree of scienter as well as introducing a safe-harbor for certain forward looking statements.

- Projections. In 1994, the SEC considered material changes to its safe-harbor rules for forward looking information. This effort stalled, but Congress surprised everyone by adopting a safe-harbor for forward looking information in the Reform Act. This congressional effort was prompted by a series of cases by the plaintiffs' bar attacking general optimistic statements as somehow confirming specific prior projections that may have become unattainable. This congressional effort, moreover, was necessitated by the SEC's policy to encourage, and even to require projections, as in the MD&A, while at the same time refraining from adopting a meaningful safe-harbor rule. The Reform Act took its cue from the "Bespeaks Caution" doctrine that had developed to allow issuers to avoid liability for optimistic statements when accompanied with specific cautionary language. Despite these favorable developments, forward looking statements remain subject to attack by plaintiffs using 20/20 hindsight.

- Duty to Update. Another disclosure controversy involves the so-called "duty to update." A panel of the First Circuit Court of Appeals in the Polaroid case had suggested that during the period between interim reports issuers have a duty to update statements which, although accurate when made, become misleading due to subsequent developments.[140] This case must be distinguished from those decisions in which issuers are held liable for failing to correct statements which are false and misleading based upon facts and circumstances at the time of issuance. The panel's opinion in Polaroid was subsequently withdrawn and its findings were rejected by the full court. Nonetheless, issuers should be aware that two other decisions

[140] Backman v. Polaroid Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,899 (1st Cir.), opinion withdrawn, judgment of the court of appeals vacated, opinion en banc, 910 F.2d 10 (1st Cir. 1990), discussed infra Section III.F.1.

hold that issuers must continually update previously made forward looking statements. Hopefully, the cases that suggest there is a continual duty to update do not represent the law, as they contradict the traditional doctrine that issuers have no general obligation between interim SEC reports to disclose material facts. Indeed, the Reform Act implies that the duty to update no longer exists, and this view has been affirmed by the Seventh Circuit.[141]

- Analysts. Issuers also face certain risks when communicating with analysts. For example, selective disclosures to analysts may be viewed as unlawful tipping in violation of Rule 10b-5. Further, while a corporation generally has no duty to review or comment on analysts' reports, if the issuer chooses to review or correct drafts of reports or otherwise, the issuer may become "sufficiently entangled" with the analysts' statements so as to assume a duty to correct the statements. As a result of the 2002 SRO rules regulating analyst conduct and conflicts, there should be far fewer opportunities for issuers to comment on analyst reports prior to publication. A significant number of recent cases also charge that management misled the market by making overly optimistic statements on roadshows and to analysts. In fact, analysts themselves have been named as defendants. Moreover, with the recent enactment of Regulation FD on October 23, 2000, the selective disclosure of material information between the issuer and analyst is now prohibited as the rule promotes the dissemination of material information to analysts and the investing public simultaneously.

- MD&A Allegations. In light of the SEC's 1989 MD&A Interpretative Release emphasizing an issuer's quarterly disclosure obligations, the plaintiff's bar has added in a few cases allegations of inadequate MD&A to Rule 10b-5 actions. As of 2002, it is still unclear as to whether there is a private right of action for alleged deficient MD&A disclosure.[142]

- The Reform Act. In late 1995, Congress -- over President Clinton's veto -- adopted the Reform Act in recognition that the litigation explosion was, among other things, adversely affecting capital formation. The Act, as mentioned above, provides a safe-harbor for projections under certain

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141 Stransky v. Cummins Engine, Fed. Sec. L. Rep (CCH) ¶ 98,668 (7th Cir. 1995); Eisenstadt v. Centel Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,458 (7th Cir. 1997); but see Weiner v. Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶ 99,563 (3d Cir. 1997) discussed infra Section III.F.6.

142 Verifone, 11 F.3d 865,870 (9th Cir. 1993); Wallace v. Systems & Computing Technology Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,578 (E.D.Pa. 1997) ("It is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs."); Steckman v. Hart Brewing, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,205 (9th Cir. 1998) (a violation of Item 303 can support a claim under Sections 11 and 12(a)(2) of the Securities Act). For a further discussion of this issue, see infra Section IV, H.

circumstances, requires specific scienter, stricter pleading and discovery rules, new rules for class-actions and limits early discovery.

- Securities Litigation Uniform Standards Act of 1998. On November 3, 1998, President Clinton signed this Act into law, making federal courts the exclusive venue for most securities class actions.

Applying Rule 10b-5 to the above situations requires continuous rethinking. Simply the sheer number of cases--in many instances involving huge damage claims--is an indication that the system was (and may still be) broken. Rule 10b-5 is used to micromanage corporate disclosure rather than to control fraudulent conduct. The broad interpretations of Rule 10b-5 and the courts' bias in favor of letting juries decide disputed factual issues does not work in our current environment. The Reform Act was in fact designed to remedy this situation. This environment consists of:

- Volatile markets where stock prices are driven by a significant number of factors beyond issuer disclosure -- e.g., index funds, program trading, etc.

- Analysts have an extraordinary influence on stock prices--they can make or break a company's market price.

- There are, moreover, many different kinds of money managers who fall in and out of love quickly. These managers look to different types of information, e.g., growth versus value. In addition, there are "momentum" managers and, to counter them, "winner's curse" managers.

- Competitive influences, the quickness with which corporate developments occur and the stock market reaction to events are far more intensified than just a decade ago.

- Many of the claims involve companies who are on the frontier of technology where their market prices are almost wholly reflective of potential future success. If these companies fail to achieve their goals for reasons other than defective disclosure, their stock prices can plummet.

- I have cautioned issuers to make certain that public disclosure corresponds to internal memos. In practice, however, this is difficult to achieve because it is hard to review all internal memos each time a public disclosure is made and often internal memos are themselves inconsistent. E-mail and voice mail messages sent internally have compounded this problem. This is a leading reason for denial of a motion for summary judgment.

- We must also take into consideration the imprecision of the English language. Consider how many cases are won or lost on the basis of a few words taken from a dense disclosure document.[143]

- The information explosion -- both in terms of amount and real time -- creates more volatility than previously experienced. Regulation FD will most likely also add to market volatility.

- The release of statistical and economic information on almost a daily basis fuels market volatility and has produced a cottage industry that tries to predict what the Federal Reserve will do with interest rates based upon the economic data.

We are also involved in a never ending game of one-upmanship. The courts and Congress in 1995, however, have both explicitly and instinctively tried to limit the number of disclosure claims that survive motions to dismiss or motions for summary judgment. For example, in Central Bank the Supreme Court explicitly expressed the goal of narrowing the scope of actionable claims beyond the pleading stage.[144] Even before adoption of the Reform Act, the lower courts limited disclosure claims by applying the "Bespeaks Caution" doctrine,[145] holding that puffing does not constitute actionable conduct,[146] and requiring plaintiffs to plead with particularity.[147]

Each time a court establishes a gate, however, the resourceful plaintiffs' bar reacts by altering the scope of their claims. This is illustrated by a number of decisions issued in mid-1994.[148] In round one, the courts in Anderson v. Clow[149] and Ross Systems[150] dismissed plaintiffs' disclosure claims, with leave to amend some of the claims. In these cases, plaintiffs charged faulty predictions, false statements made on roadshows, to analysts and in investment publications. Plaintiffs attempted to avoid basing their claims on particular issuer representations and instead focused on the "fraud on the market" theory. The court explained the theory:

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143 See e.g., Virginia Bankshares, supra; see also Slip of the Tongue section supra.

144 Central Bank, N.A. v. First Interstate Bank, N.A., 114 S. Ct. 1439 (1994).

145 See e.g., Stac Electronic, Fed. Sec. L. Rep. (CCH) ¶ 99,272 (9th Cir. 1996); World of Wonder, infra.

146 See e.g., Jakobe v. Rawlings Sporting Goods, Fed. Sec. L. Rep. (CCH) ¶ 99,406 (E.D. Mo. 1996); Northern Telecom Ltd., Fed. Sec. L. Rep. (CCH) ¶ 98,390 (S.D.N.Y. 1994).

147 See e.g., Time Warner, infra; Morin v. Trupin, Fed. Sec. L. Rep. (CCH) ¶ 97,302 (S.D.N.Y. 1993).

148 It is interesting to note that many of these cases involve California high-tech companies and that only a few law firms are involved in a majority of the cases.

149 Fed. Sec. L. Rep. (CCH) ¶ 98,367 (S.D. Cal. 1994).

150 Fed. Sec. L. Rep. (CCH) ¶ 98,363 (N.D. Cal. 1994).

> In a fraud on the market case, the plaintiff claims he was induced to trade stock not by any particular representations made by corporate insiders, *but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information* (italics in original).[151]

On the heels of these decisions favorable to defendants came a number of unfavorable decisions involving very similar types of allegations--and thus began round two. Both Kaplan v. Rose[152] and Software Toolworks Inc.[153] reversed lower court decisions dismissing plaintiffs' claims on summary judgment motions. In Kaplan it was a sweeping reversal while in Software Toolworks only a few of many claims were sent back to the district court.[154]

In 2001, the Fifth Circuit considered a fraud-on-the-market theory case and held that the investors were not entitled to a presumption of reliance under the theory because the markets did not respond to the alleged misstatements.[155] Although the court conceded that there is a general presumption that potentially significant publicly disseminated information is reflected in the price of the stock traded in an efficient market, the presumption is rebuttable with facts that reflect that the alleged misrepresentations did not affect the price of stock.[156]

Not only is predictability impossible under these cases, but more importantly, from a counseling standpoint, those with the best intentions are doomed to failure since companies are dammed whether they disclose too much or too little--it is simply impossible to describe with 100% accuracy future plans and projections, and yet also describe all the potential pitfalls that exist both internally and externally.

We appear to be watching an old-time prize fight with unlimited rounds. Plaintiffs' pleadings move to a new level in response to favorable decisions. In Stark v. Present[157], for instance, we find essentially the same "fraud on the market" allegations in great detail including charts, tables, and extensive quotes from disclosure documents,

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151 Anderson v. Clow, supra, at ¶ 90,515, quoting Apple Computer, supra.

152 Fed. Sec. L. Rep. (CCH) ¶ 98,422 (9th Cir. 1994).

153 Fed. Sec. L. Rep. (CCH) ¶ 98,426 (9th Cir. 1994).

154 See O'Sullivan v. Trident Microsystems, Inc., Fed. Sec. L. Rep. (CCH) ¶ 98,116 (N.D. Cal. 1994), which is also representative of those decisions where defendants prevail on motions to dismiss with respect to almost all of the claims, but one or two claims sneak through, thus leading to a jury trial on the merits--or settlement. See also Seagate Technology II, infra.

155 Nathanson v. Zonagen Inc., Fed. Sec. L. Rep. ¶ 91,548 (5th Cir. 2001).

156 Id.

157 No. 94-5712 (C.D. Cal. filed Aug. 22, 1994).

press releases, and analyst reports; but we also see that the analyst is personally named as a defendant and the issuers' counsel is named as essentially a non-defendant aider and abettor.[158] The complaint is carefully crafted to avoid the pleading deficiencies in Anderson and Ross Systems. If the court reacts negatively to the plaintiffs' claims, we can be certain that a new form of pleading will eventually emerge.

The Reform Act seeks to improve the whole process and to encourage meaningful forward looking and honest disclosure without subjecting issuers to the sometimes devastating costs, disruption, and adverse market effect of suits that attempt to compensate investors for essentially market risks investors should assume. As of June 1999, it remains to be seen whether the Act will be successful.

B. The Duty Not to Mislead

When an issuer is required to disclose information under a specific line-item of a periodic report or if the issuer voluntarily addresses a particular development, it must disclose all facts necessary to make the disclosure accurate on its face and on the whole not misleading.[159] This "duty not to mislead" prohibits issuers from making unqualified statements regarding new products or business prospects where the issuer has identified specific adverse developments relating thereto. A wide range of disclosures can trigger this obligation to speak with complete candor.

Historically, courts have given issuers broad discretion in making general, positive public statements about the company's performance and new products, particularly outside of formal reports filed with the SEC. The Apple Computer case and several other cases discussed below indicated that the courts for a period of time took a harder line with respect to informal public statements previously considered innocuous "puffing." More recent cases, however, have retreated from the harsher standard prevalent in the late 1980's and early 1990's. Although the cases take varying positions on this issue, as a counseling matter, clients should be advised to use caution with respect to promotional disclosures.

Issuers should therefore scrutinize their promotional press releases and statements, focusing on the following key questions:

- Does the market understand the risks of the business including those inherent in new product development, the continued viability of old products, or the condition of property, plants and equipment?

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158 Id. Again the case is brought by a prominent plaintiffs' law firm. The decision to not name issuers' counsel as a defendant is most likely a reaction to the Supreme Court's decision in Central Bank.

159 Basic Inc. v. Levinson, 108 S. Ct. 978, 985 n.13 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)).

- Has the company identified any specific problems or difficulties--or has the company experienced similar difficulties in the past--which could diminish the prospects of the product or business development in general?

- Do the press releases and statements identify such potential risks and difficulties?

- Are the statements consistent with internal memorandum and reports on the product or business development?

- How transparent are the financial statements?

- Is MD&A robust?

If the answer to any one of these questions is "no," then those persons responsible for corporate disclosure should reassess the company's promotional statements to assure that they are accurate and not misleading in the totality of circumstances.

Another interesting aspect of these cases is their treatment of alleged omissions where plaintiffs assert a "fraud-on-the-market" theory of reliance. In one case, the court held that issuers need not disclose material information which is otherwise made available to the market from third-party sources. The court considered the market to be aware of facts disseminated with sufficient intensity and credibility by securities analysts and the press. Consequently, issuers may be excused from liability for omissions of those facts in a fraud-on-the-market case. On the other hand, some courts have indicated that the market considers management disclosure more credible than that of analysts and that analysts' discussions of general risks will not counter omissions by management of more specific information.

1. Apple Computer Securities Litigation

The relatively infamous case Apple Computer[160] illustrates the perils management faces when promoting new products. At issue were several optimistic statements made by executives of Apple Computer during 1982 in press releases and interviews about two new products which the company was readying for commercial release — a business computer named "Lisa" and a compatible disc drive named "Twiggy." An Apple press release introducing Twiggy claimed "[it] represents three years of research and development and has undergone extensive testing and design verification during the past year." The Wall Street Journal quoted Apple Chairman Steven Jobs as stating, "Lisa is going to be phenomenally successful the first year out of the chute."

During the period when Apple management touted its new products Apple stock soared to almost $63 per share. Twiggy, in fact, had several significant design problems

[160] 886 F.2d 1109 (9th Cir. 1989), cert. denied, Schneider v. Apple Computer, Inc., 110 S. Ct. 3229 (1990).

and was replaced before Lisa hit the market. Lisa proved to be a commercial failure and Apple eventually discontinued the product. When Apple's stock price plummeted to $17, plaintiffs brought a class action alleging that Apple's officers had misled the market about the capabilities and prospects of Twiggy and Lisa, recklessly ignoring problems which detracted from their public statements.

a. The $100 Million Jury Verdict

In May 1991, a jury in the federal district court in Northern California found the vice chairman of Apple and another former executive personally liable for approximately $100 million for securities fraud for their role in the company's promotional campaign for these new products. The jury ruled that the two executives had defrauded investors by recklessly misrepresenting through unqualified public promotional statements the capabilities and readiness of the Twiggy disc drive. In a truly inexplicable verdict, the jury actually exonerated the company of wrongdoing but found the two executives personally liable.

In September 1991, Judge James Ware set aside the jury's verdict as "confused" and "internally inconsistent." Judge Ware ruled that there was no substantial evidence that the two men knowingly or recklessly made any false or misleading statements. Judge Ware also rejected the plaintiffs' argument that the jury's verdict against the individual executives should be construed as a ruling against Apple. The jury verdict shows the vagaries of complex securities litigation. Although the Apple case has raised the consciousness and blood pressure of many corporate executives responsible for disclosure policy, the district court proceedings actually offer little guidance on disclosure issues.

b. The Prior Ninth Circuit Decision

As is typical of federal securities law class actions, the Apple case has a long and distinguished history. In an earlier decision in 1987, the district court had granted summary judgment for the defendants on all counts. On appeal, the Ninth Circuit upheld the lower court's grant of summary judgment with respect to Apple's statements about Lisa, but reversed the lower court with respect to Apple's statements about Twiggy. The Ninth Circuit remanded the case for the jury trial described above, at which the two Apple officials were found liable for securities fraud. The Ninth Circuit's opinion on the initial appeal is enlightening for its analysis of an issuer's disclosure obligations when promoting or "touting" new products, and accordingly merits a brief review.

i) Twiggy - Unqualified Public Optimism

The Ninth Circuit held that there was a triable issue as to whether information concerning technical difficulties with Twiggy, acknowledged in internal Apple reports, was material information which "undermined Apple's unqualified public optimism" and should have been disclosed. The court rejected Apple's contention that the market at large understood that any computer product

announced for future availability was in the development stage. The court found that reasonable investors could read Apple's statements to imply that Twiggy was complete, when in reality problems had arisen which would necessitate months of delay. Apparently, the jury on remand agreed, at least with respect to the individual defendants.

ii) Lisa - No Fraud on the Market

With respect to the alleged omissions regarding problems with Lisa, however, the Ninth Circuit affirmed summary judgment for Apple. The court found that extensive press coverage of the risks involved with Lisa shielded Apple from liability for its omissions regarding difficulties with the product. At the time Apple was touting Lisa, and often in the same articles where Apple's statements appeared, the press widely publicized Lisa's risks and underlying problems. Over twenty articles appeared in such publications as The Wall Street Journal and Business Week detailing Lisa's progress and potential difficulties. The court concluded:

> In a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.[161]

The Ninth Circuit stressed the limits of its holding in Apple, and indicated that an individual plaintiff who could establish actual reliance on Apple's statements promoting Lisa could have a claim under Rule 10b-5. Further, even where plaintiffs assert that an issuer committed a fraud on the market, press coverage generally will not substitute for corporate disclosures. The investing public places too much emphasis on statements made by corporate insiders. To counter failure by a corporation to disclose material facts, information must be otherwise conveyed to the public with "sufficient intensity and

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[161] Id. at 1115. In their petition for certiorari to the Supreme Court, plaintiffs asserted that this finding created a separate standard of materiality for fraud on the market cases. To the contrary, the Court's finding in Apple suggests that, even though omitted information may be material, plaintiffs cannot claim they relied on a defrauded market when the market possessed, and presumably the stock price reflected, the allegedly omitted information.

credibility."[162] The unique and sustained focus by the press on Lisa's risks in Apple met that standard.

2. Hanon v. Dataproducts Corp.

The case Hanon v. Dataproducts Corp.[163] is one of the most interesting of the business development cases since Apple Computer. In Hanon, the plaintiffs alleged that Dataproducts misled investors by improperly touting a new computer printer even though it was aware the printer had severe technical problems. Citing Virginia Bankshares, the Ninth Circuit confirmed that projections and statements of belief may be actionable to the extent that any one of three implied factual assertions is inaccurate: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement.[164] The Ninth Circuit was influenced by references in an executive's corporate diary detailing product reliability problems. The court found a triable issue whether the technical problems with the printer did undermine the optimism of the company's public statements. To this extent, the decision is an affirmation of the Apple Computer analysis.

The most interesting aspect of Hanon is the Ninth Circuit's denial of the plaintiffs' request for class certification due to his unique background and factual situation as a professional plaintiff in securities fraud "strike suits." The court ruled that Mr. Hanon failed to establish Rule 23(a)'s typicality requirements, noting:

> Hanon's reliance on the integrity of the market would be subject to serious dispute as a result of his extensive experience

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[162] Attempts by defendants to apply this analysis to support motions to dismiss have been unsuccessful and illustrate the potentially narrow application of this holding. In these cases, the courts have held that the question of whether information has been made available to the market from third party sources with "sufficient intensity and credibility" is a question for the trier of fact and, regardless, general third party information does not substitute for specific information that may be known only to an issuer. Ballan v. Upjohn Company, Fed. Sec. L. Rep. (CCH) ¶ 97,319 (W.D. Mich. 1992) (although the market may have been aware of certain side-effects of a particular drug, the disclosure by the company of specific test results could have significantly altered the total mix of information); Aldus, Fed. Sec. L. Rep. (CCH) ¶ 97,376 (W.D. Wash. 1993) (the market's general awareness of the age and characteristics of a computer software company's products did not necessarily absolve the company from liability for the failure to disclose specific problems with these products in the face of optimistic projections being made by the company and analysts about the company's prospects).

[163] Fed. Sec. L. Rep. (CCH) ¶ 97,021 (9th Cir. 1992).

[164] As authority for the proposition that projections and general expressions of optimism may be actionable under federal securities laws, the Ninth Circuit cited the U.S. Supreme Court's decision in Virginia Bankshares, Inc. v. Sandberg, 111 S. Ct. 2749 (1991) (knowingly false statements of reasons, opinions, or belief, even though conclusory in form, may be actionable as misstatements of material fact). The Ninth Circuit has held, however, that a prediction is not an "untrue" fact just because it subsequently proves wrong. Lyondell Petrochemical Company Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 97,335 (9th Cir. 1993) (internal projections are not inherently trustworthy and therefore, the mere possession of such projections does not make a contradictory public prediction false, unless such projections are based on undisclosed facts that contradict the prediction).

in prior securities litigation, his relationship with his lawyers, his practice of buying a minimal number of shares of stock in various companies, and his uneconomical purchase of only 10 shares of stock in Dataproducts.

The Ninth Circuit's decision clearly represented an attempt to stem the tide of securities fraud class actions that has swamped the federal courts after the Supreme Court's adoption of the "fraud on the market" theory of reliance.

3. Convergent Technologies Securities Litigation

The Ninth Circuit's decision of Convergent Technologies,[165] proved that issuers can win summary dismissal on a duty not to mislead action. In Convergent, the Ninth Circuit affirmed the company's motion for summary judgment against claims that the company misled investors by recklessly overstating and projecting growth in demand for its existing line of computer workstations and also by concealing known production and profitability problems with two new product lines under development.

a. Overstated Demand for Existing Products

Convergent's March 1983 Prospectus stated that its largest customer for its existing workstation had accounted for 48% of total revenue in 1982 and that the company expected that "[this customer] may continue to account for a similar percentage of revenue in 1983." Convergent's May 1983 10-Q reported first quarter growth in revenues due to increases in shipments to its large customers. However, on August 5, 1983, Convergent disclosed in a press release that due to customer anticipation of Convergent's next generation of products, third quarter sales would be flat and that fourth quarter revenues could fall off. After this release the stock price dropped $6.60 per share, nearly 20%.

The Ninth Circuit found that Convergent's March revenue projections were accurate at the time made and did not overstate workstation demand. The court rejected the claim that the company's accurate report of past performance and specific limited predictions somehow implied that the company's growth would continue at the torrid rate of past performance. Furthermore, the court found that the market clearly understood that Convergent could not maintain its past growth rates and that demand for its existing products would decrease as its new products became available. Therefore, the court held that the plaintiffs could not maintain this omission claim in a fraud-on-the market case.[166]

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[165] 948 F.2d 507 (9th Cir. 1991).

[166] The court cited with approval the district court's decision in Seagate Technology II, Fed. Sec. L. Rep. (CCH) ¶ 94,502 (N.D. Cal. 1989) ("technical obsolescence of computer equipment in a field marked by rapid technological advances is information within the public domain"). See also Lyondell Petrochemical Company,

b. Production and Cost Problems of New Products

Convergent's March 1983 Prospectus also announced efforts to develop a new laptop computer named "Workslate." The Prospectus noted several specific risks with Workslate:

> The development of these products is anticipated to be complex and to require the development of proprietary technology; accordingly, product introduction may be subject to delay, which may adversely impact the Company's ability to market these products. There can be no assurance that the Company will successfully complete the development of its new products, or that it will be successful in manufacturing the new products in high volume or marketing the products in the face of intense competition.

Convergent did encounter problems with Workslate and had to sell certain of those products at a loss. In an August 1983 Prospectus, the company repeated the risks described in its March Prospectus and added a litany of additional risk factors. Various internal company memos and projections during the Fall of 1983 detailed the problems hampering the Workslate program. In February 1984, Convergent revealed to analysts that Workslate had been prematurely released, needed redesigning and had been sold at a loss. The company's stock price fell an additional 17% and the plaintiffs filed their class action shortly thereafter.

The Ninth Circuit rejected the claims that Convergent had concealed from the market the various cost and production problems with Workslate. The court denied that Convergent's risk disclosures were too general and misleading. The court acknowledged that Convergent had at its disposal more detailed internal Workslate projections of negative performance, but denied that the company was obligated to disclose these internal projections. The court noted:

> It is just good general business practice to make such projections for internal corporate use. There is no evidence, however, that the estimates were made with such reasonable certainty even to allow them to be disclosed to the public.

Fed. Sec. L. Rep. (CCH) ¶ 97,335 (9th Cir. 1993) (an issuer's truthful statements about its past performance did not imply a comparison between the rate of past and future growth).

4. Seagate Technology II Securities Litigation

Another high-tech California case, Seagate Technology II,[167] demonstrated the difficulty in achieving bullet-proof disclosure. In this case, the plaintiffs alleged that defendants made several partially curative disclosures and thus artificially inflated the price of the stock. Seagate, a manufacturer of computer disk drives, dominated the 5 1/4" disk drive market throughout the 1980's. In 1988, due to industry conversion to 3 ½" disk drives, Seagate faced obsolescence of a principal product and substantial costs to retool for the newer models. Nonetheless, instead of fully disclosing "the truth concerning its financial condition and business prospects," plaintiffs allege that, starting with a press release on July 18, 1988, defendants began to make a series of "grudging admissions of certain adverse facts--no one of which was fully curative."[168] Full disclosure of financial problems was delayed until October 5, 1988, when Seagate issued a press release announcing a loss for the quarter ended September 30 and the resignation of two sales executives. Seagate's stock dropped from $22 per share on April 13, 1988, to about $7 per share following Seagate's October 5 press release.

Plaintiffs sued under Rule 10b-5 alleging that Seagate's fraudulent nondisclosures and their "grudging" partial disclosures distorted, to varying degrees, the price of Seagate common over the period of from April 13, 1988, to October 5, 1988.[169] The court granted partial summary judgment for the defendants, finding that any claims based on alleged affirmative misstatements by defendants could not succeed.[170] However, the court found that defendants might have misled investors through material omissions.

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[167] Fed. Sec. L. Rep. (CCH) ¶ 98,312 (N.D. Cal. 1994).

[168] Id. at ¶ 90,148.

[169] In the district court's decision, Seagate Technology II, Fed. Sec. L. Rep. (CCH) ¶ 94,502 (N.D. Cal. 1989), the court determined that Seagate accurately disclosed existing information regarding the product transition and the potential expenditures needed to produce the new models. The company had no obligation to characterize the difficulties as "a major threat to the future," nor was the company required to publicly denigrate its products in the manner suggested by plaintiffs.

The court also noted that the dangers of obsolescence of computer disk drives "in a field marked by rapid technological change, information is within the public domain and does not exclusively lie with Seagate." Ironically, in Apple, the Ninth Circuit rejected similar arguments that the market understood the risks inherent in the new product development of Twiggy. In Seagate, however, the alleged omissions related to general industry-wide risks involved in product transition, whereas the alleged omissions in Apple related to specific risks involved in the development of Lisa and Twiggy, unique products.

Notwithstanding that Seagate made extensive disclosure regarding the product transition and its effects on earnings, the court found that Seagate may have misled investors about demand for its products. Seagate failed to disclose in its quarterly reports that it was reducing prices as a strategy to increase sales and market share. The court also allowed discovery to determine whether Seagate knew that it had overestimated demand for its products, resulting in severe excess production capacity, before it announced record sales and expansion plans.

[170] The court relied on defendants' expert analysis which "conclusively shows that none of defendants' affirmative corporate disclosures caused a statistically significant variance in the price of Seagate stock." Seagate, Fed. Sec. L. Rep. (CCH) ¶ 98,312, at 90,167.

Defendants' motion for summary judgment relied on, among other things, the contention that defendants had no duty to disclose the alleged material information to the investing public. In response to defendants' contention, plaintiffs alleged that Seagate made statements which were materially misleading due to omitted information. While defendants argued that the statements were not misleading because they were "literally true," the court stated that this argument "misses the point." Citing Convergent Technologies, the court stated that:

> [T]he disclosure required by securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers.[171]

5. Gap Securities Litigation

Gap[172] is one of the few cases that focuses on inadequate MD&A disclosure. Plaintiffs alleged that The Gap's 1986 annual report contained an overly optimistic forecast of future performance and misled investors by omitting to disclose developments which would adversely affect earnings, including: (1) an adverse build-up of inventory, and (2) a declining trend in merchandise margins due to rising wholesale costs of imported goods. The plaintiffs maintained that those omissions were aggravated by The Gap's statement in the annual report that, "we can control our own destiny," regarding wholesale costs. Finally, plaintiffs alleged that The Gap had a duty to disclose in the MD&A of subsequent 10-Q reports the continued inventory build-up and the causes and trends of this build-up.

In September of 1987, after The Gap announced a 33% decline in third quarter earnings over the prior period, The Gap stock plunged $40, from $77 to $37 per share. The plaintiffs contended that The Gap elected not to disclose the negative trends in costs, sales and inventory in order to allow insiders to sell their stock at artificially-inflated prices.

a. Projections, Puffing and Explanations

The Gap had disclosed actual inventory levels in its 10-K and 10-Q filings. The court found that The Gap had adequately warned investors in its 10-K that "[if] inventory exceeds customer demand, . . . markdowns are employed to clear the merchandise. Such markdowns may have an adverse effect on earnings." The court also determined that the company had no further duty to make projections that the inventory build-up would continue or to specify that the higher levels of inventory did not mean higher sales. The court also declared that The Gap's "destiny" statement was mere "puffing," a vague expression of optimism as to future performance, and not actionable under the securities laws.

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171 Seagate, Fed. Sec. L. Rep. (CCH) ¶ 98,312, at ¶ 90,168.

172 Fed. Sec. L. Rep. (CCH) ¶ 94,724 (N.D. Cal. 1988), aff'd, 925 F.2d 1470 (9th Cir. 1991).

The district court also dismissed, but without prejudice, plaintiffs' claim that The Gap failed to disclose a deviation from its previously announced policy of marking down inventory when supply exceeded customer demands. The court noted that a failure to adequately explain any such deviation, delaying markdowns, may have artificially inflated second quarter earnings. Plaintiffs were granted leave to plead this claim with particularity.

b. Insider Trading

The district court also dismissed plaintiffs' insider trading claims against the individual Gap officers. The information on which the insiders allegedly traded was precisely the same information which plaintiffs claimed The Gap had a duty to disclose in its reports. Apparently, because The Gap had adequately disclosed this information, the individual defendants could not have traded on "inside" information. As for predictions of future performance, the court noted that "[a]n insider is no more required to predict future inventory levels or sales trends to prospective purchasers of Gap securities than is a corporation and its officers to the public."[173] The court never addressed whether the insiders may have improperly traded on the omitted information regarding the alleged deviation in markdown policy. Notwithstanding the dismissal of these claims, the existence of trading by insiders, even if innocent, probably colors the facts and subjects an issuer's statements to heightened scrutiny by the courts.[174]

6. Jaroslawicz v. Engelhard Corporation

Jaroslawicz v. Engelhard Corporation[175] illustrates that when an issuer does disclose adverse business developments, its discussion must be full and fair. Between 1982 to 1984, the Engelhard Corporation made several statements in annual and quarterly reports which, when compared to internal memorandum, painted a conflicting picture about the operational and economic health of two of its precious metals refineries (the Newark, New Jersey facility — also referred to as the "Delancy Street" operations — and the Sheffield facility, located in England). In April 1984, on the heels of its 1983 Annual Report, Engelhard announced a $36 million write-off with respect to the two refineries, sending the company's stock value down by 11%.

As for the materiality of the company's statements, the court first noted the importance Engelhard had attached to its refining operations. In its 1982 Annual Report, Engelhard had referred to refining as one of two "principal segments" of the company's operations. The court then undertook an examination of Engelhard's public disclosures

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173 Fed. Sec. L. Rep. (CCH) ¶ 94,724, at 93,911 (citing SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968)).

174 Under the Reform Act, plaintiffs are alleging the existence of insider sales to support their scienter claims. See Section III.C.4.

175 704 F. Supp. 1296 (D.N.J. 1989).

in contrast to the company's internal memos regarding its refining business, summarized on the following pages as follows:

PUBLIC DISCLOSURES	INTERNAL MEMORANDUM
1982:	**1982:**
First Quarter Interim Report to Shareholders:	**February—Study of Newark facility presented by Engelhard's CEO to the Board:**
The weakness in this quarter's results was the refinery business conducted in the Newark facility which has been operating at reduced levels because of the recession, particularly as compared to the first quarter of 1981 which benefited from business originating in 1980.	Describing that the Newark plant was in "a critical stage of deterioration" which "constituted an intolerable situation" and the almost $15 million anticipated loss for 1982 was caused by erroneous plant design, "inadequate" management, obsolete processes and technology, a lack of "commercial wisdom" regarding plant management and contracts, poor inventory control, environmental costs and "inexpert" staffing problems.
Second Quarter Interim Report to Shareholders:	* * *
During 1982's second quarter, we streamlined the operation of the Newark refinery to improve the efficiency of our refining business. Substantial reductions were made in the number of personnel at that facility as well as related service functions, and changes in processing techniques were implemented. The expenses associated with this program have, to a considerable extent been absorbed in this second quarter earnings, but the resulting profit improvements will become evident only in subsequent periods.	Citing a 1980 independent evaluation which stated at least $8.8 million would have to be spent to be an "absolute minimum for the efficient functioning of the refinery" and "for commercial viability under normal market conditions, further major capital expenditures would be called for."
	* * *
Annual Report to Shareholders:	

PUBLIC DISCLOSURES

. . . in response to the adverse impact of worldwide economic conditions . . . on the refining operations . . . a program to introduce cost-effective specialization and to streamline the organization of certain of our facilities was . . . substantially completed in 1982. The costs of this program have been partially offset by gains derived from the reduction of inventories as an integral of this effort.

1983:

A 10-A Report:

Solid earnings results were derived from the continuing strong performance of the Company's precious metal refining operations.

INTERNAL MEMORANDUM

Recommending that "certain operations" at Newark be terminated, reducing the number of employees from 410 to 225 by the end of 1982.

June 1982—REVISED REDEFINING OPERATING STRATEGY MEMORANDUM:

Setting out plans to reduce personnel to 60 by the end of 1982.

* * *

Noting "we must get relief!"

* * *

Containing plans to "phase out all refining operations . . . leaving only preparation and sampling" at the Newark facility.

PUBLIC DISCLOSURES

Annual Report to Shareholders:

In response to . . . worldwide economic conditions on the refining operations . . . a program to introduce cost-effective specialization and to streamline the organization of certain of our facilities was . . . substantially completed in 1982. The costs of this program have been partially offset by gains derived from the reduction of inventories as an integral of this effort.

* * *

Earnings from the Company's . . . refining businesses increased substantially over 1982 levels. While cost reduction and better processing techniques were the principal causes of the earnings improvement, still more efficiencies must be obtained from both our U.S. and European refining operations.

* * *

INTERNAL MEMORANDUM

December—Memorandum written by Engelhard's assistant controller recording a meeting between their accountants and the Controller of Engelhard:

Determining that "the approximately $18 million of nonrecurring losses resulting from programs to streamline and introduce specialization at Newark and Sheffield" are to be offset by sales from inventory and concluding that nondisclosure of this measure was not "misleading with respect to ongoing operations."

* * *

Stating that "it was pointed out that disclosure of the magnitude of the refinery losses could lead to even more severe predatory practices by our competitors with adverse consequences for our stockholders" and "that it was decided ... that it was appropriate to bring [illegible] the world-wide [illegible] of refining activity and the changes made by Engelhard to the attention of the annual report readers . . . ."

A letter from Engelhard's General Counsel:

Stating that the Company had decided to suspend one of Sheffield's "circuits" in late 1982 (one-third of the facilities operations).

PUBLIC DISCLOSURES

Performance in 1983 benefited significantly from the cost reductions achieved through the restructuring of domestic refining operations in 1982. In 1983, the Company commenced a similar program at certain European refining operations, which should benefit future operating results beginning in 1984 . . . .

* * *

In addition, business conditions of our English precious metal chemical operations improved, although English and Italian metallurgical operations were adversely affected by weak local demand . . . .

* * *

INTERNAL MEMORANDUM

1983:

August—Memorandum by Coopers & Lybrand manager in charge of Engelhard's audit, regarding meeting with management relating that:

The meeting was held at Engelhard's request and related to the Company's proposed treatment of a write-down of certain P.P.&E. [Plant, Property & Equipment] at Delancy Street . . . .

* * *

We were informed by Isko that the Company intends to have an appraisal of the going concern value of the refining operations performed as a basis to recover a write-down of the P.P.&E.

We agreed that a write-down was appropriate . . ..

. . . Isko expressed his concern about the adverse impact of a Delancy Street write-down on the trend of earnings. He further stated that the write-down is a recognition of in appropriate decisions made by predecessor management . . . He requested our assistance to conceptualize a manner by which the impact of the write-down would not affect the earnings trends . . . .[176]

[176] Despite the manager's repudiation of the contents of this memorandum at trial and other testimony contradicting the memorandum's conclusions, the Court used this evidence to hold that a jury could find that Engelhard pre-planned the April 1984 write-down. The Court denied summary judgment on this matter stating that the accuracy of this accountant's portrayal of the meeting was a triable issue of fact.

PUBLIC DISCLOSURES	INTERNAL MEMORANDUM
Profit from precious metal . . . operations and related refining in Europe grew over last year as these businesses posted increased sales.	**December—Internal Management Memorandum:** Stating that "at meetings on October 13th and 14th it was decided that we should close the Sheffield site in two phases." * * * Proposing a timetable to announce unemployable workers, a union settlement, clean-up of inactive equipment, and a reduction in the remaining two operating circuits; one circuit to reduce tonnage from 80 tons to zero, and the other to decrease from 47 tons to two. **Management Testimony:** By the end of 1983 the majority of the Newark operations had ceased. * * * Capital Expenditures at Newark went from $5.58 million in 1981 to $0.68 million in 1983 and capital expenditures at Sheffield had decreased from $1.81 million in 1981 to $0.94 million in 1982.

On the basis of the above, the court held that a reasonable jury could find Engelhard's behavior reckless and in violation of Rule 10b-5.

The Engelhard decision teaches two important lessons. First, Engelhard demonstrates an issuer's duty not to mislead. The inconsistency of the company's public disclosures with Engelhard's internal communications and actions taken by management clearly suggests that Engelhard's disclosures may not have reflected the reality of the situation at the refineries. The company's statements in its Annual and Interim Reports acknowledging difficulties with the refineries pointed investors in the wrong direction, suggesting that the company had successfully implemented corrective measures. The disclosures also blamed industry conditions for problems specific to Engelhard's operations.

Second, Engelhard used standard boiler-plate language to describe its plants and other facilities in answer to Item 102 of Regulation S-K ("Description of Property"). Engelhard's 10-K Report for the period ending December 31, 1983 stated:

> The Company's processing and refining facilities, plants and mills are suitable and adequate and have sufficient capacity for its normal operations. Overall, these facilities were substantially fully utilized during the year, except for excess capacity in certain of the Company's refining facilities.

Engelhard made this exact same statement on March 31, 1984, only five days before they announced the write-down of the refineries. Too often issuers simply carry forward these types of statements from previous reports without examining them with an accurate eye. Issuers instead should compare these and other disclosures to the current state of affairs to insure that they provide investors an accurate impression of the company's business and financial condition.

The inconsistent internal document problem examined in the 1989 Jaroslawicz decision has continued to be an issue through the late 1990's. A 1998 decision reasoned that:

- Pre-merger disclosures concerning production problems that are inconsistent with a company's internal information, in addition to a motivation to conceal those problems in an attempt to make a merger attractive to another company, is sufficient to raise an inference of scienter.[177] (Emphasis added.)

C. Use Of Forward Looking Statement Information

Until the 1970's, the use of forward looking disclosure was essentially outlawed. Because of the importance of predictive information and its existence -- and indeed use in private placements -- it has gradually become not only allowable but encouraged.

But even with this more hospitable environment, except in self-dealing transactions, such as going private transactions, formal line-by-line projections are overwhelmingly not used in public disclosure or SEC filings.[178] This is primarily attributed to the wave of securities fraud class-action suits challenging even the slightest misstatement regarding predictive expression.[179] Prompted by the developments discussed below, however, softer forward looking information -- "The Company expects to exceed last year's record sales" -- is being used more often in non-Securities Act registered offerings.

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[177] Boeing, Fed. Sec. L. Rep. (CCH) ¶ 90,285 (W.D.Wa. 1998).

[178] But see CUNO, Information Statement (Form 10), Sept. 6, 1996, pp 25-27.

[179] Christie Harlan, SEC Seeks To Beef Up "Safe Harbor" Provision, Wall St. J., May 17, 1994 (noting that of 218 companies responding to a Journal Survey, more than one half indicated that the prospect of shareholder litigation affected the dissemination of forward-looking information).

1. Pre 1994 Decisions

A flood of cases challenging the propriety of certain projections and other generic expressions of optimism proved that, under the current disclosure regimen, issuers are "damned if they do and damned if they don't" make predictive statements.[180] The cases suggest that any optimistic statement by management may be construed as a present reaffirmation of formal projections previously supplied by the issuer. Unfortunately, management cannot simply ignore the future. As construed by the SEC, the MD&A requirements force issuers to look into the future on a quarterly basis and discuss known trends and uncertainties and other prospective information that management expects may impact the company. These cases illustrated that the securities markets and the plaintiffs' bar will concede no margin of error for these predictive statements.

a. Roots Partnership v. Land's End, Inc.

The case of The Roots Partnership v. Land's End, Inc.,[181] illustrates how critical it was that an issuer's public predictions comport perfectly with its internal projections. In Land's End, the plaintiffs challenged the propriety of a series of public statements and releases confirming that the company was "confident" it would achieve its goal of a 10% pretax return on sales in 1990, made at a time when the company's internal projections estimated a 9.9% pretax return. In December, 1989, after Land's End announced poor earnings for 1990 and a pretax return of as low as 8.3%, the company's stock price fell almost 50%.

The Seventh Circuit affirmed summary judgment for the defendants, ruling that the company's predictive statements fell within the safe harbor of Rule 175. The court noted that:

> The simple allegation that Land's End's internal earnings deviated slightly from its stated goals does not in itself suggest the goal fell outside the realm of reasonable probability and therefore lacked a reasonable basis.

The court also rejected the plaintiffs' claims that Land's End should have disclosed problems of slackening demand, obsolete inventory, low-margin liquidations and declining profit margins. Plaintiffs failed to establish that these alleged problems were so significant that they jeopardized the possibility of attaining the 1990 goal.

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[180] See Bruce A. Mann, Reexamining the Merits of Mandatory Quarterly Reporting, Insights, Apr. 1992, at 3, for a thought-provoking essay regarding the current regulatory scheme. See also John F. Olson and D. Jarrett Arp, Current Issues in the Use of Forward-Looking Information, Northwestern University School of Law, 22nd Annual Securities Regulation Institute (January 1995) for a detailed discussion of disclosure and forward-looking information.

[181] Fed. Sec. L. Rep. (CCH) ¶ 96,633 (7th Cir. 1992).

b. Sun Microsystems, Inc. Securities Litigation

Sun Microsystems, Inc.[182] demonstrates the danger in confirming earnings forecasts if the company's internal reports discredit such forecasts. On May 1, 1989, Sun estimated fourth quarter earnings of 33¢ per share (identical to the previous year's fourth quarter). Sun also stated its "hope" that this figure could possibly increase. Sun's stock plummeted one month later, after the company announced a decline in net income for the fourth quarter and a possible loss for the year. The plaintiffs alleged that Sun failed to disclose the risks and financial impact of an MIS conversion program and new product introduction, and a decline in bookings during the third quarter. Sun also allegedly disregarded these problems when it made the fourth quarter projections. Plaintiffs produced evidence that at the time these statements were made, the company was supplying its banks different, more accurate information and a pessimistic earnings projection.

The court applied an analysis derived from the Apple Computer case, whereby projections are actionable only if any one of three implied factual assumptions is proven inaccurate: (1) that the projection is genuinely believed; (2) that there is a reasonable basis for that belief; and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. The court found that Sun had properly disclosed both the collapse of its computer system and the risks of the transition to new products. However, the court denied summary judgment for Sun because there was a triable issue whether defendants knew that Sun would not meet its fourth quarter targets, and whether defendants were at least reckless in making the projections based on the available information.

c. Kirby v. Cullinet Software, Inc.

The decision in Kirby v. Cullinet Software, Inc.[183] illustrates the importance of fair disclosure when making voluntary statements about future performance. The court in Kirby found that Cullinet Software misled investors by affirming, in a press release and at a meeting with market analysts, prior positive projections regarding sales growth and operating margins which the company knew were unreliable. In a confused analysis, the court also implied that Cullinet had an independent duty to update the earlier projections once the company knew that it could not meet the forecasts.

i) Projections and PROJECTIONS

> On May 30, 1985 Cullinet Software stated in a press release that, while it was too early to be sure, Cullinet expected growth of 30% to 40% in its first fiscal quarter for 1986 and that the company expected to meet its traditional operating margin of

[182] Fed. Sec. L. Rep. (CCH) ¶ 95,504 (N.D. Cal. 1990).

[183] 721 F. Supp. 1444 (D. Mass. 1989).

20%. In a June 17 press release Cullinet announced 50% growth for fiscal 1985 and also expressed confidence it would "continue to exceed industry growth rates" in fiscal 1986. At the time Cullinet issued this second press release, the company's internal figures for the first half of the first quarter of 1986 revealed sales at about one tenth of those necessary to achieve the 30% growth rate projected in the May 30 release.

Cullinet's Chairman compounded his problems in a meeting with market analysts on July 18. Without mentioning the disappointing first quarter sales figures, he stated that although he was not making a forecast, he felt comfortable with 30% to 40% growth for the year. He also indicated that the traditional 20% operating margin was "sacred." On July 18, Cullinet needed $24 million in additional sales by month end to reach the 30% growth mark for the first quarter; $10 million in sales more than predicted for the entire month.

After the company announced preliminary first quarter results on August 6, estimating an increase in revenues of only 4% and operating margins at 14%, the stock price fell from $24 to $18 per share. Plaintiffs sued alleging that Cullinet's May 30, June 17 and July 18 statements constituted a common course of fraudulent conduct designed to inflate the price of Cullinet's stock in violation of Rule 10b-5. Cullinet moved for summary judgment.

ii) Duty Not to Mislead

With respect to the May 30 release, the district court held that plaintiffs did not offer sufficient evidence to establish that the initial projections for the first quarter of 1986 lacked a reasonable basis or were reckless when made. The court granted summary judgment for Cullinet with regard to this claim.

The court, however, denied Cullinet's motion for summary judgment with regard to the June 17 and July 18 statements forecasting 30% to 40% growth and 20% margins for fiscal 1986. The court stated that the evidence was sufficient for a jury to infer:

> that by June 17, 1985, Cullinet knew or should have known that the projection [of 30% to 40% growth and 20% margins for the first quarter of 1986] would not be achieved, that Cullinet then had a duty to correct the projection or, in any event, had a duty not to make statements which while not literally false would convey the misleading

> impression that the recent promising prediction remained reliable.[184]

The court specifically determined that Cullinet had crafted its public statements to avoid any specific mention of the first quarter prospects thereby reinforcing the notion of short-term growth. To avoid misleading investors, the June 17 and July 18 statements should have discussed the adverse developments and the company's shortfall in sales for the first quarter of 1986.

iii) Duty to Update

The district court persuasively reasoned that Cullinet may have violated the duty not to mislead. Unfortunately, the opinion also suggested that Cullinet had an independent duty to correct or update the May 30 projections once it understood that they had become unreliable. The court makes reference in the opinion, no less than six times, to an obligation to "update."

Cullinet's obligation to discuss the May 30 projection arose only from its subsequent statements which, according to the court, gave the misleading impression that the May 30 projection remained attainable. Had Cullinet not issued the June 17 and July 18 statements, the company would have had no duty to update the May 30 projection merely because subsequent developments proved it unreachable. Hence, a finding of a separate duty to update is inappropriate and arguably dicta. Hopefully, other courts and commentators will not interpret this case as imposing a continual duty to update material developments.[185]

2. SEC Efforts to Adopt a Stronger Safe-Harbor Rule

The SEC made an effort to promote more forward looking information through its emphasis on MD&A and its "Concepts Release on Safe Harbor for Forward-Looking Statements"[186] ("Concept Release") issued in 1994 designed to improve its 1979 safe-harbor rules -- Rules 175 and 3b-6. The Concept Release included eight alternative proposals to the safe-harbor rules and solicited comments on over 70 questions. Despite the large number of alternative proposals and widespread support for expanding the safe-

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[184] Id. at 1454.

[185] Unfortunately, the concept of a "duty to update" is still alive, but may disappear. For a more detailed discussion of the duty to update, infra Section III.F.

[186] Rel. Nos. 33-7101; 34-34831; 35-26141; 39-2324; IC-20613 (Oct. 13, 1994), 26 Sec. Reg. & Law Rep. 1405 (Oct. 21, 1994) (the "Concept Release").

harbor rules, during 1995 it became clear that the SEC would not act on this issue and legislative activity replaced the SEC initiative.

In the late 1970's, the SEC designed the safe-harbor rules to protect companies that voluntarily disclosed forward looking information from fraud claims unless the projections made were "without a reasonable basis or was disclosed other than in good faith."[187] Companies, however, have found that the safe harbor "doesn't work in practice."[188] Companies have curtailed the information they provide about future performance because the safe harbor was not so safe.[189] Consequently, in 1994 the SEC issued the Concept Release soliciting comments on possible reforms to the safe harbor rules. The various reform proposals from both the private and public sector are discussed below. The primary issue to focus on when reading these proposals is whether they effectively balance the goal of encouraging broader dissemination of forward looking information to the investing public without compromising investor protection by sanctioning fraudulent or recklessly prepared forecasts.

The Concept Release is still worth reading even after adoption of the Reform Act since (i) many of the proposals were endorsed by the Reform Act, (ii) the Reform Act expressly encourages the SEC to adopt additional safe harbor rules and (iii) the last chapter on this subject has not been written. The Concept Release traces the history of the Commission's prohibition against the use of projections (pre-1970's), through the Wheat Commission and Advisory Committee on Corporate Disclosure Reports (1969 and 1976) to the adoption of the Safe Harbor Rules (1979). It also discusses the 1989 Interpretive Release, qualitative performance, the courts' approaches toward liability for forward looking statements, and the criticisms directed toward the Safe Harbor Rules because of their under-inclusiveness, lack of judicial support -- or even recognition --, failure to deal with whether a duty to correct or update exists and how they apply to disclosures to analysts, on roadshows, or otherwise. The Concept Release then describes eight alternative proposals that had been advanced, which are described below. It concluded by soliciting public comments in a series of approximately 70 questions and announced that public hearings would be held in February 1995.

a. The Alternative Proposals

The eight proposals submitted to the Commission were:

i) Commissioner Beese's Proposal: The Business Judgment Rule

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187 The safe harbor rules -- Rule 175 under the Exchange Act and Rule 3b-6 under the Securities Act -- are 17 C.F.R. §230.175 (1994) and 17 C.F.R. §240.3b-6 (1994) (the "Safe Harbor Rules").

188 Christi Harlan, SEC Seeks to Beef Up 'Safe Harbor' Provision, Wall St. J., May 17, 1994, at C1.

189 According to the Wall Street Journal article, a recent survey by the American Stock Exchange showed that "more than half of the 218 companies responding said that the prospect of shareholder litigation affected the dissemination of forward-looking information." Harlan, supra Section III.C.

Commissioner Beese gave two reasons why companies were unwilling to use the safe harbor rules. First, the safe harbor rules covered only written statements contained in documents filed with the Commission.[190] The safe harbor rules thus did not cover a company's conversations with analysts, where projections are most often communicated. Second, the safe harbor rules failed to keep the company out of extensive and expensive litigation once a plaintiff filed a suit and commenced discovery. No matter how good an issuer's defense, it was still cheaper to settle.

Commissioner Beese proposed that the SEC improve the safe harbor rules by adopting the business judgment rule to govern projections and other forward looking information provided by corporate officers. In addition, oral, as well as written, statements would be covered by the new rule.

The business judgment rule gives directors great latitude to oversee the corporation provided that they adopt courses of action which the directors, in good faith, honestly and reasonably believe will benefit the corporation. In the case of providing forward looking information voluntarily, Commissioner Beese proposed that the SEC allow corporate officers similar leeway to make good faith mistakes.

An integral of Commissioner Beese's proposal was to have issuers create a projection binder at the time of the preparation of its projections. This binder would "reflect the data underlying the projections, as well as the steps taken by management to analyze this data."[191] If the issuer was subsequently sued, the projection binder would be turned over to the plaintiffs, who would have the burden to prove why the projections lacked a proper basis at the time of disclosure.[192] Unless plaintiffs could show the judge that additional discovery was warranted, there would be no further discovery. The judge could allow the action to move forward only if plaintiffs could demonstrate that some potential deficiencies existed. Thus, judges could make an early disposition of the case before issuers faced the threat of extensive and costly discovery.

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190 Tools for Executive Survival Program, Luncheon Address by J. Carter Beese, Jr., Commissioner, Stanford University, Palo Alto, California, June 15, 1994.

191 Id. at 17.

192 Id.

The business judgment safe harbor rule would cover projections and other forward looking information. Moreover, the rule would demand that officers gather and analyze sufficient information to justify their positions.

ii) The "Opt-In" Proposal

From the private sector, Harvey Pitt and Karl Groskaufmanis also proposed changes regarding the safe harbor.[193] Their proposal consisted of four components:

> First, companies planning to take advantage of the rule should be required to opt affirmatively for a so-called "safe-harbor regime." Companies making such an election would disclose their intention not only to make forward looking statements, but also to update those statements periodically. Once a company opted in, it would be obligated to continue to make projections for a minimum of four quarters.
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> Second, any company opting to cease disclosing forward looking should be required to give notice thirty days before its next periodic filing with the Commission. In addition, these issuers would be required to detail the reasons for this change in policy (and would be precluded from opting back into the regime for another year) . . . A company's announcement of the reason or reasons for withdrawing from the program would not, of course, be subject to any Safe Harbor.
>
> Third, . . . projections [would be required to have] an adequate basis in fact, be issued in good faith, and be consistent with any similar forward looking information utilized by the company or supplied to its financial advisors, lenders, management or members of its board of directors. The SEC could bring an administrative cease-and-desist proceeding, or an injunctive action, for any projection found to have been issued in bad faith or without a reasonable basis in fact. The Commission could seek disgorgement, restitution and/or civil fines from issuers who do not meet that standard. Any company found by the Commission to have issued its projections without an

[193] Harvey L. Pitt, Karl A. Groskaufmanis & M. Gilbey Strub, Toward a 'Real' Safe Harbor For Forward-Looking Statements: A Reassessment of SEC Rule 175, 866 PLI Corporate Law, 671 (November, 1994).

adequate basis, or in bad faith, would be barred from re-opting into the Safe Harbor regime for a five-year period.

Fourth, for any company opting into the Safe Harbor regime, its projections could not constitute a false or misleading statement, or the omission of a material fact, for purposes of any private action, express or implied, under the federal securities laws . . . mean[ing] that, to the extent enforcement of the law occurs with respect to projections, it would occur solely at the behest of the Commission.[194]

iii) "Seasoned Issuer" Proposal

Under this proposal, an issuer would be precluded from private actions for oral and written forward looking statements with respect to securities quoted on Nasdaq or listed on a national securities exchange; and, if the issuer had filed all reports required under §§ 13, 15(d) of the Exchange Act within six months prior to the making of the statement. This proposal contained two exclusions from the safe harbor protection: (1) the inapplicability of the proposed safe harbor to penny stock issuers; and (2) the exclusion of issuers previously convicted of securities law violations or issuers subject to any securities-related injunction within the previous five years.

iv) "Heightened Definition" Proposal

Under this proposal, liability would be imposed only if a misstatement or omission was material, made or omitted with scienter and, for private plaintiffs, relied upon. There would be no attribution to the issuer of statements made by third parties unless the issuer expressly endorsed or approved of the statement. Furthermore, an issuer would not have a duty to update a forward looking statement unless it expressly undertook to do so at the time the statement was made. The proposed safe harbor would expressly extend to both qualitative and quantitative statements of management's plans and objectives for future operations.

v) "Bespeaks Caution" Proposal

This proposed safe harbor,[195] available to reporting companies (except penny-stock issuers), would protect a forward

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194 Id. at 678.

195 This proposal, submitted by Professor John Coffee, would codify a variant of the "Bespeaks Caution" doctrine, discussed more fully supra Section III.E.

looking statement so long as it contained "clear and specific" cautionary language that was sufficient to inform a reasonable person of the approximate risk associated with the statement and its basis. Oral or written forward looking statements that had not been filed with the Commission would be protected only if it had been reaffirmed in a filed document or an annual report which was made publicly available within a reasonable time after the statement was first disseminated. The forward looking statement did not need to have a "reasonable basis" (as under existing Rules 175 and 3b-6). Finally, qualifying forward looking statements made in Exchange Act filings would be exempted from automatic incorporation by reference in Securities Act filings unless registrants affirmatively sought inclusion, in which case existing Rule 175 would remain available.

vi) "Fraudulent Intent" Proposal

A forward looking statement would be protected unless recklessly made or with an actual intent to deceive. To prove recklessness, the plaintiff would be required to prove that at the time the statement was made, the issuer was aware of facts that made it "highly unlikely" that the projections could be achieved.

vii) "Disimplication" Theory

Professor Joseph Grundfest proposed that the Commission redefine the elements of a private claim under Rule 10b-5 to afford projections greater protection. He suggested that Rule 10b-5 should be amended to require a showing of "knowing securities fraud," demonstrating "actual knowledge that the [projection] is false," as a precondition for private recovery in a Rule 10b-5 action complaining of a falsely optimistic projection.

viii) "Reasonable Basis In Fact" Proposal

Under this proposal, the safe harbor would protect oral or written forward looking statements, whether or not filed with the Commission, unless the statement was made without a reasonable basis in fact, was seriously undermined by existing facts, was not genuinely believed or was made other than in good faith.

b. What Happened to the Concept Release?

Notwithstanding the large number of alternative proposals and the widespread support for expanding the Safe Harbor Rules, the SEC tabled the proposal. Observers indicated that the SEC's inaction during the eight months after the Concept Release was issued in October 1994 was the result of strong differences of opinion within the

Commission on two primary issues: (1) whether a safe harbor should limit private remedies and (2) what type of information should be covered in a safe harbor.[196] Questions were also raised about the agency's authority in the area of forward looking information.[197]

3. Post 1994 Decisions

The courts have recently rendered decisions which help minimize exposure resulting from the use of forward looking statements. For example, in Herman v. Legent Corp., Thomas Herman, representative for a class of investors in Legent Corporation, brought a "fraud on the market" securities fraud class action, alleging that Legent made a series of fraudulent public statements about its future performance that inflated the value of Legent's stock over a six-month period. On appeal, the Fourth Circuit held that the statements of future performance were not fraudulent.[198]

On its face, the opinion seems to restrict the scope of securities fraud in actions pertaining to public predictions of future performance. The court proclaims that statements regarding projections of future performance are actionable under Section 10(b) and Rule 10b-5 only if they are supported by specific statements of fact or are worded as guarantees. The "specific statements of fact" would have to be extremely specific to qualify, such as statements referring to specific business projects. Otherwise, such "soft, puffing statements" involving optimistic opinions or predictions of future performance are not material, and thus not actionable as a matter of law.[199] Companies are to be given freedom to prognosticate.

Other courts have relied on the "Bespeaks Caution" doctrine to dismiss claims based on faulty projections. In Saltzberg v. TM Sterling/Austin Assoc., Ltd., another Court of Appeals affirmed the grant of summary judgment to defendants under the "Bespeaks Caution" doctrine. The court noted that "when a offering documents' projections are accompanied by meaningful cautionary statements with specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law."[200]

Many other recent decisions were unsympathetic to suits claiming the use of false or misleading forward looking information. Various reasons were used to support

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196 SEC's Safe Harbor Initiative May Be Overtaken by Litigation Reform, 27 Securities Regulation & Law Report 939 (June 23, 1995).

197 Id.

198 Fed. Sec. L. Rep. (CCH) ¶ 98,650 (4th Cir. 1995).

199 See also San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Companies, Inc., 75 F.3d 801 (2d Cir. 1996).

200 45 F.3d 399, 400 (11th Cir. 1995).

dismissals of such claims: the statements were too vague to be material[201]; the statements merely expressed general enthusiasm or non-actionable puffing[202]; the forward looking statements had a reasonable basis[203]. As is always the case, however, some courts have upheld complaints based on allegations similar to the ones which other courts have dismissed.[204]

4. The Private Securities Litigation Reform Act of 1995

December 1995 was a month of high drama for securities professionals. Congress passed the Reform Act and sent it to the White House. Most observers thought that President Clinton would sign the legislation, but at the last minute he vetoed it.[205] Both Houses quickly overrode the veto and the Reform Act became law before the end of the year.[206] According to the Conference Report ("Report"), Congress sought to limit abusive, manipulative and frivolous securities litigation and "to protect investors, issuers and all those who are associated with our capital markets."[207] The Reform Act operates on a number of levels:

- Class action procedures, including the mechanics of settlement, have been significantly tightened.
- A system of proportional liability has in many instances replaced joint and several liability.
- Pleading standards have been raised, especially those regarding "state of mind allegations", i.e., scienter.
- In certain circumstances, discovery has been limited.

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201 Searls v. Glasser, Fed. Sec. L. Rep. (CCH) ¶ 98,867 (7th Cir. 1995); Siegel v. Lyons, Fed. Sec. L. Rep. (CCH) ¶ 99,227 (N.D.Cal. 1996).

202 Fishbaum v. Liz Claiborne, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,676 (2nd Cir. 1999); Lasker v. New York State Electric & Gas Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,231 (2nd Cir. 1996); Jakobe v. Rawlings Sporting Goods Co., Fed. Sec. L. Rep. (CCH) ¶ 99,406 (E.D. Mo. 1996); Robbins v. Moore Medical Corp., Fed. Sec. L. Rep. (CCH) ¶ 98,902 (S.D.N.Y. 1995).

203 Healthcare Compare Corp. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 99,012 (7th Cir. 1996); Cyress Semiconductor Securities Litigation, Fed. Sec. L. Rep (CCH) ¶ 98,762 (N.D. Cal. 1995). See also Eisenberg, Securities Litigation - Courts Are Increasingly Willing to Dismiss Weak Claims, INSIGHTS, September 1994.

204 E.g. Valence Technology, Fed. Sec. L. Rep. (CCH) ¶ 98,793 (N.D. Cal. 1995); Clearly Canadian, Fed. Sec. L. Rep. (CCH) ¶ 98,803 (N.D. Calif. 1995).

205 President's veto message, Fed. Sec. L. Rep. (CCH) ¶ 85,714 (1995).

206 The Reform Act does not affect or apply to any private securities action commenced and pending before the Act was adopted.

207 Conference Report on HR 1058, 27 Securities Regulation and Law Report 1881, 1890, November 1995 (the "Report").

- Auditors are required to report illegal acts.

- The SEC -- but not private parties -- is expressly authorized to prosecute for aiding and abetting violations.

- More specific direction is provided regarding the calculation of damages and the necessity to prove loss causation.

- Except for when there has been a criminal conviction, "any conduct that would have been actionable as fraud in the purchase or sale of securities" cannot be the predicate for a violation of RICO.

- A defendant who settles any private action at any time before a final verdict is rendered is released from all claims for contribution brought by other parties.[208]

- A safe-harbor has been added to both the 1933 and 1934 Acts for a "forward looking statement."

Our focus will be on the new safe-harbor provisions, although the other provisions of the Reform Act are extremely important and will change the landscape of securities litigation. It is still too early to tell, but I "forecast":

- It will take considerable litigation and many years to flush out the meaning of the new legislation. This remains true regarding the issue of pleading scienter.[209]

- It will most likely reduce frivolous litigation, but "serious" suits will be more costly to defend and more expensive to settle.

- Proportionate liability may turn out to be a double-edged sword. On the other hand, in what may be the first case to be decided by a jury under the Reform Act, the accounting firm BDO Seidman was exonerated. In a press

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[208] Cendant Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,416 (D.N.J. 2001) (dismissing a defendant's claim for contribution against its audit firm, which previously settled the claims against it, because such claims are barred under the Private Securities Litigation Reform Act); aff'd, Fed. Sec. L. Rep. (CCH) ¶ 91,522 (3d Cir. 2001).

[209] Carney v. Cambridge Tech. Partners, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,415 (D. Mass. 2001) (holding that the plaintiffs' vague fraud allegations did not meet the "factual particularity" pleading requirement for scienter under the Private Securities Litigation Reform Act). For a discussion of the application of the Private Securities Litigation Reform Act to actions brought under Sections 11 and 12(a)(2) of the Securities Act, see Rombach, et al. v. Chang, et al., Fed. Sec. L. Rep. (CCH) ¶ 92,664 (2d Cir. 2004) (The Second Circuit found that the wording and imputations of the complaint, namely that the registration statement at issue was "inaccurate and misleading," that it contained "untrue statements of material facts," and that "materially false and misleading written statements" were issued, sounded in fraud, not negligence. The court then held that the Private Securities Litigation Reform Act's heightened pleading standard also applies to claims brought under Securities Act Section 11 and 12(a)(2), insofar as such claims are premised on allegations of fraud).

release, it was reported that BDO took the risk of a trial because BDO believed that the proportionate liability provisions of the Reform Act would shield it from a verdict for the total loss.[210]

- While the contours of the safe-harbor provisions are not fully formed, they will in all probability reduce the number of suits filed based upon the use of forward looking information and be of considerable value in defending against such claims.[211]

The safe-harbor provisions are rather simple. They apply to both written and oral statements made by or on behalf of a reporting issuer.[212] To fall within the safe-harbor provisions, a forward looking statement must be:

(A) General - Written and Oral Statements

(B) The forward looking statement is

(i) "identified as a forward looking statement[213] and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement."[214] **OR**

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[210] Elizabeth MacDonald, Federal Jury Exonerates BDO Seidman In Accounting Suit Over Audit of Firm, WALL ST. J. (Oct. 28, 1999); Elizabeth MacDonald, BDO Seidman Wins Overturn of Jury Verdict, WALL ST. J. (Nov. 30, 1999).

[211] Ehlert v. Singer, Fed. Sec. L. Rep. (CCH) ¶ 91,407 (11th Cir. 2001) (ruling that a software maker's allegedly material misstatements in a registration statement and prospectus were protected by the PSLRA's safe harbor for forward-looking statements because the statements, accompanied by appropriate cautionary language, concerned forward-looking events).

[212] The safe-harbor provisions apply to statements made by an issuer, a person acting on behalf of an issuer, an outside reviewer retained by the issuer or an underwriter. The term "person acting on behalf of an issuer" is further defined to mean an officer, director or employee of the issuer.

[213] See Penn Treaty American Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,911 (E.D. Pa. 2002) (holding that the allegedly misleading statements at issue were not protected by the Private Securities Litigation Reform Act because several of the misstatements concerned current conditions rather than future projections). See also Richard A. Posen, Safe Harbor for Forward-Looking Statements in the Courts: A Year 2001 Scorecard, Sec. Reg. & L. Rep. Jan. 21, 2002, at 91 (stating that issuer reluctance to apprise the market of its projections of future performance is attributable to the lively aggressiveness of the plaintiffs' class action bar).

[214] Alleged misstatements on a press release were not protected under the PSLRA safe harbor for forward-looking statements because an issuer's press releases did not contain sufficient cautionary language. Unicapital Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,512 (S.D. Fla. 2001). Compare Pacific Gateway Securities Exchange, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,906 (N.D. Cal. 2002) (holding that the alleged misstatements at issue were protected by the Private Securities Litigation Reform Act because the misstatements were accompanied by sufficient cautionary language; such cautionary language included warnings that actual results may differ from those projected because of difficulties encountered by new businesses, increasing competition, and changes in the availability of financing).

(ii) be immaterial[215]

(C) The plaintiff fails to prove that the forward looking statement

(iii) "if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading;" **OR**

(iv) "if made by a business entity; was --

(I) made by or with the approval of an executive officer of that entity," **AND**

(II) "made or approved by such officer with actual knowledge by that officer that the statement was false or misleading."[216]

(2) Oral Forward Looking Statements Are Also Protected

(A) If the oral forward looking statement is accompanied by a cautionary statement indicating that the oral statement is forward looking **and** that actual results could differ materially from those projected in the forward looking statement; **and**

(B) If --

(i) "the oral forward looking statement is accompanied by an oral statement that additional information ... is contained in a readily available written document,"[217]

(ii) the accompanying oral statement identifies where to locate the additional information; and

(iii) the additional information in the written document is in fact cautionary that satisfies the standards established in (1)(A) above.

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215 See MCI Worldcom, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,758 (S.D. Miss. 2002) (stating that the forward looking statements contained in the defendant's prospectus were immaterial and were therefore protected by the Private Securities Litigation Reform Act).

216 27 Securities Regulation and Law Report at 1885.

217 "Readily Available Information" means any "document filed with the Commission or generally disseminated." Id.

Forward looking information is broadly defined to include:

- Projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure or other financial items.

- Plans and objectives of management for future operations including future products or services.

- Future economic performance, including any statement contained in MD&A. The assumptions underlying any of the foregoing.

- A report issued by an outside reviewer to the extent that it assesses a forward looking statement made by the issuer.

- Statements containing projections that may be covered by specific rules of the SEC.

Very importantly, the Reform Act specifically provides that the safe-harbor provisions do not impose a duty to update forward looking statements. The SEC, moreover, is expressly granted authority to craft additional safe-harbors.

There are a number of specific and important exclusions from the safe-harbor:

- Forward looking statements by certain issuers are excluded:
    - Those with a "bad boy" history.
    - Forward looking statements made by a blank check company in connection with an offering of its securities.
    - Penny stock issuers.
    - An issuer who makes a forward looking statement in connection with a roll up transaction.
    - An issuer who makes a forward looking statement in connection with a going private transaction.
- Forward looking statements made in certain SEC forms or in certain transactions are excluded:
    - Statements made in certified financial statements.
    - Statements made by investment companies.
    - Statements made in connection with a tender offer.
    - Statements made in connection with an IPO.

- Statements made in connection with an offering by, or relating to the operation of, partnerships, limited liability companies or direct participation investment programs.

- Statements made concerning beneficial ownership in Schedules 13D.

- Statements of present fact are not covered by the safe harbor.[218]

The Report emphasizes that of the rationale for adopting the safe-harbor is to encourage companies to disclose forward looking information. It also furnishes some helpful legislative history that will be useful in interpreting and applying the new safe-harbor provisions:

- Boilerplate warnings do not qualify as "meaningful cautionary statements" -- the cautionary statements must convey substantive information that realistically could cause results to differ from those projected.[219]

- "Important factors" need to be identified, but not "all factors" or "the particular factor that ultimately causes the forward looking statement not to come true."[220]

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[218] This was true before the adoption of the safe harbor. Jaroslawicz v. Engelhard, 704 F.Supp. 1296 (D.N.J. 1989) (statements regarding company's current production problems are statements of present fact). Since the adoption of the Reform Act, a number of courts have held the safe harbor inapplicable to historic statements of fact. For example, the District Court in Massachusetts held that the safe harbor for forward-looking statements did not protect press release comments concerning order volume and backlogged orders as a matter of law because they were statements of current conditions rather than projections. Geffen v. Micrion Corp., Fed. Sec. L. Rep. ¶ 90,307 (D. Mass. 1998). See also, Boeing, Fed. Sec. L. Rep. (CCH) ¶ 90,285 (W.D. Wa. 1998); Wenger v. Lumisys, 2 F. Supp. 2d 1231 (N.D. Ca. 1998); Harris v. IVAX Corp., 998 F.Supp. 1449 (S.D. Fla. 1998), aff'd, Fed. Sec. L. Rep. ¶ 90.528 (1999). On the other hand, in Stratosphere Corp., the District Court in Nevada found that statements phrased in the past tense, but used to trumpet a future event, were predictive in nature, and protected by the safe harbor. Stratosphere Corp., Fed. Sec. L. Rep. ¶ 90,669 (D. Nev. 1999).

See also Richard A. Posen, The Statutory Safe Harbor for Forward-Looking Statements: A Scorecard in the Courts from January 2002 Through April 2003, 35 Sec. Reg. & L. Rep. 1000 (Jun. 16, 2003) (stating that since the enactment of the Reform Act, the question that has generated the most case law is whether an issuer's challenged statement is forward-looking or one of historical fact).

[219] The cases applying the "Bespeaks Caution" doctrine will clearly be useful in interpreting the term "meaningful cautionary statements." Indeed, the Report states that the Conference Committee does not intend that the safe-harbor provisions replace the "Bespeaks Caution" doctrine or to stop further development of that doctrine by the courts. 27 Securities Regulation and Law Report at 1894. See also Amylin Pharmaceuticals, Inc., where the District Court of the Southern District of California denied the company's motion to dismiss and held that certain forward-looking statements were not protected under either the bespeaks caution doctrine or the safe harbor provision for forward-looking statements because the cautionary language consisted of boilerplate warnings and was not sufficiently meaningful. Fed. Sec. L. Rep. (CCH) ¶ 92,007 (S.D. Calif. 2002).

[220] Id.; see also Rasheedi v. Cree Research Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,566 (M.D.N.C. 1997) (holding that forward look statements will be protected under the safe harbor even if the specific risk factor is not mentioned in the cautionary language; thus, the safe-harbor does not require "companies to make accompanying cautionary

- The courts, "where appropriate," are invited to decide motions to dismiss "without examining the state of mind of the defendant."[221]

- A second prong of the safe-harbor does focus on the state of the mind of the person making the forward looking statement: such person will not be liable in a private action "unless a plaintiff proves that person or business entity made a false or misleading forward looking statement with actual knowledge that it was false or misleading."[222]

- The Conference Committee has established the safe-harbor as a "starting point" and "fully expects" the SEC to continue rulemaking procedures in this area.

Client education concerning the Reform Act is essential. Emphasis should be on the development of "meaningful cautionary statements" and the adoption of procedures to implement the oral safe-harbor, i.e., including the magic language in the oral statement and identifying and publishing the "readily available written document."[223]

Many questions have been raised regarding the cautionary statements, including, what does it mean that a forward-looking statement must be "accompanied by" cautionary language, and which "important factors" must be included in the meaningful cautionary language?

- "Accompanied by" has not received much attention in case law, but cautionary language that is adjacent to or in close proximity to the forward-looking statement should be considered "accompanying" the statement. Cross-references should also be sufficient.[224]

- Since the courts in Rasheedi and Harris stated that not *all* important factors need be mentioned, it is up to each company to decipher which factors could have an impact upon a reasonable investor. Some

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language that identifies all important factors that could cause results to differ materially from projections"); Harris v. IVAX, 998 F.Supp. 1449, 1450 (1998), aff'd, Fed. Sec. L. Rep. ¶ 90,528 (S.D.Fla. 1999). For the safe harbor legend in Harris, see Section III. C. 5 infra.

221 Id.

222 Id.

223 For an excellent discussion of the Safe Harbor requirements, see Carl W. Schneider and Jay A. Dubow, Forward-Looking Information - Navigating in the Safe Harbor, 51 Bus. Law. 1071 (1996).

224 Thomas W. Kellerman, Anthony S. Wang and Felix Lee, Update on Forward-Looking Statements and the Reform Act Safe Harbor, Securities & Commodities Regulation, Vol. 32, No. 12 at 129 (June 23, 1999).

statements, moreover, are mere puffery and not required to be identified in the cautionary language.[225]

It is important that clients understand that cautionary language must be used in cyberspace documents as well. The special risks involved in posting news bulletins or other information on a Web posting include the availability on the Web of stale and/or unreliable information (not updated perhaps, because the SEC does not mandate a duty to update).[226] In her article on Safe Harbors in Cyberspace, Lisa Klein Wager of Morgan, Lewis & Bockius LLP in New York, offered the following suggestions:

- Establish and enforce effective procedures for internal review of all public statements and Web postings.
- Explicitly identify written forward-looking statements in all contexts.
- Ensure that documents containing forward-looking statements enumerate the risks relevant to the specific subjects of the forward-looking statements.
- Take precautions when converting oral statements to a written medium or posting them on the Web.
- Disclaim a duty to update.
- Avoid entanglements with third parties and disclaim responsibility for content or updating of hyperlinked sites.
- Segregate marketing and investor information, current and historic information on the corporate Web site.
- Regularly review and update investor pages of the corporate Web site.

5. The Safe Harbor Legend

Unfortunately, to the extent that the safe harbor rules have been litigated, there is no discernible trend and the outcomes tend to be highly fact specific.[227] Therefore, it is

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225 Stratosphere Corp., 1998 U.S. Dist. LEXIS 4759 (D. Nev. Apr. 7, 1998); see also Nathenson v. Zonagen, Fed. Sec. L. Rep. (CCH) ¶ 91,548 (5th Cir. 2001) (ruling that certain of defendant's alleged vague and optimistic generalizations were immaterial and not actionable as mere puffery); Freedman v. Value Health, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,791 (2d Cir. 2002) (holding that a prospectus statement describing a proposed merger partner as a "thriving business" was mere puffery).

226 Wager, Lisa Klein, Securities Disclosure: Finding Safe Harbors in Cyberspace, INSIGHTS, Volume 12, Number 11 (November 1998).

227 See supra note 183 and surrounding text; infra note 250. See also Operating in the New World of Securities Regulation, INSIGHTS, October, 1996, Ronald L. Marmer and C. John Koch identify three common errors that

difficult to predict precisely what language must be included, or even where and how often the language must appear in order to protect the issuer from liability.

Nevertheless, the Eleventh Circuit case of Harris v. IVAX Corporation is one of the leading cases that examines an adequate safe harbor legend. The court stated that the following cautionary language issued in connection with a press release was sufficient under the safe harbor. In its August 1996 Press Release, the Chairman and CEO of IVAX Corporation stated that while a disappointing quarter had just passed, the outlook for the pharmaceutical industry, and for IVAX in particular, was much better than it might appear at first glance. The cautionary language reprinted below was found to be adequate even though it did not identify the specific factor that caused the results to differ from those predicted, namely the write-off of goodwill. The press release was followed by the following warning in italics.

> *Statements made in this press release, including those relating to expectations of increased reorders, receipt of a credit facility waiver, earnings distribution, and the generic drug industry, are forward looking and are made pursuant to the safe harbor provisions of the Securities Reform Act of 1995. Such statements involve risks and uncertainties which may cause results to differ materially from those set forth in those statements. Among other things, additional competition from existing and new competitors will impact reorders; the credit facility waiver is subject to the discretion of the bank syndicate; and IVAX's ability to distribute earnings more evenly over future quarters is subject to industry practices and purchasing decisions by existing and potential*

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issuers made in failing to comply fully with the requirements to bring their forward-looking statements within the safe harbor:

(1) failing to identify which statements are forward-looking;

(2) failing to accompany forward-looking statements with cautionary statements and important factors; and

(3) using boiler plate and generic important factors.

See also Boeing, Fed. Sec. L. Rep. ¶ 90,285 (W.D. Wash. 1998) (Forward-looking statement given in a boiler plate, and not speaking to specific factors that could cause actual results to differ materially from those in the statement not given safe harbor protection because the Safe Harbor legend was insufficient); and Clorox Co. Securities Litigation, Fed. Sec. L. Rep. ¶ 92,227 (N.D. Calif. 2002) (Statements by the company were protected by the safe harbor for forward-looking statements under the PSLRA because the statements concerned the impact of an acquisition on company profitability, which were forward-looking in nature and accompanied by sufficient cautionary language).

> *customers. In addition, the U.S. generic drug industry is highly price competitive, with pricing determined by many factors, including the number and timing of product introductions. Although the price of generic product generally declines over time as competitors introduce additional versions of the product, the actual degree and timing of price competition is not predictable. In addition to the factors set forth in this release, the economic, competitive, governmental, technological and other factors identified in IVAX's filing with the Securities and Exchange Commission, could affect the forward looking statements contained in this press release.*[228]

A representative example of a comprehensive annual MD&A that integrates the safe harbor language is that of Intel Corporation[229] Intel's MD&A includes the following subjects:

- Results of Operations;
- Purchased in-process research and development;
- Financial condition;
- Financial market risks;
- Strategy; and
- Outlook (including the safe harbor legend and a detailed discussion of critical accounting practices).

The MD&A of the Form 10-K also provides the following language regarding Outlook and risk factor statements:

> We expect that our corporate representatives will meet privately from time to time with investors, the media, investment analysts and others. At these meetings, we may reiterate the current published Outlook, including portions that are repeated or incorporated by reference in this Form 10-K. At the same time, we will keep our Outlook publicly available on our Web site (www.intc.com). Prior to the start of the Quiet Period (described below), the public can continue to rely on the

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[228] Harris v. IVAX Corporation, 998 F.Supp. 1449 (1998), aff'd, Fed. Sec. L. Rep. ¶ 90,528 (S.D.Fla. 1999).

[229] Intel Corporation, Form 10-K for fiscal year ended December 29, 2001.

Outlook on the Web site as still being our current expectations on matters covered, unless we publish a notice stating otherwise.

From the close of business on March 15, 2002, we will observe a "Quiet Period" when we no longer publish or update Outlook, as our current expectations and Intel representatives will not comment concerning Outlook or Intel's financial results and expectations. The Quiet Period will extend until the day when our next quarterly Earnings Release is published, presently scheduled for April 16, 2002. We also observed a "Quiet Period" from close of business on March 1 until we published our mid-quarter update on March 7.

6. Results of the Reform Act

It is still too early to make definitive conclusions regarding the effect of the Reform Act, some recent studies indicate that the impact has been far from positive.

a. The Grundfest Study

Former SEC Commissioner Joseph Grundfest issued a study on February 27, 1997, that compares patterns of class action securities fraud litigation in federal and state courts filed before and after the Reform Act's effective date.[230] The study highlights the increase in securities fraud suits filed in state courts where plaintiffs seek to avoid the provisions of the Reform Act. Significantly, Grundfest's preliminary findings include the following:[231]

Overall litigation rates have changed little.

About 26% of litigation activity has moved from federal to state court.

Allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation.

Pure "false forecast" cases explain a relatively small percentage of pending Reform Act claims.

Litigation typically follows larger price declines than observed prior to the Reform Act.

Federal claims are now rarely filed against the largest issuers.

High technology issuers continue to be the most frequent targets of class action litigation.

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[230] Joseph A. Grundfest and Michael A. Perin, Securities Litigation Reform: The First Year's Experience, available at http://securities.stanford.edu/report (Working Paper Series, February 27, 1997).

[231] Id.

The dominant plaintiffs' class action law firm, Milberg Weiss Bershad Hynes & Lerach, appears to have increased its significance nationally and in California in particular. Judges appear to be resolving legal questions regarding the interpretation of the "strong inference" requirement in favor of plaintiffs

The growth of parallel state and federal litigation, with concomitant disputes over discovery stays and other matters, suggests that attention to federal preemption issues is warranted.

b. Forward-Looking Statements and Cautionary Language After the 1995 Reform Act: An Empirical Study.[232]

This study, conducted by attorneys at seven law firms, found that in general, forward-looking disclosure has not expanded or become more detailed since the passing of the Reform Act. The study had the following observations:

- The Safe Harbor has had little effect on the written disclosure of forward-looking information.

- The study determined that only with federal preemption of state law claims would issuers alter their disclosure practices.[233]

c. The SEC's Report to the President and the Congress

In its "Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995,"[234] the SEC echoes some concerns raised in the Grundfest Study. After noting that "it is too soon to draw definitive conclusions," the SEC made the following preliminary observations about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection:[235]

- The number of companies sued in securities class actions in federal court is down for the twelve months following passage of the Reform Act.

- Most securities class action complaints filed in federal court post-Reform Act appear to contain detailed allegations specific to the action.

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232 This study was conducted by Gerald S. Backman, Karl A. Groskaufmanis, Richard A. Rosen, and Stephen J. Schulte. Copyright 1997.

233 On October 13, 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998, preempting state securities fraud class actions relating to covered securities. The Act became law when it was signed by the President on November 3, 1998 (Pub. Law 105-353).

234 Fed. Sec. L. Rep (CCH) ¶ 85,931 (1997).

235 Id. at 89,475.

- The race to the courthouse has slowed somewhat.

- Secondary defendants, such as accountants and lawyers, are being named much less frequently in securities class actions.

- The discovery stay imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards required by the Act, has made it more difficult for plaintiffs to bring and prosecute securities class action lawsuits.

- Plaintiff's law firms continue to control securities class actions; institutional investors have not actively sought to become involved in such suits.

- The number of state filings reportedly has increased.

- While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

- Companies have been reluctant to provide significantly more forward looking disclosure beyond what they provided prior to enactment of the safe harbor.

  The SEC noted that it was too soon to draw any definitive conclusions about the effect of the Reform Act in light of the fact that no federal appellate court had an opportunity to interpret the provisions of the Act. The SEC thus did not recommend any legislative changes in its Report although other Bills have been subsequently introduced to close loopholes, as discussed below.

d. NERA's "Recent Trends in Shareholder Class Actions" Study

This study is a compilation of data through June 1999, and it is arguably one of the most influential studies in this area. The National Economic Research Associates ("NERA") have studied the impact of the PSLRA since its enactment in 1995. Moreover, NERA has compiled data relating to securities class action filings since January 1991. The recent study's findings include the following:[236]

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[236] Todd S. Foster, Denise N. Martin, Vinita M. Juneja, Frederick C. Dunbar and Lucy P. Allen, National Economic Research Associates, "Trends in Securities Litigation and the Impact of the PSLRA," American Bar Association, 1999.

- The number of accounting fraud cases has increased dramatically since the passage of the PSLRA, and the number with more serious accounting allegations have been increasing at an even faster rate.

- The number of dismissals is also up because of the more stringent pleading requirements, especially on scienter, although often there is the potential for repleading.

- Post-PSLRA average settlement values have been higher -reflecting the growth in the stock market.

- The number of filings in 1998 set an all-time record and the filing rate during the first five months of 1999 was even greater than in 1998. But since July 1999, shareholder class action filings were lower by almost eight per month than they were in the first half of the year.

e. PWC's 2001 Securities Litigation Study

According to a study by PricewaterhouseCoopers LLP ("PWC") of securities litigation in 2001, an unprecedented 483 cases were filed that year.[237] Analysts and investors began to scrutinize every public company in light of Enron, while shareholders and plaintiffs' attorneys filed lawsuits against underwriters and the companies they took public in the late 1990s and early 2000. Most notably, 308 of the 483 cases filed were IPO allocation lawsuits or "laddering" cases.[238] Generally, these lawsuits allege that companies and underwriters solicited and received excessive, undisclosed commissions from certain investors prior to the IPO.[239] In the "non-laddering" cases:

- 57% included accounting allegations, the highest percentage of initial filings to contain accounting allegations;

- CEOs were named in 87% of the cases, Chairpersons of the Board were named in 69% of the cases, CFOs were named in 67% of the cases and presidents were named in 63% of the cases;

- More than half involved high-technology companies; and

- Improper revenue recognition continues to be the most commonly alleged accounting abuse.[240]

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[237] PricewaterhouseCoopers LLP 2001 Securities Litigation Study (2002), available at http://www.pwcglobal.com/extweb/pwcpublications.nsf.

[238] Id.

[239] Id.

[240] Id.

During 2001, approximately 190 companies traded on U.S. stock exchanges announced a restatement of prior reported earnings. The primary reasons for restatements were changes in accounting standards and accounting errors or irregularities. Fifty-three percent of the accounting cases filed involved a restatement of earnings.[241]

f. Conclusions

Few, if any, of the PSLRA goals previously mentioned in this article have been achieved during the past five years.[242] So far, the Act has not produced a decrease in the number of federal securities class action suits filed. In fact, the filing of such lawsuits increased over the past three years.

Additionally, the passage of the PSLRA failed to alleviate the pre-PSLRA pressure to be the first to file the action. Law Firms still attempt to file complaints first so that they may be the first to file notice of the action and attract potential clients. With the use of the internet, attorneys have turned the filing of the notice into a marketing tool.

Furthermore, though the PSLRA requires that plaintiffs employ a stringent uniform pleading standard, the courts differ on the interpretation of such standard. As a result, plaintiffs attempt to "forum shop" and file actions in districts with less stringent pleading requirements.

The PSLRA also heightened the pleading standard with respect to scienter in Rule 10b-5 claims, especially in cases where defendants are sued based on the alleged falsity of their opinions or predictions. Today, it is only a client's "false" opinion or prediction that may result in legal liability. As a result, clients are well advised to "make the effort to record and retain the objective, reasonable bases for the opinion and predictions they express."[243] This documentation may ultimately aid the defense if a lawsuit based on the falsity of the client's opinion or prediction happens to arise.[244]

The calculation of damages continues to be a problem under the PSLRA. The 90-day "look back" provision does not make the calculation of damages more certain, rather, it bars certain investors from recovery based on irrelevant stock fluctuations.

Lastly, with respect to the use of forward-looking information, the courts have not settled on a definition of a "forward-looking statement." Moreover, uncertainty remains

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241 Id.

242 Jordan Eth and Daniel S. Drosman, "The Private Securities Litigation Reform Act: Five Years Young", Securities & Commodities Regulation, Vol. 34, No. 13, July 2001, pgs. 153-64.

243 William O. Fisher, "Opinions and Predictions: Remembering Objective Falsity", Insights, Vol. 15, No. 9, September 2001.

244 Id.

about whether forward-looking statements have been "accompanied by" meaningful cautions. The safe harbor only applies if the cautions are "meaningful." As a result, it has become increasingly difficult for courts to make uniform decisions about the disclosure of forward-looking information or the use of the safe-harbor provision under the PSLRA. Accordingly, the PSLRA has not achieved most of its ambitious goals.

7. Reform Act Cases

a. Pleading[245]

The Act requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[246] Plaintiffs have generally used a pattern of sales by insiders as evidence of scienter, and the courts have found that evidence of insider trading is often enough to find a strong inference of scienter.[247] However, to prove scienter, one bears the burden of showing that sales by insiders were in fact unusual or suspicious in amount or timing.[248] The interpretation of this standard has been the subject of considerable disagreement among district and appellate courts. The debate focuses on whether the Reform Act simply adopts the "reckless" Second Circuit standard, or requires more. Several cases have held that the

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[245] The circuits remain split on the issue of what constitutes scienter under the Reform Act, and the Supreme Court is apparently reluctant to address the issue. See Pleading Scienter After Enron: Has the World Really Changed?, 35 Sec. Reg. & L. Rep. (BNA) 45 (Nov. 17, 2003) ([Post-Enron,] a great divide still exists among the circuits, leading to inconsistent outcomes on similar facts – sometimes within the same circuit).

[246] 15 U.S.C. § 78 u-4(b)(2); see also DT Industries, Inc., Case No. 00-3369-CV-S-4-ECF (W.D. Mo. 2001) (granting defendants' motion to dismiss because the plaintiffs did not allege specific facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness on the part of defendants).

[247] Bryan v. Apple South, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,275 (MD Ga. 1998) (unusual insider trading during the class period can support a strong inference of scienter); Employee Solutions, Fed. Sec. L. Rep. (CCH) ¶ 90,293 (D. Az. 1998) (motion to dismiss denied where the CEO used offshore entities to conceal his stock transactions while selling over a million shares of stock because of strong inference of scienter).

[248] Lirette v. Shiva Corp., 1998 WL 812696 (D. Mass. 1998); see also Ronconi v. Larkin, Fed. Sec. L. Rep. (CCH) ¶ 91,450 (9th Cir. 2001) (holding that insider stock sales failed to support an inference of scienter because the trades in this case were not unusual or suspicious).

Reform Act adopted the Second Circuit pleadings standard,[249] while other cases have found that the Reform Act standard goes beyond the Second Circuit standard.[250]

Despite varying language used by the courts, one commentator has concluded that actual results reached in the district courts are generally consistent.[251] Accordingly, it is uncertain if, in the long run, courts will adopt the Second Circuit standard or move to the stricter standard of the Ninth Circuit in Silicon Graphics. The higher the standard is set, the more difficult it will become for plaintiffs to withstand motions to dismiss, and thus, potentially lowering the volume of litigation in the federal courts.

The appellate courts that have reviewed the pleading standard under the Reform Act have reflected a lack of uniformity, making it likely that the Supreme Court will have to decide this issue, and put an end to the pleading requirement conjecture.[252]

> First Circuit The First Circuit held that plaintiffs relying on confidential sources need not name those sources so long as the complaint provides sufficient additional facts to provide an adequate basis for believing that the defendants' statements were

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249 The district courts are in disagreement about what the pleading requirement is. In Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297 (C.D. Cal. 1996), the court held that the two tests established by the Second Circuit should be employed. In Baesa Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 97,633 (S.D. NY 1997), the court held that the Reform Act did not change the requirement for liability in a private securities fraud action by raising the scienter higher than recklessness. Also, the mere pleading of opportunity and motive did not suffice in raising the inference of fraudulent scienter. Other cases have followed the Second Circuit tests. See e.g., Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996); STI Classic Funds v. Bollinger Industries, Inc., No. 3-96-CV-823-R (N.D. Tex. Nov. 12, 1996); Fischler v. AmSouth Bancorporation, 1996 U.S. Dist. LEXIS 17670 (N.D. Fla. Nov. 14, 1996); Rehm v. Eagle Finance Corp., 954 F. Supp. 1246 (N.D. Ill. 1997).

250 See e.g., Silicon Graphics, 970 F. Supp. 746 (N.D. Cal. 1997) (plaintiff must create a "strong inference of knowing or intentional misconduct."); Friedberg v. Discreet Logic, 959 F. Supp. 42, 48 (D. Mass. 1997) (holding that the pleading standard was intended to be stronger than the existing Second Circuit standard); Norwood Venture Corp. v. Converse, 959 F. Supp. 205, 208 (S.D.N.Y. 1997) (holding that Congress sought to raise the pleading standard beyond the Second Circuit standard); and Voit v. Wonderware Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,541 (E.D. Pa. 1997).

251 Rosenfeld, Pleading Scienter Under the Private Securities Litigation Reform Act of 1995, 31 rev. of sec. & com. reg. 25 (1998). The Second Circuit is plainly wedded to its pre-Reform Act interpretation. See Stevelman v. Alias Research, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,455 (2d Cir. 1999) where the court cited all pre-Reform Act cases in analyzing the fraud and scienter pleading standards. The court also relied upon the sale of "large portions" of the defendants' stock to support a "strong inference of fraudulent intent", i.e. motive and opportunity. Id. at 92,110. See also Press v. Chemical Investment Services Corp., Fed. Sec. L. Rep. (CCH) ¶ 90,415 (2d Cir. 1999); Maldonado v. Dominquez, Fed. Sec. L. Rep. (CCH) ¶ 90,159 (1st Cir. 1998).

252 The Appellate Court of the Eleventh Circuit reviewed the district court's decision in Harris v. IVAX Corp., but specifically did not address the question of "what exactly a 'strong inference' of the appropriate scienter is." Harris v. IVAX Corp., Fed. Sec. L. Rep. (CCH) ¶ 90,528 (11th Cir. 1999). The court did, however, reiterate that cautionary statements need not mention *all* possible factors, that could cause, or the particular factor that did cause, actual results to differ materially from those in the forward-looking statement. The Fourth Circuit also acknowledged the disagreement among the circuits, and did not find reason to visit the issue, as the stockholders had not pleaded sufficient facts to meet even the most lax of standards. Phillips v. LCI International, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,645 (4th Cir. 1999).

false.[253] The court ruled that the investors had adequately identified fraudulent statements with claims that the company had improperly recognized revenue through fictitious sales and return agreements. Furthermore, the complaint adequately pleaded scienter because the insider stock sales and the number and magnitude of accounting violations supported the inference of fraudulent intent.[254]

Second Circuit The Second Circuit held that plaintiffs may meet the "strong inference" standard by setting forth specific facts either (1) showing motive to commit fraud and an opportunity to do so, or (2) constituting circumstantial evidence of either reckless or conscious misconduct.[255]

Third Circuit The Third Circuit declined to come to terms with conflicting legislative history, and opted for a plain-language analysis, determining that the Reform Act language was "virtually identical" to the pleading requirement set forth by the Second Circuit, and therefore must be interpreted in an identical manner.[256] Unlike the Second Circuit, however, the Third Circuit also ruled that the Reform Act's "additional requirement that the plaintiffs state facts 'with particularity' represents a heightening of the standard."[257]

Fourth Circuit The Fourth Circuit also disagreed with the Second Circuit's approach and appears to require intentional or deliberate conduct to state a claim under 10(b) and 10b-5.[258]

Fifth Circuit The Fifth Circuit ruled that fraud plaintiffs may satisfy the pleading requirement for scienter by alleging

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253 Cabletron Systems, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,202 (1st Cir. 2002).

254 Id.

255 Press v. Chemical Inv. Serv. Corp., No. 98-7123, 1999 U.S. App. LEXIS 1494 (2d Cir. 1999), cited in Silicon Graphics at 92,503.

256 Advanta Corp., 180 F.3d 525 (3d Cir. 1999).

257 Id. See also Paul J. Collins, "Pleading Fraud Allegations Under the Private Securities Litigation Reform Act," Newsletter of the Federal Regulation of Securities Committee of the Business Law Section of the ABA, Volume 5, Issue 1 (Spring 2000).

258 Phillips v. LCI Int'l, Inc., 190 F.3d 609 (4th Cir. 1999). See also Paul J. Collins, "Pleading Fraud Allegations Under the Private Securities Litigation Reform Act," Newsletter of the Federal Regulation of Securities Committee of the Business Law Section of the ABA, Volume 5, Issue 1 (Spring 2000).

particularized facts that result in a strong inference of the defendant's "severe recklessness."[259]

Sixth Circuit The Sixth Circuit took issue with the Second Circuit and stated that plaintiffs may show a strong inference of recklessness, but alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud would not be sufficient. If motive and opportunity simultaneously establish that the defendant acted recklessly or knowingly, or with the requisite state of mind, the Sixth Circuit's middle of the road test would be met.[260]

Eighth Circuit The Eighth Circuit adopted the Second Circuit's "strong inference" standard which examines the plaintiffs' "motive and opportunity allegations" to support a strong circumstantial case for reckless or intentional wrongdoing.[261] Furthermore, this court agreed with the Third Circuit and ruled that each fact supporting the inference of scienter be stated with particularity.

Ninth Circuit The Silicon Graphics court, in the first appellate opinion on this issue, and also the most stringent, wrote that mere recklessness "may provide some inference of intent," but did not satisfy the strong inference requirement of the Reform Act. "A heightened form of recklessness, i.e., deliberate or conscious recklessness, at a minimum" is required.[262] The court went on to say that had Congress intended to simply codify the Second Circuit standard, it would have done so, instead of numerous times stating an intent to raise the bar on the standard. The Silicon Graphics case is discussed in more detail below.

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259 Nathenson v. Zonagen, Fed. Sec. L. Rep. (CCH) ¶ 91,548 (5th Cir. 2001). See also Abrams v. Baker Hughes Inc., Fed. Sec. L. Rep (CCH) ¶ 91,912 (5th Cir. 2002) (affirming a district court dismissal because plaintiffs failed to raise a strong inference of recklessness or conscious misbehavior; although the plaintiffs made general allegations that the defendants had access to non-public information, plaintiffs did not specify what information the defendants actually concealed). See also ABC Arbitrage Plaintiffs Group v. Tchuruk, Fed. Sec. L. Rep. (CCH) ¶ 91,915 (5th Cir. 2002) (dismissing the plaintiff's fraud claim on materiality grounds because the alleged misstatments involved amounts of money immaterial to the company's earnings).

260 Comshare Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,513 (6th Cir. 1999).

261 Fla. State Bd. of Admin. v. Green Tree Fin. Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,612 (8th Cir. 2001).

262 Silicon Graphics, 970 F. Supp. 746 (N.D.Cal. 1997), aff'd, Fed. Sec. L. Rep. (CCH) ¶ 90,512 (9th Cir. 1999).

But see No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.,[263] which may signal a retreat from Silicon Graphics.[264]

Tenth Circuit This circuit ruled that plaintiffs can adequately plead scienter by setting forth facts raising a strong inference of intentional or reckless misconduct, however, allegations of motive and opportunity alone may be important, but not sufficient to establish a strong inference of scienter.[265]

Eleventh Circuit This circuit agreed with the Sixth Circuit, refusing to accept the proposition that allegations of motive and opportunity to commit fraud were sufficient to plead scienter, unless the facts demonstrate the required state of mind, namely that the defendant acted recklessly or knowingly.[266]

The district courts have reflected the same disharmony as the appellate courts. In Silicon Graphics, the district court ruled on the pleading standard under the Reform Act.[267] According to the court, to adequately plead scienter under the Reform Act, plaintiffs must establish a strong inference of knowledgeable or intentional misconduct. The court stated further that "[m]otive, opportunity and non-deliberate recklessness may provide some evidence of intentional wrongdoing . . . but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud."[268] The appellate court then stated that "Congress intended to elevate the pleading requirement above the Second Circuit standard."[269] This standard takes issue with a more liberal standard articulated in older Second Circuit cases that allow for unqualified allegations of recklessness to establish scienter.[270]

Plaintiffs alleged in Silicon Graphics insider trading and false and misleading statements. The district court stated that, in evaluating scienter, the Reform Act required the court to consider each defendant's stock sales separately, as well as the amount and timing of the sales. The court held that plaintiffs artificially inflated the level of

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263 Fed. Sec. L. Rep. (CCH) ¶ 92,278 (9th Cir. 2003).

264 See supra Section II.D.

265 City of Philadelphia v. Fleming Companies, Fed. Sec. L. Rep. (CCH) ¶ 91,525 (10th Cir. 2001).

266 Bryant v. Avado Brands, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,636 (11th Cir. 1999).

267 Silicon Graphics, 970 F. Supp. 746 (N.D. Cal. 1997).

268 Id. at 757.

269 Silicon Graphics Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,512 (9th Cir. 1999).

270 Silicon Graphics, 970 F. Supp. 746, 755-756 (N.D. Cal. 1997).

defendants' trading activities by failing to consider available options in evaluating stock sales. The court then stated that as to two senior officials whose sales represented a high portion of their holdings, the stock sales may be considered as evidence of fraud if plaintiffs could substantiate their claims regarding negative internal reports.[271]

It is unclear how courts will interpret the "all facts" pleading requirement.[272] In Silicon Graphics, the court granted a motion to dismiss plaintiffs' amended complaint. In interpreting the "all facts" pleading requirement, the court observed that the provision was the subject of specific debate in Congress. Concerns were raised that the provision would require disclosure in the complaint of specific names and other potentially confidential information.[273] The court reasoned that if Congress enacted the requirement despite these concerns, plaintiffs were obligated to plead "all facts". Plaintiffs did not meet this burden and the court dismissed the complaint.

The other case which has interpreted the "all facts" requirement is Zeid v. Kimberley, a class action involving Firefox Communications, Inc.[274] In Zeid, the court held that when a complaint is based on "investigation of counsel" rather than "information and belief", plaintiffs are not required to state with particularity all facts. In such circumstances, however, the court held that plaintiffs must meet the other strict pleading requirements of the Reform Act. "Plaintiffs cannot rely on conclusory allegations or tenuous inferences but instead, must allege with particularity: (1) each statement, (2) why each statement is false, and (3) as to each statement, facts giving rise to a strong inference that Defendants acted with scienter."[275] The court found that plaintiffs' complaint failed to satisfy this standard, and it was dismissed with prejudice.[276]

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271 Id. at 767, citing Acito v. Imcera Group, Inc., 47 F.3d 47 (2nd Cir. 1995) (stock trading will support a strong inference of fraud when the sales are unusual or suspicious). See also San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Companies, Inc., 75 F.3d 801 (2d Cir. 1996) where the Second Circuit, in reviewing plaintiffs attempt to plead scienter via insider stock sales, concluded that "[i]n the context of this case...the sale of stock by the company executive does not give rise to a strong inference of the company's fraudulent intent; the fact that other defendants did not sell their shares during the relevant class period sufficiently undermines plaintiffs' claims regarding motive."

272 Zeid v. Kimberley, et al., Fed. Sec. L. Rep. (CCH) ¶ 91,410 (9th Cir. 2001) (holding that the complaint did not state with particularity all facts which form the belief that an omission is misleading).

273 Silicon Graphics, 970 F. Supp. 746, 763 (N.D.Cal. 1997).

274 No. 96-20136 SW at 8-9 (N.D. Cal. May 6, 1997).

275 Id. at 9.

276 See also Harris v. IVAX Corporation, 998 F.Supp. at 1450 (cautionary language in a press release was found to be adequate even though it did not identify the specific factor that caused the results to differ from those predicted), aff'd, Fed. Sec. L. Rep. ¶ 90,528 (1999); Wenger v. Lumisys, 2 F. Supp.2d 1231 (N.D. Cal. 1998) (defendants not required to couple each forward-looking statement with a particular warning); Friedberg v. Discreet Logic Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,491 (D. Mass. 1997) (four separate statements made by the company and its officers were pleaded particularly enough to constitute claims under the heightened standard of the Reform Act); Schwartz v. Celestial Seasonings, Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,538 (10th Cir. 1997) (a securities fraud claim stated with sufficient particularity by incorporating by reference to press releases,

If other courts follow either the Silicon Graphics or Zeid holdings, it is reasonable to expect an increase in the percentage of defendants that prevail on motions to dismiss. The interpretation of the "all facts" pleading requirement is a major uncertainty regarding the Act. With all of these conflicting opinions leading to differing results in federal securities litigation, the Supreme Court will have to take a stand and determine the pleading requirement under the Reform Act.[277] Accordingly, when the Ninth circuit refused to rehear Silicon Graphics in October 1999, it paved the way for the Supreme Court to do just that.

b. Historical v. Forward Looking Statements

A number of courts have found the safe harbor to be inapplicable to what they consider historical facts rather than forward looking statements.[278]

c. Is the Safe Harbor Broad Enough?

The safe harbor has been interpreted to allow companies to decipher which factors could have an impact upon a reasonable investor.[279] Even if a specific risk factor is not mentioned in the cautionary language, and that factor results in a material impact upon an investor, a company can still be protected by the safe harbor; thus, the safe-harbor does not require "companies to make accompanying cautionary language that identif[ies] all important factors that could cause results to differ materially from projections."[280] Since some statements are mere puffery, and not required to be included in the cautionary language,[281] and others are actionable, the decision does not promise to be an easy one.

8. New Securities Litigation Reform Bills After the Reform Act

Some members of Congress could not wait for more precise interpretations of the Reform Act. Soon after the SEC's report hit the press, two Bills were introduced to close the perceived loophole in the Reform Act that had resulted in an increased amount of

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prospectuses, and reports. Plaintiff need not have matched individual statements with particular sources or individuals; annual reports and prospectuses presumably involved the collective effort of the company.) See also Rasheedi v. Cree Research, Inc., Fed. Sec. L.Rep. (CCH) ¶ 99,566 (D.N.C. 1997) (plaintiff must specifically allege to which defendants certain statements are attributable in order to trigger the group-published information presumption.)

277 For a thorough analysis of each case and outlook on the possible Supreme Court decision, see James E. Day and Ivan B. Knauer, Four Appeals Courts Cannot Agree on Post-Reform Act Standard for Pleading Scienter, Insights, Sept. 1999, at 4.

278 See discussion of safe harbor cases supra nn. 185, 187-88, 192, 194.

279 Rasheedi v. Cree Research Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,566 (D.N.C. 1997).

280 Id.

281 Stratosphere Corp., 1998 U.S. Dist. LEXIS 4759 (D. Nev. Apr. 7, 1998).

securities actions filed in the state courts and, as combined, were made into law on November 3, 1998.

Representatives Anna Eshoo (D-Calif.) and Rick White (R-Wash.) proposed the "Securities Litigation Uniform Standards Act," (H.R.1689) on May 21, 1997. This bill proposed to amend the 1993 Securities Act and the 1934 Securities Exchange Act and supplement the Reform Act of 1995. The White-Eshoo Bill proposed to require securities class actions against nationally traded securities to be litigated in federal court under a uniform federal law. The bill would thus insure that the remedies available to purchasers and sellers of nationally traded securities would not vary based on the state in which the purchasers or sellers reside.

Subsequently on October 7, 1997, a bill entitled the "Securities Litigation Uniform Standards Act of 1997" (S.1260) was introduced in the Senate by Senators Phil Gramm, Pete Dominici, and Chris Dodd.[282] The "Senate Bill" was substantially similar to the White-Eshoo Bill, except with respect to its definition of a covered security. The White-Eshoo Bill tied preemption to an issuer that has covered securities while the Senate Bill applied only to the covered securities themselves. In addition, the White-Eshoo Bill adopted the definition of covered security contained in section 18(b)(1) of the Securities Act of 1933 while the Senate Bill looked to sections 18(b)(1) and (b)(2).

On May 13, 1998, the Senate passed S.1260 by a vote of 79-21. Shortly before S.1260 was reported to the Senate by the Senate Banking Committee, the Securities and Exchange Commission and the White House endorsed the legislation.

On June 10, 1998, the House Commerce Finance and Hazardous Materials Subcommittee voted 21-4 to report to the full Committee an amended version of the White-Eshoo Bill. The amended bill generally aligns the operative provisions of the White-Eshoo Bill with those of S.1260. Specifically, the amendments did the following:

- Narrowed the White-Eshoo Bill's definition of covered securities to the definition in the 1996 National Securities Markets Improvement Act (so that only suits involving nationally traded securities, rather than suits involving any security of a nationally traded company, are covered);

- Inserted language from S.1260 to preserve state court authority over certain corporate governance questions; and

- Provided that state and municipal pension funds may bring class action suits in state court, so long as those in the class are named plaintiffs and the pension fund has authorized the action.

[282] 143 Cong. Rec. S10475 (Oct. 7, 1997).

President Clinton signed the Securities Litigation Uniform Standards Act of 1998 into law on November 3, 1998 ("SLUSA").[283] SLUSA made federal courts the exclusive venue for most securities class action suits. The highlights of SLUSA are:

- State courts are barred from hearing class actions alleging fraud in connection with the purchase or sale of nationally-traded securities, such as those listed by the NYSE or Nasdaq, as well as securities issued by registered investment companies (privately placed debt securities do not fall within SLUSA).

- A federal court is permitted to stay discovery proceedings in any state court action in order to deny class action plaintiffs the ability to circumvent the Reform Act's stay of discovery pending a motion to dismiss by conducting state court discovery.

- State court jurisdiction is preserved over a number of actions, including certain actions based on the law of the subject issuer's state of incorporation, as well as certain other actions.

- Shareholder derivative actions are not considered class actions within SLUSA.

Before the passage of SLUSA, there was concern over whether changes to the Reform Act were premature. The focus of the dispute was over the potential pre-emption of investor protection at the state level through private securities actions. However, according to Michael Perino of Stanford:

> Neither bill [White-Eshoo or the Senate Bill] is intended to limit the scope of any state's authority to bring lawsuits alleging violations of state law. Nor are they intended to intrude upon the dominant corporate law causes of action that are traditionally the province of the states. Such a provision would be wholly consistent with the structure of the Reform Act itself, which is intended to regulate only private litigation. It would also be a straightforward matter to add language assuring that uniform securities fraud litigation standards do not intrude on traditional corporate law causes of action.[284]

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[283] Securities Litigation Uniform Standards Act of 1998 (Pub. Law 105-353), as reported in Fed. Sec. L. Rep (CCH), November 11, 1998.

[284] What We Know and Don't Know About the Private Securities Litigation Reform Act of 1995. Written Testimony of Michael A. Perino, Stanford Law School, before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, United States House of Representatives on October 21, 1997.

On the other hand, Rep. Edward J. Markey attacked the Bills' underlying assumptions at their core, arguing that there has been "no showing" of an increase of securities class actions in state courts. He asserted that in 1997, only 44 securities class action suits were filed in state courts. Most of the suits were in California, Markey pointed out, and stated that if anyone needs to address the issues at hand, it is the California legislature. In 1994, prior to the 1995 Reform Act, 67 securities class actions were filed in state courts, and in 1996, the year following the Reform Act's enactment, 66 such cases were filed.[285]

It is too soon to tell if the passage of such "uniform standards legislation" will make it increasingly difficult for plaintiffs to circumvent the stringent requirements of the Reform Act.

D. Risk Factors

Risk factors have become a common section in many disclosure documents, even for seasoned companies. Historically, risk factor sections were first found in filings for very speculative public offerings, and then most IPOs. Since the mid-1990s, underwriters and cautious issuers inserted risk factors into almost all '33 Act filings because of the protections that they provided, especially under "Bespeaks Caution." In the late 1990s, risk factor sections migrated into the Form 10-K of many issuers and even some Form 10-Qs (many Form 10-Qs at least refer to the risk factors in the annual Form 10-K). By 2001 and 2002, issuers were melding the risk factors into the MD&A, together with the safe harbor legend and a formal description of critical accounting practices.[286]

The risk factor section helps in establishing a company's "Bespeaks Caution" compliance and is also useful in ensuring an issuer's disclosure is complete. There is generally some discussion as to whether the risk factor section should be drafted prior to the rest of the prospectus or only after all other items in the prospectus have been drafted. I generally advise preparing the risk factor section after everything else is complete to ensure that specific risks associated with a particular issuer are identified.

The growing concern involving the risk factor section of prospectuses is that companies are so concerned about liability that they bombard the prospective investor with many irrelevant and impractical risks. There is an ever present tension between the underwriters' counsel, who wants to avoid potential liability through the disclosure of as much information as possible, and the company, who wants to disclose fewer risk factors to remain an attractive investment to potential investors. Issuers should be cautious so that the stated risk factors are actual and not overly exaggerated. Although the SEC does not like mitigating factors, inaccurate or incomplete risk factors may subsequently prove

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[285] Rachel Witner, House Panel Reports Securities Litigation Standards Bill to Full Commerce Committee, 30 Sec. Reg. L. Rep. 883 (1998).

[286] See infra note 431 and accompanying text on critical accounting practices. See also supra Section III.C.5 regarding safe harbor legends.

to be problematic. For example, if an issuer states in a filing that a particular company is its main competitor and then later attempts a merger with or acquisition of the competitor, the issuer will most likely encounter antitrust hurdles to hinder the transaction.

Often, the result is a risk factor section filled with a list of boiler plate risks that could apply to any offering or risks unlikely to occur. Consequently, the SEC has urged issuers to draft the risk factor section to avoid overwhelming investors with irrelevant and improbable risks. In an effort to facilitate complete disclosure, the SEC has recommended (i) writing the risk factors in Plain English, (ii) listing the risk factors in the order of their importance, and (iii) removing "boiler plate" risks entirely from the risk factor section.[287] In addition, the SEC has also considered limiting the total number of risk factors. The likely result of such proposals is the substantial reduction in size of the risk factor section of a prospectus. We would see a scaled down list of generic offering risks associated with the particular company.

1. Plain English

The SEC wants the risk factor section of a prospectus written in plain English. While there have not been many objections to the use of plain English in the risk factors section, some opponents fear that simpler writing will expose companies to greater liability. Opponents fear that plain English will prevent them from adequately warning prospective investors of potential risks. The SEC counters that the substance of the risk factors section will not change, only the way the risks are presented.[288] See Section VII for a more complete discussion of the Plain English requirement.

2. Order of Importance

The SEC's proposal to require issuers to list risk factors in the order of their importance has been met with some objections. The New York State Bar Association's Committee on Securities Regulation (the "Committee") argues that this proposed requirement is impractical and unwise. The Committee argues that the order of importance of risk factors is impossible to determine, and the process of ranking such factors will make issuers vulnerable to claims that they attempted to downplay certain risks by listing them last.[289] The Capital Markets Committee of the Securities Industry Association (the "SIA") also believes that such ranking of risk factors is inappropriate. According to the SIA, "such a requirement would not only expose companies to greater

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[287] SEC Release No. 34-38164, (Jan. 14, 1997).

[288] See Bureau of National Affairs, Conference Report: PLI's Annual Institute on Securities Regulation, Securities Regulation & Law Report, Nov. 14, 1997, p. 1591; Section VII, infra.

[289] New York State Bar Prefers Staff Guidance on Plain English Disclosure, Corporate Secretary's Guide, May 6, 1997, p. 68.

liability, but also result in investors being misled and encouraged to consider less than all the material risks."[290]

3. Prohibition of "Boiler Plate" Risks

The purpose of the proposal to eliminate boiler plate risks is to remove the unnecessary general risks that can overwhelm an investor and that potentially provides no meaningful information to the investor. The SEC wants disclosure that communicates to the potential investor. As the amount of information given to an investor increases, so does the likelihood that he or she will choose to ignore some of that information. Often, if an investor sees boiler plate language, he or she might assume it is not important and will skip over that passage. The SEC believes that if the risks disclosed are tailored to a particular company and are industry specific, the investor will make a more informed decision concerning his or her investment versus facing a myriad of general risks that could apply to any offering.

4. Limiting the Number of Risks

Concerned that plain English alone will not address the problem of describing too many meaningless risk factors, the SEC considered limiting disclosure to a specific number of risk factors (such as eight), or alternatively, limiting the length of the risk factor section to two pages. While this may help to ferret out the impractical general risks that an investor may already be aware of, some fear that this is a step in the wrong direction because the SEC is equating fewer disclosures with better disclosure. While encouraging the listing of industry specific risks is a good goal, the mechanics of numerically limiting risks is dangerous. Some industries are more speculative in nature and may require more risk disclosure, while others require less. With regard to placing a numerical limit on risk factors, the Committee stated that "[n]o issuer should be put in a position of choosing among significant material risks in order to satisfy a numerical limitation."[291] Likewise, the page limitation for the Risk Factor section may place a burden upon the issuer to eliminate some key risks in light of the Plain English initiative.[292] Plain English, moreover, suggests using dual columns, lists, or open white space, which would significantly subtract from the amount of space the issuer has to list the risks associated with the investment.[293]

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[290] SIA Committee Urges SEC "Plain English" Initiative Should be Voluntary, BNA's Securities Regulation and Law Report, May 2, 1997, p. 610. See also Nov. 14, 1997 BNA SRLR at 1591 (final Plain English rule may allow greater flexibility); Section VII, infra.

[291] New York Bar Prefers Staff Guidance on Plain English Disclosure, BNA's Corporate Secretary's Guide, May 6, 1997, at 68.

[292] Nov. 14, 1997 BNA SRLR at 1591 (final Plain English rule may allow greater flexibility) and Section VII, infra.

[293] The SEC plans on providing more guidance through the final Plain English rule to "rein in the excess" of risk factors. Nov. 14, 1997 BNA SRLR at 1592.

5. What Should the Risk Factors Section Look Like?

Risk factors are not only found in a company's prospectus, but also in other SEC filings such as Form 8-Ks, Form 10-Qs[294] and Form 10-Ks. The inclusion of risk factors in such other filings can often times be beneficial in a company's defense. For example, in Geffon v. Micrion Corp., the defendant company's inclusion of a risk factor section in its Form 8-K ultimately defeated appellants' claims that the company made materially misleading statements regarding its sales.[295] In Geffon, the court ruled that summary judgment should be granted in the defendant company's favor because the appellants failed to introduce evidence that the company had the requisite scienter at the time the misleading statements were made.[296] In this case, the company disclosed that it "booked an order" worth $50 million, however, the company did not simultaneously reveal the fact that the purchaser had the right to cancel the order.[297] The court reasoned that the company did not act with the intent to deceive investors because it attempted to provide investors with adequate warnings of the possibility that not all of the units would be purchased under the agreement.[298] Moreover, in its press releases and conference calls, the company referred to the risk factor stated in the company's Form 8-K which warned that the order could be cancelled or terminated at any time.[299] Accordingly, the reference to the risk factor defeated any inference that the company had the requisite scienter to support a claim that it violated the Securities Exchange Act.[300]

E. "Bespeaks Caution" Doctrine

A recurrent theme of cases attacking forward looking information is the claim that the issuer reaffirmed prior projections through general expressions of optimism or by confirming its goals at a time when it knew or should have known that identified problems with products or operations threatened its ability to achieve the earlier projections. These allegations often are commingled with a sundry of other counts constituting a Rule 10b-5 action. Defendants have a difficult burden dismissing these claims when internal memorandum, statements to third parties or other "smoking guns" contradict the issuer's public statements. Issuers should beware that virtually any public

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294 Although accurate statements of historical fact in a Form 10-Q report are immaterial and inactionable. McDonald v. Kinder-Morgan, Fed. Sec. L. Rep. (CCH) ¶ 91,778 (10th Cir. 2002).

295 Geffon v. Micrion Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,419 (1st Cir. 2001).

296 Id. at 96,402. See also Ronconi v. Larkin, Fed. Sec. L. Rep. (CCH) ¶ 91,450 (9th Cir. 2001) (granting defendants' motion to dismiss because the plaintiffs failed to plead specific facts indicating that the defendant company's optimistic statements, or puffing, concerning the integration of two businesses, were false when made).

297 Id. at 96,399.

298 Id. at 96,403.

299 Id.

300 Id.

expression of optimism can be construed as a reaffirmation of prior forward looking statements.

A number of other cases, however, hold that issuers can avoid liability for projections and other predictive information when the information is accompanied by specific risk disclosure. This "Bespeaks Caution" doctrine holds that when precise cautionary language that directly addresses itself to future projections, estimates or forecasts is used, such projections, estimates or forecasts cannot be misleading as a matter of law.[301] This doctrine does not apply, however, when the speaker knows he is making untrue statements.[302] Regardless of the "matter of law" rhetoric used when speaking of this doctrine, as illustrated by the cases below, and in light of certain statements made by the Supreme Court in Virginia Bankshares Inc. v. Sandberg[303], the application of the "Bespeaks Caution" doctrine is indeed a case-by-case factual analysis.

The following cases demonstrate that, regardless of any safe harbor or disclosure of risk factors and underlying factual assumptions, forward looking statements will be subject to a plaintiff's 20/20 hindsight and may be actionable under the federal securities laws, although this trend appears to be shifting. On the brighter side, the Ninth Circuit's adoption of the "Bespeaks Caution" doctrine in Worlds of Wonder shows that issuers may indeed find protection when cautionary language is specific and not generic -- but, as emphasized by the Ninth Circuit in Fecht, the cautionary language must be specific.[304]

In the recently enacted Reform Act, Congress provided for a statutory safe-harbor for many "forward looking statements" based upon the "Bespeaks Caution" doctrine.

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301 The rationale for some courts in applying this doctrine is that where there is enough cautionary language attached to optimistic statements, investors have no right to rely on only the optimistic statements. See e.g., Donald C. Langevoort, Disclosures that "Bespeak Caution", 49 Bus. Law. 481 (1994), for a more detailed discussion of the "Bespeaks Caution" doctrine. It has been argued, however, that "even caution-laden disclosures may have the propensity to mislead" because the "presence of cautionary language actually may make the projections more influential." Id. at 497-98. Thus, it can be argued that courts which assume that cautionary language automatically negates optimistic statements would be erroneously applying the doctrine. Id. at 497. See also Rubenstein v. Collins, discussed infra Section III.E.3. The other rationale expressed by the courts is that the cautionary language so dilutes the disclosure that no reasonable person would find an optimistic message. See Id. at 487.

302 But see the district court's decision in Donald J. Trump Casino, 793 F. Supp. 543, 553 (D.N.J. 1992), aff'd, 7 F.3d 357 (3d Cir. 1993), where the court stated: "The 'Bespeaks Caution' analysis subsumes the misrepresentation analysis. No reasonable inference can be drawn in favor of a plaintiff that a statement which bespeaks caution as to future forecasts contains actionable misrepresentations." See also Langevoort, supra note 249.

303 111 S. Ct. 2749 (1991). In Virginia Bankshares, the Supreme Court held that statements by management of reasons, opinions or beliefs - even though conclusory in form - may be material facts that could give rise to misstatement liability under the federal securities laws.

304 See also Parnes v. Gateway 2000, Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,509 (8th Cir. 1997); In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,480 (S.D.N.Y. 2003) (finding that an analyst's opinions of future stock performance contained specific risk warnings).

1. Donald Trump Casino Securities Litigation

In Donald Trump Casino Securities Litigation,[305] investors who purchased bonds to provide financing for the Taj Mahal alleged that the prospectus which accompanied the bond offering contained materially misleading statements and omissions regarding, among other matters, defendant's belief that operation of the Taj Mahal would generate enough money to cover its debt service. The language from the Management Discussion and Analysis section stated:

> The Partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal).
>
> However, the above statement was followed by a warning:
>
> No assurances can be given, however, that the actual operating results will meet the Partnerships' expectations. See "Special Considerations -- Ability of the Partnership to Service Debt."

The subsection, "Ability of the Partnership to Service Debt" listed several specific risk factors and scenarios under which the contemplated adverse effects would materialize.

The district court dismissed the action, applying the "Bespeaks Caution" doctrine and stating that the prospectus "virtually bristle[d] with warnings" concerning the "extremely risky nature of the investment."[306] The Third Circuit subsequently affirmed the lower court's ruling, concluding that in light of the disclaimers contained in the prospectus, "no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment."[307] The court stated that:

> . . . when an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.[308]

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[305] 793 F.Supp. 543 (D.N.J. 1992), aff'd, 7 F.3d 357 (3d Cir. 1993).

[306] 793 F.Supp. at 555.

[307] 7 F.3d at 369.

[308] Id. at 371. See also Gasner v. Board of Supervisors, Fed. Sec. L. Rep (CCH) ¶ 99,379 (4th Cir. 1996). The Court applied the "total mix" standard from Trump and dismissed plaintiff's complaint concluding that cautionary statements in offering materials for municipal bonds for a new solid waste facility were sufficient to warn investors of the high risks at stake. Plaintiffs alleged that the issuer had additional information as to the viability of the facility. The Court held, however, that the risks that materialized were the same as those outlined

On March 7, 1994, the U.S. Supreme Court allowed the federal appeals court's decision to stand.

2. Sinay and Mayer

In Sinay v. Lamson & Sessions Co.[309], the Sixth Circuit held that the issuer's optimistic statements regarding its performance and confirmation of an analyst's earnings estimates were not misleading where the predictions bespoke sufficient caution. The Court also found that the issuer also could not predict a decline in the construction market nor a devastating labor strike any better than the public.

But in Mayer v. Mylod,[310] the Sixth Circuit backed down from the "Bespeaks Caution" doctrine in light of the Supreme Court's statements in Virginia Bankshares that, while publishing accurate facts may render misleading statements too unimportant to create liability, not every mixture of the truth will neutralize the deceptive. In Mayer, the Sixth Circuit overturned the district court's application of Sinay to several statements of "opinion" made by a Michigan bank, holding that Virginia Bankshares required a weighing of the true with the untrue and thus, cautionary statements cannot "as a matter of law" render optimistic statements inactionable.

3. Rubenstein v. Collins

In Rubenstein v. Collins,[311] the Fifth Circuit stated that "cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law."[312] Thus, while "[i]nclusion of cautionary language along with disclosure of any firm-specific adverse facts or assumptions is, of course, relevant to the materiality inquiry . . . cautionary language as such is not per se dispositive of this inquiry."[313]

In Rubenstein, Plains Resources, Inc. ("Plains"), one of the defendants to the suit, announced on August 19, 1991 that it had made a significant natural gas discovery, which was characterized as "substantial." Initial tests of the discovery were conducted, and analysts subsequently gave optimistic opinions about high yields from the discovery. On October 23, 1991, Plains' CFO reportedly characterized as "realistic" an analyst's opinion that, among other things, the asset value of Plains was between $66 to $100 per share. In November 1991, Plains filed a registration statement for a proposed secondary

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in the issuers cautionary statements such that the "total mix" of information was not misleading. Specifically, the offering statement disclosed that repayment of the bonds depended on the commercial success of the facility.

309 948 F.2d 1037 (6th Cir. 1991).

310 Fed. Sec. L. Rep. (CCH) ¶ 97,379 (6th Cir. 1993).

311 20 F.3d 160 (5th Cir. 1994).

312 Id. at 167.

313 Id. at 168.

public offering which reiterated the initial test results and contained the following assertion:

> Although there is insufficient production history and other data available to definitely quantify the proved reserves attributable to this discovery, the Company believes . . . that [the] well is a significant discovery that, when fully evaluated, could add substantially to the Company's oil and natural gas reserves. There can be no assurance, however, that subsequent production, drilling and other data will not cause the Company to reevaluate its assessment of the significance of this discovery.[314]

Similar statements were made in the prospectus that accompanied the offering.

The plaintiffs alleged that the registration statement and the October 23rd statement were misleading because the defendants knew that the discovery testing conducted up to that time "was not sufficient to provide a reasonable basis for these statements, and failed to disclose the declines in flow-tube and shut-in pressures."[315] On December 4, 1991, the defendants began to disclose some of the adverse information regarding the discovery. Five days later, however, Plains' CEO announced that the discovery was up and running and was producing gas and condensate at levels seen before the recent sharp drop in flow-tube pressure. On January 24, 1992, the planned public offering took place. Plains filed its 10-K report on March 20, 1992, in which it reiterated the favorable October test results. Finally, on April 13, 1992, an analyst publicly reported that the well's reserves were worth less than $2 million, which was insufficient to cover the actual cost of the well.

The plaintiffs alleged, among other things, that defendants violated Sections 10(b) and 20(a) of the Exchange Act, as well as Rule 10b-5. The district court dismissed these claims holding that the statements by defendants "were made in good faith, suggested reliability and bespoke caution."[316] According to the district court, "positive economic forecasts and predictions such as those made by defendants may not form the basis of a securities fraud action when such statements are couched in cautionary language."[317]

The Fifth Circuit subsequently overturned the district court's decision, stating that the district court had applied the "Bespeaks Caution" doctrine too broadly.[318] In its

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314 Id. at 163-64.

315 Id. at 164.

316 Id. at 165.

317 Id.

318 See also Prudential Securities, Fed. Sec. L. Rep. (CCH) ¶ 99,253, 95,430 (S.D.N.Y. 1996) (cautionary language does not protect material misrepresentations or omissions when registrant knows they are false when made).

decision, the Fifth Circuit declined to follow Sinay and instead cited Mayer favorably. Thus, it appears that some courts will continue to back down from the "Bespeaks Caution" doctrine, as Mayer and Rubenstein reveal, and instead find that statements couched in cautionary language are merely of the "total mix of information" that courts look to in determining liability. Conversely, the "Bespeaks Caution" doctrine has gained support in other courts, as Worlds of Wonder, discussed below, illustrates.

4. Worlds of Wonder Securities Litigation

In Worlds of Wonder,[319] the Ninth Circuit adopted the "Bespeaks Caution" doctrine and affirmed the district court's summary judgment in favor of the defendants regarding the text of a Debenture Prospectus.

Worlds of Wonder ("WOW") was formed in 1985 and quickly achieved huge success with its two lines of toys: Teddy Ruxpin and Lazer Tag. To fund further expansion, WOW conducted a debenture offering in June of 1987, raising $80 million. This additional infusion of capital was inadequate to sustain WOW's uncontrolled growth and sluggish sales in the 1987 Christmas season, which led to WOW filing for bankruptcy on December 21, 1987. Several purchasers of WOW debentures subsequently filed this class action alleging that the prospectus accompanying the offering was false and misleading in violations of Sections 11 and 12(2) of the 1933 Act and Section 10(b) of the 1934 Act.

The district court held that where a prospectus contains extensive discussions of the specific risks inherent in investing in a start-up toy company, optimistic statements about such investment are not misleading as a matter of law.[320] According to the district court:

> It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous statements when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based . . . [321]

On appeal, the Ninth Circuit considered the issue whether the district court erred by adopting and applying the "Bespeaks Caution" doctrine. The Ninth Circuit began its discussion of the doctrine by noting that at least six circuits have adopted some form of the "Bespeaks Caution" doctrine. The court further stated that "the doctrine, when properly construed, merely represents the pragmatic application of two fundamental

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[319] Fed. Sec. L. Rep. (CCH) ¶ 98,393 (9th Cir. 1994).

[320] 814 F. Supp. 850 (N.D. Cal. 1993).

[321] Id. at 858-59.

concepts in the law of securities fraud: materiality and reliance."[322] The Ninth Circuit then found that the district court had applied the doctrine narrowly and thus affirmed the district court's summary judgment in favor of defendants. To prevent overboard application of the doctrine, the Court stated that:

> The "Bespeaks Caution" doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.[323]

5. Harden v. Raffensperger

In Harden v. Raffensperger,[324] plaintiffs alleged that Raffensperger, as underwriter, was liable for, among other things, misstatements concerning the issuer's ability to secure insurance and its plans to restore company profitability. Raffensperger argued that the statements were couched in sufficient cautionary language creating a viable "Bespeaks Caution" defense.

> In rejecting Raffensperger's arguments, the Court noted:
>
> Essentially, Raffensperger contends that the word 'plans' used in this statement means 'future efforts' rather than existing methods, ideas or means of achieving some goal. We cannot agree ... Contrary to Raffensperger's attempt to portray the 'plans to restore [profitability] statement' as containing solely 'soft information,' the statement constitutes a present assertion of fact . . . [325]

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322 Fed. Sec. L. Rep. (CCH) ¶ 98,393 (9th Cir. 1994)

323 Id. (citing Worlds of Wonder, 814 F. Supp. at 858). See also Prudential Securities Inc. Limited Partnerships, Fed. Sec. L. Rep. (CCH) ¶ 95,430 (holding that cautionary language must precisely address the substance of the specific statement or omission that is challenged); Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co., 2004 WL 32963 (9th Cir. Jan. 7, 2004) (Clorox's Chief Financial Officer made statements to analysts that it would take approximately one year for the company to resolve problems arising from the acquired company's artificial inflation of short-term profits. The 9th Circuit held that the Chief Financial Officer's disclaimer of certainty at the beginning of the analyst call, her reference to additional cautions in Clorox's Form 10-K filing and the indication that Clorox anticipated it would be losing money on a recent acquisition for several quarters were protected by the safe harbor because they were forward looking statements accompanied by meaningful disclosures of caution identifying important factors that could lead to different results).

324 Fed. Sec. L. Rep. (CCH) ¶ 98,869 (7th Cir. 1995).

325 Id. at 93,224. Cf. Winick v. Sowell, Fed. Sec. L. Rep. (CCH) ¶ 92,652 (7th Cir. 2003) (The Seventh Circuit found that a statement in a quarterly report that the company believed "existing cash balances" and lines of credit, combined with cash provided by operating activities and "anticipated" financing activities would be sufficient to fund the company's obligations was "entirely forward-looking").

With respect to the issuers cautionary statement regarding its efforts to secure insurance the court found that:

> [The company] knew, prior to the issuance of the registration statement, that there was in fact no possibility of such approval and omitted to disclose this fact. The information . . . does not concern subjective or 'soft information,' but rather 'hard facts.' The "Bespeaks Caution" doctrine does not, as a matter of law, offset the materiality of such information. [326]

The court's distinction between "hard" and "soft" information has lead some commentators to suggest that the decision cuts back on the "Bespeaks Caution" defense. However, the court's emphasis on the language used by defendant in preparing the registration statement suggests that more concise drafting by issuer and underwriter may preserve a "Bespeaks Caution" argument even if the cautionary language concerns "hard facts."

6. Fecht v. Price Company

The Ninth Circuit signaled that it would carefully review dismissals of securities fraud claims based upon the "Bespeaks Caution" Doctrine.[327] The court quoted its ruling from Worlds of Wonder, but went on to state:

> The "Bespeaks Caution" doctrine is thus wholly consistent with our analysis that whether a statement in a public document is misleading may be determined as a matter of law only when reasonable minds could not disagree as to whether the mix of information in the document is misleading. Inclusion of some cautionary language is not enough to support a determination as a matter of law that defendants' statements were not misleading.

In early 1996, the Ninth Circuit made clear that it considered Fecht to be the controlling case for reviewing dismissals based on the "Bespeaks Caution" doctrine. In Warshaw v. Xoma,[328] the court applied the Fecht standard to dismiss a plaintiff's complaint, concluding that effective cautionary language must be so obvious that reasonable minds could not differ as to its meaning. The court concluded: "The complaint asserts that the defendants knew that the facts contravened their 'optimistic'

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326 Id.

327 Fecht v. Price Co., Fed. Sec. L. Rep. (CCH) ¶ 98,946 (9th Cir. 1995).

328 Warshaw v. Xoma Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,013 (9th Cir. 1996).

statements that E5 was safe, effective, and would be approved by the FDA. In this case, we easily conclude that the complaint satisfied Rule 9(b) requirements."[329]

7. Pozzi v. Smith

In Pozzi v. Smith,[330] an electronics and software company, Quad Systems Corp., could not successfully invoke the "Bespeaks Caution" doctrine because the company's use of cautionary language was qualified. Quad disclosed certain problems it was having with its software, but qualified the disclosures by saying that the problems were not unusual and could be satisfactorily resolved. The court concluded: "Thus, even though Quad made certain cautionary statements about software limitations and bugs (which it soft-pedaled by describing them as not unusual), it was simultaneously hiding the effect of those problems on the Company's business."[331]

8. Saslaw v. Al Asakari

In Saslaw v. Al Asakari,[332] a garment manufacturer, Plaid Clothing Group, successfully invoked the Bespeaks Caution doctrine and defeated investors' claims that the company made false representations in its registration statement. The registration statement detailed the past, present and future turmoil in the clothing industry as well as a "panoply" of risks facing the company and its recent acquisitions. The company disclosed as a risk factor that its margin would decline as sales shifted from higher-priced specialty stores to value-priced retailers, and that problems with its information systems

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329 Id. For another example of stringent application of the bespeaks caution doctrine, see Westinghouse, Fed. Sec. L. Rep (CCH) ¶ 99,271 (3d Cir. 1996). In Westinghouse, plaintiffs alleged that the company misrepresented the adequacy of its loan loss reserves in its 1991 Registration Statement. Westinghouse's Registration Statement contained cautionary language regarding "future economic developments" that may cause losses in the company's marketable securities portfolio. In holding these cautionary statements insufficient to warrant dismissal of defendant's complaint, the court stated:

> "In our view, a reasonable investor would be very interested in knowing, not merely that future economic developments might cause further losses, but that (as plaintiffs allege) current reserves were known to be insufficient under current economic conditions. A reasonable investor might well be willing to take some chances with regard to the future of the economy, but might be quite unwilling to invest in a company that knew that its reserves were insufficient under current conditions and knew it would be taking another major write-down in the near future (as plaintiffs allege)." Id. at 95,582.

330 Pozzi v. Smith, Fed. Sec. L. Rep. (CCH) ¶ 98,967 (E.D. Pa. 1995).

331 Id. See also Voit v. Wonderware Corp.., Fed. Sec. L. Rep. (CCH) ¶ 99,541 (E.D. Pa. 1997). In Voit, the bespeaks caution doctrine could not be invoked by executives who allegedly omitted present facts. See P. Stolz Family Partnership L.P. v. Daum, 2004 WL 50787 (2d Cir. Jan. 12, 2004) (Allegations that no initial public offering was being planned and that there had never been any agreement to take a LLC public at the time of the alleged misstatements related to present and historical facts and were not, therefore, forward looking statements that could be cured by cautionary language).

332 Fed. Sec. L. Rep. (CCH) ¶ 99,461 (S.D.N.Y. 1997).

led to poor inventory control. The court concluded that these risk factors were clearly delineated and were not "buried in a mass of trivial information."[333]

9. International Business Machines Corp.

The Second Circuit upheld the lower court in dismissing a suit against IBM for fraudulent representations of fact concerning future payment of dividends.[334] The court held that an officer's statement to the press that there was "no plan, no desire" to cut the dividend, followed by a cut of the dividend first by $0.67 and then again by $0.29 were opinions concerning an uncertain future event, and not actionable as such.[335] Because the statements were opinions and not guarantees and because the power to declare dividends is clearly vested in the Board of Directors and not in the management or person making the statements, the court upheld the dismissal.[336] Additionally, the court relied upon the Bespeaks Caution doctrine and held that the statements of opinion were followed by appropriate cautionary language, making it unreasonable for an investor to rely on the statements as long-term guarantees.[337]

10. Rissman v. Rissman

The Northern District of Illinois held in Rissman v. Rissman that a shareholder in a closely-held corporation could not claim reliance on allegedly misleading oral statements when deciding to sell his shares to a majority shareholder.[338] Plaintiff Arnold Rissman sold his one-third ownership in Tiger Corporation ("Tiger") for $17,000,000, and at that time signed a Buy-Out settlement agreement (the "Agreement"). The Agreement provided for, among other things, a full release and a statement that Arnold Rissman had received no promises or inducements to sell. Additionally, Arnold Rissman was informed in the Agreement that a potential future sale to a third party or to the public in an initial public offering could be for a price substantially more than the purchase price in the Agreement.

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333 See also Brogen v. Pohlad, Fed. Sec. L. Rep. (CCH) ¶ 99,462 (D. Minn. 1997). In Brogen, the risks of a recently acquired chain of beauty salons were sufficiently warned of through a variety of cautions and warnings to render defendants' optimism only part of total mix of information available.

334 International Business Machines Corp., Fed. Sec. L. Rep. (CCH) ¶ 90,328 (2d Cir. 1998).

335 Note that some statements of opinions or predictions are actionable. See Time Warner, 9 F.3d at 266; Apple, 886 F.2d 1109, 1113 (9th Cir. 1989). Those opinions that are actionable are so because they are worded as guarantees, or if the speaker does not genuinely believe them.

336 International Business Machines, at ¶ 91,599.

337 Id. at ¶ 91,560. See also San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris, 75 F.3d 801 (2d Cir. 1996) ("[l]iability may not be imposed based on statements that, considered in their entirety, clearly 'bespeak caution.'").

338 Rissman v. Rissman, Fed. Sec. L. Rep. (CCH) ¶ 90,630 (N.D. Ill. 1999).

Arnold Rissman, however, claimed that he had been told that under no circumstances would Tiger be sold to a large company who could then take Tiger public (and, presumably, garner major fortunes for shareholders), and because this was not a possibility, he chose to sell. Less than a month after he sold his shares, Tiger was sold to Hasbro for a price that far exceeded the price per share Arnold Rissman received.

Citing Teamsters Local 282 Pension Trust Fund v. Angelos,[339] the court stated that "an investor cannot close his eyes to a known risk."[340] "No reliance is reasonably made upon antecedent declarations that Tiger would never be sold. Here, the plain language of corporate opportunity to sell or merge or consolidate Tiger bleeds upon the Agreement."[341] The court stated that a shareholder with perhaps less than all available information can still be held to have had enough information to reasonably sell his shares.[342]

11. Helwig v. Vencor

After the district court initially upheld the defendants' motion to dismiss plaintiffs' case for failure to state a claim of securities fraud, the Sixth Circuit, en banc, reversed the lower court's finding in what has now become a controversial decision due to Judge Kennedy's strong dissent.[343] In Helwig, the Sixth Circuit ruled that the plaintiffs' complaint raised a strong inference that defendants projected financial stability at a time when they knew such statements were false.[344] Accordingly, the court ruled that the defendants cannot claim the safe harbor protection under the PSLRA for their forward-looking statements made in connection with the defendant company's earnings, revenue and future economic performance.[345]

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339 Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 530 (7th Cir. 1985).

340 Rissman at 90,874.

341 Id.

342 See also Dayton Technologies v. Aluminum Co. of America, Fed. Sec. L. Rep. (CCH) ¶ 91,770 (6th Cir. 2002)(dismissing plaintiff's fraud claim because plaintiff should have been aware that the defendant intended to sell another subsidiary that was a major customer of the company that plaintiff had purchased).

343 Helwig, Fed. Sec. L. Rep. (CCH) ¶ 91,445 (6th Cir. 2001).

344 Id.

345 Id. at 96,645; see also Lindelow v. Hill, Fed. Sec. L. Rep. (CCH) ¶ 91,483 (N. D. Ill. 2001) (holding that claims against a company that allegedly made false forward-looking statements would not be dismissed because such statements were not protected by meaningful cautionary language as required by the PSLRA safe harbor); Unicapital Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,512 (S.D. Fla. 2001) (holding that alleged false statements did not fall within the purview of the PSLRA's safe harbor for forward-looking statements because the press releases did not print meaningful cautionary language with such forward-looking statements); compare Splash Technology Holdings, Fed. Sec. L. Rep. (CCH) ¶ 91,524 (N.D. Cal. 2001) (holding that the alleged misstatements fell under the PSLRA's safe harbor for forward looking statements because such statements were accompanied by sufficient cautionary language).

In this case, the plaintiffs alleged that the defendants made positive statements about the financial condition of the company to inflate the stock price though evidence suggests that the defendants knew proposed legislation could adversely impact their operations.[346] The court determined that the defendants failed to use specific and substantive cautionary language in connection with the forward-looking statements.[347] More specifically, Vencor's general statements regarding the pending legislation offered investors little guidance concerning the potential results of the health care reform upon the company's business.[348] Accordingly, defendants cannot avail themselves to the protection of the PSLRA's safe harbor provision.[349]

12. Further Applications of the "Bespeaks Caution" Doctrine

Certain court rulings around the country have demonstrated that the "Bespeaks Caution" doctrine remains a viable defense for defendants that face claims of securities fraud. In 2002, the District Court of Maryland held that the "Bespeaks Caution" doctrine applied in a case in which extensive cautionary language was contained in the prospectus at issue.[350] USEC involved a complaint that the defendant's prospectus was materially false and misleading in that it did not adequately inform investors of a number of issues with potentially negative effects on the company.[351] Citing language from Donald Trump, the court stated that "cautionary language in the prospectus may negate the materiality of an alleged misrepresentation or omission."[352] Because the prospectus contained such cautionary language, the court granted the defendants' motion to dismiss the claim.[353]

Also in 2002, the District Court of Utah held in Spiegel v. Tenfold Corp. that the prospectus at issue contained sufficient risk disclosures to immunize the defendant from a securities fraud claim.[354] In Spiegel, the plaintiffs alleged that defendant repeatedly made on-time guarantee statements despite knowing that there was a significant chance that

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346 Helwig at 96,646.

347 Id. at 96,648. See also In re Amylin Pharm., Inc. Sec. Litig., Fed. Sec. L. Rep. ¶ 92,502 (S.D. Cal. 2003) (holding that defendants' general cautionary statements were not tailored to the defendants' statement that they had "completed clinical testing of SYMLIN that [they believed was] sufficient to support [FDA] approval to market SYMLIN," and did not provide meaningful information to the plaintiffs regarding the FDA's concern that the trial designs were inconsistent with clinical practice and that data from such trials would not be considered pivotal data for FDA approval).

348 Id.

349 Id.

350 USEC, Fed. Sec. L. Rep. (CCH) ¶ 91,752 (D. Md. 2002)

351 Id. at 98,534

352 Id. at 98,540

353 Id. at 98,543

354 Spiegel v. Tenfold Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,736 (D. Ut. 2002)

they would not be able to perform certain contracts before deadlines were reached.[355] Additionally, plaintiffs claimed that defendants overstated the capabilities of their technology.[356] The court again focused on whether the prospectus at issue contained sufficient risk disclosures to immunize statements relating to the disclosure.[357] The court stated that the prospectus disclosed that Tenfold had experienced delays in completing projects in the past and could experience delays in the future.[358] Additionally, the court noted that the prospectus disclosed that the defendant had not extensively tested its technology.[359] Thus, "neither the on-time nor the technological guarantee statements could have misled a reasonable investor."[360]

F. Duty to Update

It was hoped that the Reform Act would clarify the question of whether issuers have a "duty to update" statements which were accurate when made, but which become inaccurate due to subsequent developments. Although nothing in the Reform Act's safe harbor imposes such a duty, the statutory language does not eliminate the duty to update which may arise under current case law.[361] According to Carl Schneider, "in effect, the Reform Act does not change the law, whatever it may be, relating to the duty to update.[362]

The cases discussed below, including the well-publicized Polaroid case, suggest that issuers have a "duty to update." These cases often confuse the duty to correct and the duty not to mislead. If an issuer makes a statement that is inaccurate or is misleading based on the facts and circumstances existing at the time of such statement, then the issuer has a duty to correct such misstatements. That is not to say that an issuer has a duty to update statements which were accurate when made, but later became inaccurate or misleading due to a change of facts and circumstances. Until the enactment of S-O, there was no precedent for the proposition that either the duty to correct or the duty not to mislead requires that issuers update prior, accurate statements. Section 409 of S-O provides the SEC an opportunity to adopt rules to require rapid and current disclosure.[363]

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355 Id. at 98,420

356 Id. at 98,422

357 Id. at 98,423

358 Id.

359 Id.

360 Id.

361 Carl W. Schneider and Jay A. Dubow, Forward-Looking Information--Navigating in the Safe Harbor, 51 Business Lawyer 1071, 1077 (1996).

362 Id.

363 See supra Introduction to Section II and Section II.A.2.

In fact, these cases are misconstrued duty not to mislead claims. The "duty to update" theory is a misnomer which threatens to negate the established principle that an independent trigger of a duty to disclose is a distinct element of a Rule 10b-5 action. Although a narrower duty to update only "so-called forward looking" statements appears more palatable, in practice it would be an unworkable and dangerous precedent. Such a duty to update prior disclosures would discourage issuers from making disclosure in the first place, and therefore is counterproductive to a system which encourages timely voluntary disclosure of material information.[364] Nevertheless, there was a trend to require such a duty, as some of the earlier cases such as Time Warner illustrated. Fortunately, recent cases such as Cummins Engine and Centel Corp. indicate that this trend to require a duty to update may be reversing.

1. Backman v. Polaroid Corporation

If bad facts make bad law, then the opinion by a panel of the First Circuit in Backman v. Polaroid Corporation[365] shows that unique circumstances also can produce bad law. The panel's opinion would have imposed upon Polaroid a broad duty to disclose material adverse developments concerning its new instant movie system called "Polavision" solely to update prior, accurate statements which were rendered inaccurate by subsequent adverse developments. The panel would have imposed this interim period disclosure obligation even though it was unable to conclude that Polaroid was either trading its own securities or making statements which, without an update, would have been otherwise misleading.

Fortunately, the court's opinion was withdrawn, and the judgment vacated. After a rehearing en banc the First Circuit held that Polaroid's statements could not have been considered misleading when made, nor did they become misleading in light of subsequent events.[366] Nevertheless, because the full court did not completely reject the notion that certain "forward looking" statements could require further disclosure, the Polaroid case merits close attention to prevent the so-called "duty to update" from receiving further credibility.

a. Unique Circumstances: The Third Quarter Report, Polavision Problems and The Foundation Stock Sale

Polaroid introduced its much-heralded Polavision with a massive ad campaign in the Spring of 1978, projecting sales of 200,000 units for the year. By October, the

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364 See e.g., Carl Schneider, Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?, 23 Rev. Sec. & Comm. Reg. 83 (1990); Carl Schneider, The Uncertain Duty to Update -- Polaroid II Brings a Welcome Limitation, Insights, Oct. 1990, at 2; Carl Schneider, The Duty to Update: Time Requires a Reevaluation of Basics, Insights, Apr. 1994, at 2.

365 Fed. Sec. L. Rep. (CCH) ¶ 94,899 (1st Cir. 1990), opinion withdrawn, judgment of the court of appeals vacated, opinion en banc, 910 F.2d 10 (1st Cir. 1990).

366 910 F.2d 10 (1st Cir. 1990) (en banc).

company had adjusted projected sales to 100,000 units and ordered its supplier to decrease production. Polaroid temporarily ceased all production of Polavision in November to deplete excess inventory. On both occasions, Polaroid requested secrecy from its supplier concerning the cutbacks. In early December, 1978 Polaroid circulated among upper management a forecast estimating 1978 sales of Polavision at 97,000 units.

Polaroid's Third Quarter Report to Stockholders issued on November 5, 1978, emphasized increased earnings, booming sales and record manufacturing output for the company as a whole. These representations were true and correct in every respect. The Report made only the following direct reference to Polavision:

> [The President] noted also that earnings continue to reflect substantial expenses associated with Polavision, Polaroid's new system of instant movies.[367]

The Report also attributed a major of the company's increase in the ratio of cost of sales to net sales for the first nine months of the year and the third quarter, to "substantial expenses associated with Polavision." These statements also were true.

On January 9, 1979, the Rowland Foundation, a charitable organization run by Dr. Edwin Land, Polaroid's founder, Chairman and CEO, issued a press release through Polaroid's public relations department announcing its intent to sell 300,000 Polaroid shares. The press release had been reviewed by Polaroid's in-house counsel and the Foundation's attorney, a vice-president and director of Polaroid. The press release cited the Foundations' desire to diversify as its reasons for the sale and mentioned Dr. Land's impending retirement as Chairman and CEO of Polaroid. The release made no reference to Polavision. The stock was sold on January 11, 1979 for $52 per share.

On January 15, 1979, Polaroid circulated to management an internal report estimating fourth quarter earnings slightly lower than anticipated, and recommending a reserve for additional Polavision expenditures. Polaroid booked a reserve of $6.8 million for Polavision losses on February 1. At the close of the market on February 22, 1979, Polaroid issued a press release announcing a 26% increase in earnings for fiscal year 1978 and earnings per share of $1.32 for the fourth quarter. The release further disclosed that Polavision had incurred manufacturing and marketing expenses "substantially in excess of revenues" and that the project would continue to make such demands on cash and earnings in 1979. Polaroid's stock fell from almost $50 on February 22 to $43 on February 23, stabilizing at about $40 by March 1.

Plaintiffs sued, alleging that Polaroid misled investors by intentionally de-emphasizing the Polavision difficulties when it announced record earnings for the third quarter. The plaintiffs alleged that Polaroid had a duty to disclose the subsequent

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[367] Fed. Sec. L. Rep. (CCH) at ¶ 94,956.

Polavision production cuts and the December and January internal reports to prevent the Third Quarter Report from "becoming misleading." Finally, the plaintiffs asserted that the press release announcing the Foundation stock sale was misleading because it did not discuss the adverse developments in the Polavision project.

After a bifurcated trial, the jury returned a verdict for the plaintiffs and awarded an aggregate of $9.75 per share in damages to all the class participants. Polaroid appealed the verdict, arguing that it never uttered any misleading statements or engaged in any conduct that would trigger a duty to disclose. Polaroid also challenged the jury instructions regarding materiality and the duty to disclose.

b. Duty to Disclose — No Misstatements

The First Circuit panel in Polaroid held that the trial judge's instructions to the jury regarding Rule 10b-5 improperly equated the duty to disclose with materiality and failed to specify the events that would trigger a duty to disclose.[368] Writing for the panel, Judge Bowne properly stated the circumstances that would trigger an obligation to disclose material information:

> (1) when a "corporate insider trades on confidential information,"
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> (2) when a corporation has made "inaccurate, incomplete, or misleading prior disclosures," and
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> (3) when a statute or regulation requires disclosure.[369]

The panel also determined that the Third Quarter Report was accurate and not misleading at the time of its issuance. Due to its significant involvement in the Rowland Foundation press release, the panel found that Polaroid was responsible for its content. Judge Bowne expressed significant reservations, however, that the release, standing alone, would provide an adequate basis to impose liability on Polaroid for the alleged omissions.

c. Bad Law: The Duty to Update

Notwithstanding that the Third Quarter Report was accurate and not misleading when made, the panel held that a reasonable jury could conclude that the Report "became misleading" once Polaroid ordered the November production halts and had assembled earnings estimates showing poor fourth quarter performance. The panel asserted that even though the statements were accurate when made, "a duty to disclose can arise if a

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[368] The panel also found that the trial judge failed to specifically instruct the jury with respect to the good-faith defense to scienter. The Rule 10b-5 scienter requirement is beyond the scope of this article.

[369] Fed. Sec. L. Rep. (CCH) at ¶ 94,942 (citing Roeder v. Alpha Industries, Inc., 814 F.2d 22 (1st Cir. 1987)).

company possesses material facts that must be released in order to render prior statements not misleading."[370] Therefore, rather than overturn the jury verdict, the First Circuit panel ordered a new trial.

d. Dubious Relief: The En Banc Opinion

In the opinion en banc, the First Circuit reasserted that a duty to disclose would arise only if the issuer: traded in its own securities; made prior inaccurate statements; or was required by a specific statute or regulation. The full court also concluded that Polaroid's statements in the Third Quarter Report about Polavision's negative effect on earnings were complete and accurate when made, and remained true and correct at all times thereafter. The court ruled that Polaroid had satisfied its obligations by disclosing that Polavision was being sold below cost. The court rejected the claim that Polaroid misled investors by electing not to say how much below cost. The court stated that the duty not to mislead:

> does not mean that by revealing one fact about a product, one must reveal all others that, too, would be interesting, market-wise, but means only such others, if any, that are needed so that what was revealed would not be "so incomplete as to mislead."[371]

Finding no evidence in the record to suggest that Polaroid knew by November that Polavision was a commercial failure, the court refused to consider the Polavision statements misleading simply because the Third Quarter Report omitted to mention exact sales figures.

The court also confirmed that if the Polavision statements had been misleading when made, Polaroid would have had a duty to correct them. Because the Polavision statements remained true and correct at all times after their utterance, no duty to correct ever arose. As for the so-called "duty to update," the full court stated that:

> in special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for.[372]

The court acknowledged that it need not face that question, however, because even if the Polavision statements were forward looking, they

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370 Fed. Sec. L. Rep. (CCH) at ¶ 94,944 (citing Greenfield v. Heublein, Inc., 742 F.2d 751, 758 (3d Cir. 1984)).

371 910 F.2d at 16 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)).

372 Id. at 17.

remained precisely correct after their release. Hence, the court's statements as to the duty to update are dicta.[373]

e. A Bad Precedent

Although the First Circuit's rejection of a broad "duty to update" is a welcome relief, the dicta language suggesting that certain forward looking statements require further disclosure is very troubling. To distinguish statements of present fact from purely speculative and forward looking disclosure is practically impossible. Issuers also have no reasonable guidance as to the duration of viability of such statements in the market. Because of the compliance difficulties it presents, acceptance of even a limited duty to update would eviscerate the traditional rule that issuers have no general duty to disclose.

Various commentators and the SEC have long recognized the peculiar problems raised by forward looking statements, speculative analysis and projections.[374] The SEC has historically accepted a modicum of "touting" as an acceptable business practice and has adopted Rule 175 as a safe harbor to encourage issuers to provide projections of future performance, estimates and forecasts.[375] A duty to continually update all material statements, including forward looking statements, would discourage voluntary disclosure and undermine the SEC's efforts in this regard.

To undermine the doctrine of timely disclosure in this manner appears particularly short-sighted given the development of the MD&A as a quarterly disclosure vehicle, requiring issuers to disclose all material changes or subsequent developments in their 10-Q reports. Because virtually all such material changes relating to forward looking statements would be encompassed in the MD&A, courts should refuse to

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373 Ironically, Judge Bowne's dissent to the opinion en banc provides a better discussion of the disclosure issue than that given in the majority opinion. Judge Bowne admits that the language in the panel opinion could be construed as creating an overly broad "duty to update" past accurate statements of historical fact and that no such "duty to update" should exist. Unfortunately, Judge Bowne also stated that the duty to correct should apply to forward-looking statements which remain "alive" and become inaccurate due to events that occur while the statement is still viable in the marketplace.

374 In his article, Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?, Carl Schneider describes statements which could possibly warrant a "duty to update" because of an "implied representation and/or reasonable expectation of continuity." See Schneider, supra note 338. Schneider states that if a company announces a long-term contract award which would double its sales, and loses that contract months later, the company should have to disclose the loss of that contract, solely because of its prior disclosure. Management should be entitled, however, to exercise its business judgment and delay disclosure of this information to assess the impact on the business and develop strategies to counter any losses. See supra note 1. Regardless, the company's next MD&A would require disclosure of the contract, loss if the company's liquidity or capital resources would be affected, or if the cancellation would cause the historical financial data in the report not to be indicative of future operating results or financial condition.

375 Rule 175 generally provides a safe harbor for projections that are made with a reasonable basis and in good faith. See 17 C.F.R. § 230.175. For a discussion regarding the "enhanced" safe harbor rule under the Private Securities Litigation Reform Act of 1995, see infra Section III.C.4-5.

eliminate the flexibility and business judgment afforded management under the current regulatory scheme.

2. Time Warner Inc.

After the takeover by Time of Warner, the resulting company faced a substantial debt. Time-Warner embarked on a highly publicized campaign to find international "strategic partners" to infuse billions of dollars of capital to the company. The plan failed, and Time-Warner resorted to a stock offering that diluted the rights of the existing shareholders, and a lawsuit followed. The plaintiffs alleged that Time-Warner and certain executives misled the investing public by making certain statements and omissions that were generally optimistic about the progress of the "strategic partnerships" and never indicated the actual difficulties.

The district court considered two categories of misstatements: (i) press releases and public statements from the individual defendants, and (ii) unofficial statements from unnamed sources given to analysts and the press. With regard to the first category, the court found that the statements indicating that talks were ongoing were accurate when made, and that later attempts did not give rise to a duty to correct or update the statements. As to the second category, the court concluded that the defendants could not be held responsible for any of the unattributed statements, and that the statements were not actionable for the same reasons as category one. The district court then dismissed the complaint for failure to adequately plead either material misrepresentations or omissions attributable to the defendants, and for failure to plead scienter adequately.

The Court of Appeals, however, reversed and partially granted the defendant's motion to dismiss. The court discussed, among other matters, two updating issues with regard to the attributed statements and corporate press releases: (i) failure to disclose problems in the strategic alliance negotiations, and (ii) failure to disclose the active consideration of an alternate method of raising capital.

With regard to the first issue, the plaintiffs' theory was that the defendants' statements promoting strategic alliances gave rise to a duty to disclose problems in the alliance negotiations as problems developed. The court found, however, that the attributed public statements "lack the sort of definitive positive projections that might require later correction." Thus these statements "did not become materially misleading when the talks did not proceed well."[376]

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[376] The court added in a footnote:

> Although the statements are generally open-ended, there is one sense in which they have a solid core. The statements represent as fact that serious talks with multiple parties were ongoing. If this factual assertion ceased to be true, defendants would have had an obligation to update the earlier statements. But the complaint does not allege that the talks ever stopped or ceased to be 'serious,' just that they eventually went poorly.

Fed. Sec. L. Rep. (CCH) at ¶ 98,156-7, fn.4. Carl Schneider argues that this footnote should be interpreted to require at most "terminal" disclosures, i.e., when either an agreement is reached or the "serious" negotiations end

Addressing the second issue of the failure to disclose alternative methods of raising capital, the Court of Appeals found that the information about the consideration of the stock offering alternative material because the offering could have a negative effect on the market price for the company's stock. The court then considered whether there was a duty to disclose the omitted fact. The court stated that:

> Time Warner's public statements could have been understood by reasonable investors to mean that the company hoped to solve the *entire* debt problem through strategic alliances. Having publicly hyped strategic alliances, Time Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.[377]

The court concluded that "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."[378]

3. Good v. Zenith Electronics Corporation

Unfortunately, the duty to update refuses to die a rational death. In Good v. Zenith Electronics Corporation,[379] the district court suggested that Zenith may have violated a duty to update certain earnings projections which were accurate and reasonable when made, but subsequently proved unattainable. Zenith's 1988 Annual Report stated that the company "expected further profit improvements in 1989." On April 25, 1989 Zenith reported a $4 million first quarter loss. The release stated that the company's initial forecasts had anticipated the loss and confirmed that the company still expected profit improvement for the full year. On July 21, 1989, Zenith reported a $13 million loss for the second quarter. The price of Zenith stock fell significantly. The plaintiffs alleged that Zenith's April statements confirming the initial projections and projecting profit improvement constituted securities fraud.

In denying the defendant's motion for summary judgment, Judge Bua held that Zenith may have violated Rule 10b-5 by confirming the prior earnings projections at a

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with no agreement. Carl Schneider, The Duty to Update: *Time* Requires a Reevaluation of *Basics*, Insights, Apr. 1994, at 4. Thus, updating disclosures during the course of ongoing negotiations should not be required. Further, it is unclear whether the duty to update would arise if the terms being negotiated were announced but were subsequently changed materially during the course of negotiations. Id.

377 Fed. Sec. L. Rep. (CCH) at ¶ 98,157.

378 Fed. Sec. L. Rep. (CCH) at ¶ 98,157-158. In a subsequent decision, the Second Circuit acknowledged the duty to update, but narrowed its application considerably. See note 219 and accompanying text.

379 Fed. Sec. L. Rep. (CCH) ¶ 96,142 (N.D. Ill. 1990).

time that the company may have been in possession of information which undermined the accuracy of such projections. It is unclear from the opinion whether Zenith actually had actual knowledge of facts contradicting the initial projections because materials relating to this charge were submitted under seal. Any voluntary confirmatory statements, if made at a time when the company had reason to believe that the initial projections were no longer accurate, would likely violate the duty not to mislead.

Unfortunately, Judge Bua went on to state that Zenith also may have had a "duty to update" the initial projections, which were accurate when made, "if additional information became known to the parties that changed the meaning of the statement." Because Zenith's April statements apparently were inaccurate, Judge Bua need not have attributed his ruling to an independent duty to update the initial projections and his statements in this regard are dicta.[380]

4. Stransky v. Cummins Engine Co., Inc.

Although the debate is far from over, the Seventh Circuit repaired some of the damage in Stransky v. Cummins Engine Co., Inc.[381] In Stransky, Cummins Engine Co. issued optimistic press releases regarding its newly redesigned engines, and later discovered because of faulty design problems that warranty costs were skyrocketing. Alan Stransky filed a class action suit for securities fraud, and based the case (at least partially) on a duty to update. The Court noted that some legal scholars have argued that a duty to update arises when a company makes a forward looking statement (i.e., a projection) that, because of subsequent events, becomes untrue. The Court emphatically stated, however, that "This court has never embraced such a theory, and we decline to do so now."[382]

The Seventh Circuit explained that Rule 10b-5 implicitly precludes liability in circumstances that arise after the speaker makes the statement. It commented that "the securities laws typically do not act as a Monday Morning Quarterback," and it noted that the securities laws approach matters from an ex ante perspective. Consequently, forward

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380 Another case where the court applied the "duty to update" is Kulicke & Soffa Indust., Inc., 747 F. Supp. 1130 (E.D. Pa. 1990), where the jury responded in special interrogatories that an issuer had a duty to disclose material information which rendered a prior projected sales forecast misleading, even though defendants made no statements supporting the projections once the projections became unattainable. However, both the jury and the court found that defendants lacked scienter in their failure to correct the forecast immediately. The court in Meridian, 772 F. Supp. 223 (E.D. Pa. 1991), suggested that an issuer had a duty to correct and update between periodic reports its optimistic statements regarding certain successful business operations after difficulties arose. However, in Capri Optics Profit Sharing v. Digital Equip., 760 F. Supp. 227 (D. Mass. 1991), the court cited Backman and rejected the claim that an issuer had a duty to disclose "additional information" regarding expected company performance.

381 Fed. Sec. L. Rep. (CCH) ¶ 98,668 (7th Cir. 1995). For further discussion of a "duty to update" decision in the Seventh Circuit, see Section III.F.9 infra and accompanying text regarding Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001) (holding that there is no continuous duty to update).

382 Id. at 92,105.

looking statements can lead to liability only if they are unreasonable in light of the facts known at the time.[383]

5. Eisenstadt v. Centel Corp.: The Death of the Duty to Update?

In this decision, handed down May 12, 1997, Judge Posner, *in dicta*, followed the Stransky precedent that no duty to update exists in the Seventh Circuit and suggested further that the Reform Act eliminated the duty in all Circuits.[384] Eisenstadt involved a claim by Centel stockholders that Centel exaggerated the prospects of a planned auction for the company, thus inflating the company's stock price. According to the Court, Centel made "repeated claims that the auction process was going well, implying that lots of firms were interested in making attractive bids."[385] Ultimately, the auction failed. Only seven bids were submitted and Centel accepted none of them. Centel then quickly negotiated a sale of the entire company to Sprint at a price equivalent to $33.50 per share, which was $9 below the then-current market price and 10% below the market price before the auction was first intimated.[386]

In upholding the District Court's dismissal, Judge Posner first noted that Centel's statements were not an attempt to cover up a "disaster" since Centel is entitled to "put a rosy face on an inherently uncertain process."[387] Furthermore, the auction process itself was uninterrupted although the results were disappointing. The Court then noted that even if Centel "had made a public prediction of [a more valuable result], it would have had no legal duty, in this Circuit anyway and perhaps in no Circuit after the Private Securities Litigation Reform Act of 1995, [*cite omitted*] to make a public revision of the prediction when it became clear that no such bonanza was in store."[388] The Court stated further that "Centel cannot be faulted for having failed to tell the stock market that there would be only seven bidders and their bids would be no good. Had it known this from

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383 The Seventh Circuit applied the same reasoning in Grassi v. Information Resources, Inc., 63 F.3d 596 (7th Cir. 1995) in upholding the District Court's denial of plaintiffs post-trial motion for judgment as a matter of law. In Grassi, plaintiffs alleged, among other things, that Information Resources made fraudulent misrepresentations regarding projected earnings for 1989. Citing Stansky, the Court held that the projection was not fraudulent absent evidence that "management did not genuinely believe the projection or that the projection lacked any reasonable basis at the time it was made." Id. at 599.

384 Eisenstadt v. Centel Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,458 (7th Cir. 1997). Compare Elliot Assocs. v. Covance, Inc. Fed. Sec. L. Rep. (CCH) ¶91,269 (S.D.N.Y. 2000) (reasoning that a duty to update may exist when a statement, reasonable at the time it is made, becomes misleading in light of later events, however, there is no duty to update a vague or optimistic expression of opinion).

385 Id. at 97,022.

386 Id. at 97,020.

387 Id. at 97,024.

388 Id. at 97,023.

the start, it wouldn't have announced an auction. Hindsight is not the test for securities fraud."[389]

6. Weiner v. Quaker Oats Co.: Duty to Update Resuscitated?

This case, decided on November 11, 1997, reverses a district court's dismissal of plaintiffs' claims that Quaker owed a duty to update projected debt-to-total capitalization ratios.[390] Quaker involves the claims of shareholders that Quaker knowingly made disclosures of projections on debt-capital ratios and earnings growth when such projections could not be achieved because of its impending merger with Snapple Beverage Corp.

The Third Circuit affirmed the dismissal of the projected earnings claim, focusing on the language of Quaker's 10-K which discussed the earnings growth figure as a goal "over time." This phrase insulating Quaker from claims of fraud as no "reasonable finder of fact could conclude that the projection influenced prudent investors."[391]

However, the court reversed the dismissal of the debt-capitalization claim. The court found that, given the 1993 and 1994 projected guidelines to keep the debt ratio under 70%, a potential investor "would have no ground for anticipating that the . . . ratio would rise as significantly as it did in fiscal 1995."[392] The merger took place one month after the 1994 annual statement was released. The court agreed that a trier of fact could find that "the merger would compel Quaker to take on sufficient additional debt to raise [the ratio beyond the purported guideline.]."[393]

Though the Court acknowledged that the terms of the merger were not set by the time the 1994 annual state was released, the probability that Quaker would have known of the costs and effect of the impending merger created a basis which a reasonable fact finder could determine that Quaker had a duty to update its projections when they became unreliable.

The significance of Quaker is somewhat questionable for several reasons. First, the fact pattern of the case is quite unusual - each of the three periodic reports relied upon by the plaintiffs (two annual reports and one quarterly report on Form 10-Q) stressed the debt/equity ratio goal frequently and prominently. The prominence placed on this projected ratio in all three publications essentially invited the court to apply a duty to update. Secondly, defendants relied upon the rather weak defense that updating the

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389 Id.

390 Weiner v. Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶ 99,563.

391 Id. at *10.

392 Id. at *7.

393 Id.

debt/equity ratio forecasts could indirectly disclose the impending merger with Snapple. The court, however, was not impressed and explained that the ratio goals could have been revised (and in fact had been in the past prior to other Quaker acquisition) without disclosing the Snapple merger.[394] Lastly, the court relied upon the language of Burlington Coat Factory[395] and ignored the Seventh Circuit cases of Stransky v. Cummins Engine[396] and Eisenstadt v. Centel,[397] arguably undermining the strength of the opinion.

On remand, a federal district court in Illinois declined to follow the Seventh Circuit law on the "duty to update" but instead followed the "law of the case" doctrine and deferred to the Third Circuit.[398] The court ruled against defendant's motion for summary judgment. In so holding, the court interpreted Third Circuit law as requiring updating for forward looking statements that "could *fundamentally* change the natures of the companies involved" as contrasted with "run of the mill" forward looking statements for which updating is unnecessary. (Emphasis added.)[399]

7. International Business Machines Corp.

The Second Circuit issued a decision indicating that the Time Warner duty to update is still alive in deciding whether IBM had a duty to update an officer's statements that he did not anticipate a cut in dividends.[400] The court narrowed that duty, however, by stating that "there is no duty to update vague statements of optimism or expressions of opinion... There is also no need to update when the original statement was not forward looking and does not contain some factual representation that remains 'alive' in the minds of investors as a continuing representation...or if the original statements are not material." (Omitted citations).[401]

8. Oran v. Stafford

The Third Circuit recently issued a decision which also indicates that the Time Warner duty to update is still an issue in deciding whether a drug manufacturer's failure to disclose potential safety problems with new weight-loss drugs was material.[402] In this

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394 Id.

395 114 F.3d 1410 (3d Cir. 1997).

396 Discussed supra at Section III.F.4.

397 Discussed supra at Section III.F.5.

398 See Weiner v. The Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶ 91,266 (N. D. Ill. 2000).

399 Id. See also the discussion of this case at II.B.2.c., supra.

400 International Business Machines Corp., Fed. Sec. L. Rep. (CCH) ¶ 90,328 (2d Cir. 1998).

401 Id. at 91,561. See also San Leandro, infra note 574 and accompanying text.

402 See Oran v. Stafford, Fed. Sec. L. Rep. (CCH) ¶ 91,205 (3d Cir. 2000).

case, the plaintiffs alleged that the manufacturer, American Home Products Corp., (AHP), knew that taking the weight-loss drug resulted in serious health problems, however, AHP did not disclose this knowledge until after obtaining statistical evidence that its product was linked to the health problem months later.[403] In finding that the district court properly granted a motion for summary judgment in favor of AHP, the court determined that the defendant had no duty to update its prior statement that it was merely investigating any potential health risk related to its drug.[404] The court reasoned that the manufacturer never made any prior statement regarding the time it learned of or received notice of the potential health problems.[405] In making this determination, the court made these statements:

> Moreover, AHO had no legal duty to correct or update even following…its receipt of the FDA report. The duty to correct exists "when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not." Here, because AHP never made any prior statement regarding when it learned of the heart-valve data, there can be no legal duty to correct.
>
> The duty to update, in contrast, "concerns statements that, although reasonable at the time made, become misleading when viewed in the context of subsequent events." ….In this case, AHP never made any factual representation – implicit or explicit – regarding when it was first placed on notice about potential heart-valve problems.

Accordingly, the court held that because there was no misleading prior factual representation, which "remained alive in the minds of investors as a continuing representation," AHP had no duty to update.[406]

9. Gallagher v. Abbott Laboratories

The Seventh Circuit in late 2001 held that there is no continuous duty to update on the part of the issuer.[407] In this case, investors unsuccessfully alleged that Abbott

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403 Id. See also Carter-Wallace, Fed. Sec. L. Rep. (CCH) ¶ 91,039 (2d Cir. 2000).

404 Id.

405 Id.

406 Id.

407 Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001).

committed fraud in violation of Rule 10b-5 by failing to publicly reveal sanctions imposed on the company by the FDA.[408] In the company's 10-K report dated March 9, 1999, the sanctions and correspondence with the FDA were not mentioned.[409] In fact, it was not until March 17, 1999, eight days later, that Abbott received the FDA letter demanding compliance with all regulatory requirements.[410] By September of that year, an Abbott press release revealed that the company was in settlement negotiations with the FDA, and on November 2, 1999, a settlement was reached between Abbott and the FDA.[411] It was at this time that the price of Abbott stock fell and plaintiffs alleged they were injured.[412]

In holding that plaintiffs failed to plead fraud with the particularity required by the PSLRA, the Seventh Circuit ruled that the company did not have a duty to disclose all material information as soon as the letter was received.[413] The court reasoned that the federal securities laws do not require a system of continuous disclosure, rather, issuers are only required to file annual reports, which are updated by periodic reports.[414] These periodic reports do not require the disclosure of company regulatory problems.[415] As a result, the court concluded that updates are not required every time something "material" occurs, but only on the next filing date.[416] Moreover, the court dismissed the plaintiffs' "duty to correct" argument because the Abbott Form 10-K was filed before the FDA letter was received and Abbott had made no false statements.[417] The court reasoned that the 10-K's failure to mention any FDA regulatory action was correct on March 9th.[418] Accordingly, there is no duty to correct a statement that was correct when made.[419]

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Though the duty to update is at least apparently eliminated in the Seventh Circuit, the greater question now is whether other courts will follow the lead and reasoning of

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408 Id. at 97,598.

409 Id.

410 Id. at 97,597.

411 Id.

412 Id. at 97,598.

413 Id.

414 Id.

415 Id.

416 Id.

417 Id. at 97,599.

418 Id.

419 Id.

Gallagher, Stransky and Eisenstadt or Quaker, Oran and Time Warner.[420] The duty to update thus continues to be a widely interpreted and conflicted issue. Until the Supreme Court or the SEC, through rulemaking[421], acts, the courts will most likely continue to recognize a duty to update. The courts, however, will continue to narrow the duty to update by distinguishing the facts before them and finding that under the circumstances present there was no duty to update.

G. Issues in Electronic Media

Just as management can be held liable for statements made in financial statements, press releases, or earnings estimates, it can be held liable for items included on a company's Web site. Because there is no paper involved, companies may tend to forget, for example, to file advertisements with the NASD, or to monitor statements for accuracy and timeliness. As internet usage continues to grow, and reliance on the internet as a primary information resource deepens, companies are responding by prominently displaying all that they can on their Web sites. However, companies are still not using disclaimers as often or as effectively as they should, as "only half the Fortune 100 companies have a ... link on their home page linking to a set of disclaimers," only 30% use safe-harbor disclaimers for their investor relations page, and only a third disclaim a duty to update their Web site content.[422] Companies that choose to utilize the

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420 Such a trend may be developing in some jurisdictions. The opinion in Cypress Semiconductor Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 98,762 (N.D. Cal. 1995), echoes the Seventh Circuit's distaste for the duty to update: "All of Cypress forward-looking statements had a reasonable basis at the time they were made, which is the only time that matters as far as the securities laws are concerned." Id. at ¶ 92,639. Similarly, in Symbol Technologies, Fed. Sec. L. Rep. (CCH) ¶ 99,412, 96,686 (E.D.N.Y. 1997), the court stated that "[d]efendants cannot be held liable for statements that were true when made; there is no fraud by hindsight." This optimism must be tempered, however, given the holding in Quaker. Also, in Burlington Coat Factory, 114 F.3d 1410 (3d Cir. 1997), the Third Circuit, prior to Quaker, examined the application of the duty to update for the first time. The court recognized that the duty to update might exist under certain circumstances based on Time Warner, but declined to do so on the facts before the court. Here, plaintiff argued a duty to update on one erroneous earnings forecast. The Court declined to hold that a "single, ordinary disclosure [could] produce such an expansive set of disclosure obligations." Id. at 1432. Similarly in Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997), the court did not rule out the possibility of holding a defendant to a duty to update, but chose not to do so on the facts of the case before it. Relying on Time Warner, the court declined to impose a duty to update for a "vague, optimistic statement that . . . was not a 'definite positive projection'." Id. at 1125, citing Time-Warner, 9 F.3d at 267.

For a detailed analysis of the duty to update doctrine and the cases, see Jeffrey A. Brill, The Status of the Duty to Update, Cornell Journal of Law and Public Policy, Winter 1998 ("As a result of inter-circuit inconsistency and the SEC's and Congress's failure to provide clarification, the precise contours of the duty to update remain uncertain."); this article was cited twice by the district court in the Quaker case on remand, Fed. Sec. L. Rep. (CCH) ¶ 91,266 (N.D. Ill. 2000) and it also supports the view that the courts will find ways to hold the duty inapplicable.

421 The SEC has proposed more current filing requirements through the Form 8-K. See supra Section II.A.2.c.

422 See Broc Romanek, Corporate Web Disclaimers: To Disclaim or Not to Disclaim, It Should Not Be A Question, Wallstreetlawyer.com, Vol. 3, No. 3, pp 9-13.

highly effective internet method of communication must become aware of the potential for securities law liability that stems from such activities. The SEC stated that "Issuers are responsible for the accuracy of their statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet.[423] Potential causes for liability that companies need to be concerned about include:[424]

- Companies will be held just as liable for a statement on the Web site as for one in an SEC disclosure form.

- The duty to update statements introduces special problems for Web sites. Statements can be deemed as "republished" every time that someone logs onto the Web site.

- The SEC has opined that providing hyperlinks on a Web site offering is akin to including the contents of the second site in the same delivery envelope as the prospectus.[425] Whether or not the company in question has "adopted" the information on a third-party Web site depends on three factors: 1.) The context in which the hyperlink is offered; 2.) the risk of an investor's confusion as to the source of the information; and 3.) the presentation.[426] First, when determining whether information on a third-party's Web site is attributable to the issuer, the SEC will take into account the context in which the issuer places the hyperlink. Does the issuer say anything about the hyperlink on the Web page? Second, the SEC will consider whether there is a likelihood of investor confusion about the source of information, the issuer or the third party? Did the issuer make it clear that the browser is leaving its Web site before linking to the third-party site is complete? Lastly, the SEC will consider the presentation of the hyperlink on the issuer's Web page. For example, does the issuer promote the link by increasing its size or differentiating its color to attract Web browsers?[427]

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423 SEC Release No. 33-7856 (May 4, 2000).

424 See Mary Lou Peters, Avoiding Securities Law Liability for a Company's Web site, Insights, April 1999, at 16. Also See Section III. C. 4 of this article for a discussion on cyberspace documents and the Private Securities Litigation Reform Act.

425 Release No. 33-7233, Example 16.

426 Release No. 33-7856. See also Brown &Wood, LLP, "Memorandum to Clients Re: Use of Electronic Media", May 19, 2000; Gibson, Dunn & Crutcher, LLP, "SEC Approves New Internet Release", May 12, 2000; Paul, Weiss, Rifkind, Wharton & Garrison, "SEC Issues Guidance on the Use of Electronic Media", May 2000; and Proskauer Rose LLP, Client Alert - "SEC Interpretations on the Use of Electronic Media", May 2000.

427 Release No. 33-7856. See also Brown &Wood, LLP, "Memorandum to Clients Re: Use of Electronic Media", May 19, 2000; Gibson, Dunn & Crutcher, LLP, "SEC Approves New Internet Release", May 12, 2000; Paul, Weiss, Rifkind, Wharton & Garrison, "SEC Issues Guidance on the Use of Electronic Media", May 2000; and Proskauer Rose LLP, Client Alert - "SEC Interpretations on the Use of Electronic Media", May 2000.

- Just as statements about research and developments printed and disseminated in scientific journals can be used to support a claim for 10b-5 liability,[428] so can marketing statements posted on a Web site be used.

- Not all investors have access to the internet, and as such, disclosure on a Web site may not yet be considered full disclosure. Other, more traditional, means should still be used until the law catches up to the reality of the internet.[429]

Companies can act to limit their liability. The following suggestions come from Nora M. Jordan, a partner with the New York firm of Davis Polk & Wardwell.[430]

- Pretend the Web site is paper, and review statements of fact for accuracy and completeness before posting them on the Web site, just as would be done with a mailing.

- Do not give control of the Web site to the marketing department. All items on the site should be reviewed and approved by the appropriate business people.

- Date all statements on the site, and disclaim any duty to update them. There is no way to know how much time has passed since the document was posted before it is read. This will help visitors to the Web site decipher which information is current, and which is stale.

- Be wary of hyperlinks. Always alert a Web site visitor to the fact that they are leaving your site to enter another, drawing a distinct line between your statements, and those of other companies.

- Keep security over the Web site tight. Be aware that even if someone else posts a statement, if it made it onto your Web site, you may be held liable.

There are additional concerns when a company is in the midst of a registration process. The communications a company makes are restricted during the "waiting period," and the only written material issuers may send to investors is a preliminary prospectus. Companies, therefore, must be aware of the content on the Web site so that it cannot be deemed improper pre-filing communications that condition the market for the

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428 See, e.g., Carter-Wallace, 150 F.3d 153 (2d Cir. 1998), aff. in Carter-Wallace, Fed. Sec. L. Rep. (CCH) ¶ 91,039 (2000) (holding that complaint failed to plead scienter with particularity because at the time of defendant drug company's alleged misstatements in product ads there was no statistical link between defendant's product and any adverse side effects in patients).

429 The SEC reiterated its belief that the reality of the situation does not yet indicate that everyone has access to the Internet in Release No. 33-7856 when it stated, "Under the ["access-equals-delivery" model], investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or a third-party's Web site. We believe that the time for an "access-equals-delivery" model has not arrived yet."

430 Practical Advice for Reviewing Corporate Web sites, The SEC Today Vol. 99-195 (Oct. 8, 1999).

offering. Alan Berkeley and John McDonald note that companies may continue to advertise their products and services, but counsel should insure that the Web site has no product or market forecasts, nor links to third-party Web sites that might contain prohibited information.[431] The SEC also defined permissible ordinary-course business information during the "in registration" period to include:

- advertising materials regarding products and services;
- Exchange Act reports filed with the SEC;
- proxy statements, annual reports or dividend notices; and
- press materials regarding financial or business developments.[432]

1. Electronic Delivery

Electronic means of communication are typically faster, less expensive and easier than traditional methods involving paper delivery. Electronic media includes audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, bulletin boards, Internet Web sites and computer networks. To provide investors with the same protections offered with paper delivery, the SEC has instituted certain rules regarding the use of electronic delivery of SEC required documents. In order to utilize electronic delivery, a company must (1) give timely notice to its investors of the opportunity and the risks associated with it, (2) be able to assure access to the information and (3) be in the position to evidence delivery of the documents. The following items help to clarify the SEC's position relating to electronic delivery and disclosure.[433]

- **Telephonic Consent** – While investors can continue to give informed consent by written or electronic means, the SEC has now authorized the receipt of telephonic consent, so long as the consent is informed and a record of that consent is retained. In discussing examples of ways to assure authenticity of the telephonic consent, the SEC allowed its receipt if the investor was known to the individual receiving the consent, or if a password or personal identification number was used.

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431 Alan Berkeley and John McDonald, Observations on Corporate Web sites and the Federal Securities Laws, *Securities Reporter*, Vol. 4, No. 2, pp. 2-9.

432 Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 5 [hereinafter Mooney].

433 SEC Release No. 33-7856. See also Wilmer, Cutler & Pickering, *SEC Issues New Release On Use of Electronic Media (Part 1 of 2)*, Securities Law Developments (May 3, 2000). See also Linda C. Quinn and Ottilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*. Northwestern University 27th Annual Securities Regulation Institute.

- **Global Consent** – An investor may give global consent to electronic delivery relating to all documents of any issuer, so long as the consent is informed. This particular consent requires that the investor be informed explicitly that he or she is consenting to a broad scope of electronic delivery, and that he or she has the right to revoke the consent at any time.

- **Portable Document Format** – The Release clarifies that, while Portable Document Format ("PDF") may be a special software that is not necessarily owned or used by each investor, PDF may be used for electronic delivery, so long as investors are fully informed as to the requirements necessary to download PDF and investors are provided with any necessary software and technical assistance at no cost.

- **Envelope Theory** – Because certain SEC documents are required to be delivered simultaneously, meaning traditionally delivered in the same envelope, there has been some question as to what is deemed to be delivered in the "same envelope" when documents are delivered via a company's Web site. This Release clarifies some of the ambiguity in stating that if an issuer includes a hyperlink within a Section 10 prospectus, the hyperlinked information becomes a part of the prospectus, and must then be filed as part of the prospectus in the effective registration statement.[434] Conversely, a hyperlink from an external document into the Section 10 prospectus does not constitute inclusion of the external document in the prospectus.

2. Online Offerings

The Securities Act Release on electronic media also addressed the issue of online registered and private offerings.[435] The release stressed the view that online offerings of securities must comply with the general rule that until the registration statement is effective, no sale may occur and no part of the purchase price may be received by the seller of the securities.[436] Accordingly, the best approach to understanding the release is to first determine whether a public or private online offering is at issue.

- **Online Public Offerings:** The SEC reserved the right to continue to analyze issues presented by online public offerings in the context of emerging technology. As a result, the release provides little guidance in this area.[437]

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[434] A consent of the third party must also be obtained and filed with the SEC in textual format. Mooney, supra note 406 at 1.

[435] Use of Electronic Media, Securities Act Release No. 33-7856.

[436] See Mooney, supra note 406 at 6.

[437] See Wilmer, Cutler & Pickering, "Securities Law Developments," May 3, 2000 [hereinafter Wilmer, "Securities Law Developments"].

- **Online Private Offerings under Regulation D:** On the other hand, the release examined issues presented by private online offerings. The SEC focused on whether Web site operators, who are not registered brokers or dealers, violate the registration requirements of the 1933 Act if they engage in general solicitations.[438] When may a service provider solicit information from investors to determine if they meet the "sophisticated" or "accredited" requirement under Regulation D? Must the Web site operator register as a broker or dealer? The SEC has not yet addressed this issue. The SEC's comment simply stated that such determinations will be made based on the facts and circumstances of the solicitation. Generally, where there is a "pre-existing, substantive relationship" between the issuer or broker and the offeree, the inference will be that the solicitation was not "general." Accordingly, the solicitation would not be prohibited by the Securities Act.[439]

3. ABA Letter Responding to the SEC Release Regarding Use of Electronic Media

On August 3, 2000, the American Bar Association commented on the SEC's May 4, 2000 release regarding the use of electronic media.[440] The comment reflected the belief that the SEC release failed to promote the use of electronic media for both public and private offerings and the dissemination of information.[441] The ABA Committee first proposed that the Commission "rework the existing framework of notice, access and evidence of delivery to eliminate any functional distinction between traditional delivery (in paper form) and electronic delivery."[442] Accordingly, the ABA sought a more simplified framework for electronic delivery based on the principles of informed consent.[443]

In response to the SEC's comments concerning Web site content, the ABA critiqued the use of the "entanglement" and "adoption" theories as the analytical framework for assessing liability for hyperlinked information.[444] The ABA sought to encourage the SEC to implement "safe-harbor" standards where certain clear policies and procedures will promote issuers and intermediaries to establish easy access to third-party

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438 See Mooney; supra note 406 at 6.

439 See id. See also Wilmer, "Securities Law Developments," supra note 411.

440 Stanley Keller, Chair, Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association, Final Comment Letter Re: Use of Electronic Media (File No. S7-11-00), August 3, 2000.

441 Id. at 1.

442 Id. at 3.

443 Id. at 5.

444 Id. at 10.

Web sites through hyperlinks.[445] Furthermore, the ABA urged the SEC to require that clear exit notices be posted when browsers jump from one Web site to another via the hyperlinks. Such exit notices would reduce investor confusion relating to issuer or intermediary endorsement of hyperlinked information.[446] Accordingly, the ABA's letter sought to encourage the Commission to accept advanced technology in the securities industry, while it constructively criticized the rigid interpretations regarding the use of electronic media set forth in the SEC's May 2000 release.

4. Future Electronic Media Issues

- **Message Boards and Internet Chat Rooms:** Online message boards and chat rooms are a popular way for investors and employees of issuers to anonymously communicate about the market.[447] Employees often share information about their issuer-employer's securities and as a result, issuer companies may be liable for the message posted by an employee if it is construed as selective or misleading disclosure.[448] To avoid having employee postings attributed to them in violation of securities laws, employers should institute insider trading policies regarding message boards and implement employee education through training and programs which create an awareness of corporate and legal policy.[449] Moreover, companies are also advised to develop "Electronic and Telephonic Communications Systems Policies" so that employees realize that unless they are designated speakers on behalf of the company, sharing information about their employer may be detrimental to the company.[450]

- **Corporate Web Disclaimers:** Companies are just realizing the legal ramifications of their online investor relations activities.[451] The "post now, review later" philosophy may lead companies straight into court as there is an increased level of potential corporate liability for investor communications on Web sites. Accordingly, a way to mitigate this exposure to litigation is to use

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445 Id.

446 Id.

447 See Broc Romanek, "Understanding the 'Undernet': Message Boards Can Be Tricky for Employers," Insights, Volume 14, Number 5, (May 2000).

448 Id.

449 Id.

450 See Louis M. Thompson, Jr., "A Suggested Electronic and Telephonic Communications System Policy," Insights, Volume 14, Number 1, (January 2000). For a sample policy, the Thompson article contains a model drafted by Maryann Waryjas, a partner at Katten Muchin Zavis Rosenman in Chicago.

451 See Broc Romanek, "Corporate Web Disclaimers: To Disclaim or Not To Disclaim, It Should Not Be a Question", Vol. 3 No.3, wallstreetlawyer.com.

disclaimers which "warn investors that their legal rights are restricted."[452] Though prominently implementing disclaimers in "plain English" on Web sites does not completely insulate an issuer from liability, it is a proactive step in this technologically advanced society. Nevertheless, corporate Web disclaimers remain quite rare and this legal issue will no doubt become very interesting as our society becomes more electronically advanced.[453]

H. Suggested Guidelines for Counseling Disclosure

As a means to better protect themselves, corporate personnel responsible for drafting reports and press releases, and counsel who review them, should have in their possession and review all prior reports, releases and internal and external projections, if any, investment banker studies and analysts' reports to ensure that they understand the total context and environment in which the issuer speaks. These documents should be compared with the company's business plan and latest operations reports to ensure that information in the marketplace is consistent with the issuer's internal views and memoranda. Those executives charged with speaking on behalf of the issuer must be advised of the risks and sensitivities of their task. Under the safe harbor provisions of the Reform Act, all formal and informal projections and predictive statements, including materials promoting new products directed to the financial markets, should include specific and tailored "Cautionary Warnings" regarding their limitations, assumptions, and uncertainties, and should state clearly that they will not be updated or revised.

A significant number of current cases allow some degree of corporate puffing, but practitioners and corporate personnel should be aware that this trend may change with the growth of information services and news media. Off-the-cuff remarks made by personnel, calls to analysts, and annual meeting releases are now regularly reported and made public through the various news services or the internet. The growing accessibility to off-the-cuff or formerly unreportable statements through the development of the media may cause courts to take a more serious look at puffing statements.[454]

Although issuers are not responsible for and have no duty to correct third party statements, a continuous monitoring of these extra-corporate materials is important because it reveals the information that the market views as important. If management fails to scrutinize these public statements and perceptions, and does not anticipate the market's reaction to information regarding positive or adverse corporate developments, its disclosure will be subject to attack by investors suing with the benefit of hindsight.

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452 Id.

453 Id.

454 See Quaker, supra at Section III.F.6, discussing the significance of publicly reported puffing statements made by the CEO and the potential for liability for such statements.

It is becoming more difficult to defend the issuer on the ground that omitted information was not required to be disclosed under traditional concepts of materiality and timely disclosure. Management may believe in good faith that the success or failure of a new product, or the effect of a potentially negative business development, will not have a significant impact on the company's financial condition or operations. Plaintiffs and often courts, however, will look instead to the reaction of the market to positive or negative news regarding the product or development in determining its materiality. The purposes of the recommended exercises described above are to enable management to gauge investors and anticipate those developments and occurrences which, when disclosed, might have a significant impact on the market.

Finally, disclosure practitioners should educate their clients regarding the perils of MD&A and train them to prepare the MD&A with a view to anticipating the almost inevitable attack. In addition, counsel should learn to cross-examine vigorously the issuer's statements from the perspective of plaintiff's counsel suing with the benefit of hindsight. One must ask, has the issuer accurately depicted in the MD&A those trends and uncertainties which may affect its business and results of operations and which the market may perceive as significant? A process which includes a review of prior periodic reports, press releases, analysts' reports and the company's business plan and projections should provide counsel a sense of the company in motion, thereby providing more safety in disclosure. Knowing what the last 10-Q disclosed and anticipating what the next disclosure document will include is also a useful exercise. Moreover, perfunctory mark-ups of prior disclosure documents should be avoided.

In summary, as earlier stated, issuers should focus on the following key questions:

- Does the market understand the risks inherent in new product development, the continued viability of old products, or the condition of property, plants and equipment?

- Has the company identified any specific problems or difficulties--or has the company experienced similar difficulties in the past--which could diminish the prospects of the product or business development in general?

- Do the press releases and statements identify such potential risks and difficulties?

- Are the statements consistent with the internal memorandum and reports on the product or development?

- Do all statements reflect the new, somewhat blurred, definition of "materiality?"

- Is the statement complete enough or does it need more substance to minimize market reaction?

If the answer to any one of these questions is "no," then those persons responsible for corporate disclosure should reassess the company's promotional statements to assure that they are accurate and not misleading in the totality of the circumstances.

IV. DEVELOPMENTS IN MANAGEMENT'S DISCUSSION AND ANALYSIS (the "MD&A")

Management Discussion and Analysis (the "MD&A") has regained center stage in the aftermath of the Enron bankruptcy and its related scandals. This is the first major SEC reinterpretation (and proposed amendment) of the MD&A since its seminal 1989 Interpretive Release ("MD&A Release").[455] At the time of its issuance, the MD&A Release was heralded as a major policy statement regarding compliance with MD&A disclosure requirements.[456] The MD&A requires issuers to provide information on financial conditions with an emphasis on liquidity, capital resources and the results of operations. Registrants are required to discuss in the MD&A known trends, material changes and uncertainties, including inflation, that would cause the historical financial data disclosed therein not to be necessarily indicative of future operating results or future financial conditions.[457] According to the SEC, the MD&A is intended to provide investors "an opportunity to see the company through the eyes of management." Moreover, beginning in 2001 the traditional MD&A has expanded to include critical accounting practices, risk factors and the safe harbor legend.[458]

The SEC's actions against Caterpillar, Inc., Bank of Boston and Sony illustrate the SEC's continued focus on the adequacy of MD&A disclosures and has served as a warning to issuers that the SEC will not tolerate boiler-plate MD&A disclosures. Even more ominous is the trend to view inadequate disclosure under Item 303 as also supporting a claim under Rule 10b-5.[459]

In late 2001 and early 2002, the SEC refocused its attention on MD&A, largely due to the circumstances surrounding Enron. The SEC issued a statement explaining that critical accounting policies are those that are both important to the portrayal of a company's financial

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[455] Exch. Act. Rel. No. 26831 (May 18, 1989). For several years, the SEC warned issuers regarding the sufficiency of MD&A disclosures. In 1987, the SEC sought comments on the adequacy of MD&A disclosure rules, including proposals submitted to the SEC by the accounting profession to expand MD&A disclosures and subject the MD&A to auditing procedures. See Sec. Act. Rel. No. 6711 (Apr. 17, 1987). In November 1987, Linda Quinn, the director of the SEC Division of Corporation Finance, announced that the division's accounting staff would routinely review more 10-K's for MD&A compliance. See 19 Sec. Reg. & L. Rep. (BNA) ¶ 1725 (Nov. 13, 1987).

[456] Exch. Act. Rel. No. 26831 (May 18, 1989).

[457] For a detailed discussion of the MD&A requirements, see Ronald M. Loeb et al., The Focus on MD&A, C859 ALI-ABA 343 (1993); Thomas Gilroy & Mary Elizabeth Pratt, Preparing the Management's Discussion and Analysis, 835 PLI/Corp. 9 (1994).

[458] See supra note 257 and accompanying text.

[459] See section IV.E infra

condition and results.[460] The Commission encouraged public companies to include in their MD&A full explanations, in plain English, of their "critical accounting practices," the judgments and uncertainties affecting the application of those policies and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.[461] The SEC stated that the objective of this kind of disclosure would be consistent with the objective of MD&A.[462] The Commission also asked companies to consider making disclosures regarding liquidity and capital resources, including "off-balance sheet" arrangements, certain trading activities, including non-exchange traded contracts accounted for at fair value, and the effects of transactions with related and certain other parties.[463] The major accounting firms reacted by petitioning the SEC to publish an interpretive release providing more guidance. The SEC responded with a more detailed release indicating the steps issuers should take to meet their disclosure obligations.[464] The S-O Act, in effect, codified the SEC's release by requiring companies to disclose information regarding its off-balance sheet arrangements. In November 2002, the SEC proposed sweeping rules that would mandate that issuers disclose all off-balance sheet transactions in MD&A.[465]

The Commission also emphasized the importance of MD&A in May 2002. It proposed, "as an initial step in improving the transparency of financial disclosure," revisions to MD&A which would:

- require detailed explanations of "critical accounting estimates" used in preparing financial statements if the assumptions about these matters were highly uncertain at the time of estimation and

- mandate disclosure of the initial adoption of an accounting policy if the policy would have a material impact on the financial presentation.[466]

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460 Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release Nos. 33-8040; 34-45149; FR-60, (Dec. 12, 2001), available at http://www.sec.gov/rules/other/33-8040.htm (last modified Jan. 16, 2002) [hereinafter "Cautionary Advice"]. Chairman Harvey Pitt has also repeatedly stated that there is a need for more "current disclosures" versus just public disclosures, and more Form 8-K items that are not so limited and ambiguous. Chairman Harvey L. Pitt, Public Statement by SEC Chairman: Remarks at the Winter Bench and Bar Conference of the Federal Bar Council (Feb. 19, 2002), available at http://www.sec.gov/news/speech/spch539.htm (last visited Mar. 5, 2002). See also Chairman Harvey L. Pitt, Speech by SEC Chairman: Remarks at the PLI 33rd Annual Institute Securities Regulation (Nov. 8, 2001), available at http://www.sec.gov/news/speech/spch520.htm (last visited Mar. 5, 2002).

461 Cautionary Advice, supra.

462 Id.

463 Id.

464 See infra Section IV.J.

465 See infra Section IV.L.

466 Release No. 33-8098; 34-45907 and Int'l 1258 (May 10, 2002) [hereinafter "Critical Accounting Policies Release"].

The Commission noted that it is continuing to consider more additions to MD&A, including, among others, disclosure regarding structured finance transactions, related person transactions and disclosure of trends that management follows and evaluates.[467]

In December 2003, the SEC published interpretive guidance regarding MD&A in anticipation of the preparation of Forms 10-K, 20-F and 10-Q in 2004 (the "2003 MD&A Release").[468] The following points are apparent from the 2003 MD&A Release:

- The 2003 MD&A Release does not offer any new requirements, however, the SEC believes and expects that when companies follow the guidance in the 2003 MD&A Release, the overall quality of their MD&A will improve.

- The 2003 MD&A Release places more emphasis on analysis. For example, it is not sufficient to state that revenues increased because sales increased. Instead, the company should discuss the reasons why sales increased.

- Companies should present their MD&A disclosure so that the most important information is most prominent.

The SEC indicated that the guidance was "intended to elicit more meaningful disclosure in MD&A in a number of areas, including the overall presentation and focus of MD&A . . . and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates."[469] While some of the guidance is helpful, including the suggestion that companies include an executive-level overview and that companies should consider using tabular presentation of financial or other data in certain circumstances, other recommendations are inconsistent. For example, the SEC suggests that companies should "emphasize material information that is required or promotes understanding," because "many companies [since the introduction of the MD&A requirements] have become larger, more global and more complex," but at the same time, the SEC strongly encourages "not only disclosure of information responsive to MD&A's requirements, but also an analysis that is responsive to those requirements that explains management's view of the implications and significance of that information."[470] This

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467 Id. at 7, 11-12. Alan Beller, director of the Division of Corporation Finance, stated that the Commission's staff is considering a possible rulemaking to require a plain English summary of MD&A. SEC Considering Rulemaking to Require Use of Plain English in MD&A Summary, Corp. Counsel Weekly, at 153 (May 15, 2002). However, in September 2003 Beller is quoted to have said "for the time being [the SEC's Division of Corporation Finance] has decided to eschew a rulemaking [on the Management's Discussion & Analysis portion of the annual report]," but possibly will issue an interpretive release on the subject. One reason for this decision, Beller explained, is that the rules governing MD&A "serve our purposes the way they are." Second, he said, the securities law bar, faced with an onslaught of new regulation in the past year, does not need any additional rulemaking at this time. Changes to Sarbanes-Oxley Seen as Unlikely; Beller Notes Progress on MD&A Disclosure, Corp. Counsel Weekly, at 281 (September 17, 2003).

468 Release No. 33-8350 (Dec. 19, 2003), available at http://www.sec.gov/rules/interp/33-8350.htm.

469 Id.

470 Id.

inconsistency concerning the quantity and quality of disclosure mitigates, to some extent, the effectiveness of the SEC's guidance.

While the overly repetitive 2003 MD&A Release should be reviewed by companies and their advisors in connection with the preparation of periodic reports for fiscal year 2003 and beyond, the guidance is, in the aggregate, not that enlightening.[471]

A. Pre-1989 Interpretive Release: American Savings and Loan Association of Florida

Prior to the 1989 MD&A Release, the SEC bolstered the notion of a general quarterly MD&A disclosure obligation in In the Matter of American Savings and Loan Association of Florida,[472] an enforcement release arising out of the well-publicized collapse of E.S.M. Government Securities, Inc. ("E.S.M."). In a consent order, the SEC ruled that American Savings and Loan Associations of Florida ("ASLA") failed to adequately disclose in its MD&A an unusually large securities repurchase transaction with E.S.M., which resulted in a $69 million write-off when E.S.M. failed.

Several egregious circumstances made this case particularly vulnerable to SEC attack. E.S.M. was controlled by a director of ASLA. In addition, the $1 billion U.S. Treasury Bill repurchase transaction was enormous compared to any previously undertaken by ASLA, had an unusually long one-year term and was over-collateralized such that ASLA was exposed to an unsecured position of nearly $100 million. Nonetheless, prior to E.S.M.'s demise, ASLA's MD&A in its 10-Q report had not specifically mentioned the repurchase transaction and its 10-K reports mentioned the repurchase transaction only in brief reference to the corresponding increase in assets, liabilities and investments. The SEC criticized ASLA's failure to analyze the risks attendant to the repurchase transaction in the MD&A as follows:

> Mere overviews or limited, cursory financial footnote disclosures do not provide shareholders with the required perspective on the financial condition and results of operations of an institution. A complete discussion by management of the insured institution's operations and the risks attendant thereto is the type of full disclosure mandated by the federal securities laws.[473]

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471 See supra, IV.K.2.

472 Exch. Act Rel. No. 25788 (June 8, 1988). The SEC now mandates that financial institutions disclose in the MD&A the effects of federal assistance programs, especially the potential loss of such assistance, on financial condition and operations. See Exch. Act. Rel. No. 26831 (May 18, 1989). For a discussion of the unique disclosure problems facing these financial institutions, see Gary Lynch et al., Application of the Securities Laws to Financial Institutions, 414 P.L.I. Comm. 69 (1987).

473 Exch. Act Rel. No. 25788, at 84. The SEC reinforced this view in its action against Bank of New England Corporation ("BNEC"), alleging that BNEC's MD&A was deficient for its failure to discuss adverse trends

The SEC elaborated that Texas Gulf Sulphur and its progeny required that ASLA disclose in its MD&A the factors considered by management in undertaking the transaction and also "explain the reasoning behind an assessment by management that an eventual loss was unlikely to occur."[474] There is no practical difference between requiring disclosure of particular information and forcing management to disclose thoughts as to why they believe the information is not material and need not be disclosed. The latter enables investors to substitute their own risk-analysis for the business judgment of management. Such analysis ignores the business judgment rule and undermines the concept of materiality as a limitation on the SEC's power to mandate disclosure.

The SEC eventually determined that the repurchase transaction was material under Texas Gulf Sulphur, concluding that the magnitude of the potential loss was so great that even a remote risk of default required detailed disclosure in the MD&A. The SEC's analysis is rather disturbing and suggests that any contingent event of substantial magnitude must be disclosed in the MD&A no matter how remote the likelihood of its occurrence. It would appear that the rejection of a probability/magnitude test and the elaboration of a "more likely than not" threshold of probability for determining MD&A materiality in the 1989 MD&A Release, described below, recants the position taken by the SEC in this case. Under the new SEC MD&A materiality standard, ASLA arguably would not have to discuss risks attendant to the repurchase transaction if management could determine that the default was not likely to occur.[475] However, all of this optimism must be tempered by the thought of the SEC Staff Accounting Bulletin on Materiality, discussed at length above in Section II.D., which has the potential to change the definition of "material" in innumerable ways.

B. The 1989 Interpretive Release

The 1989 Interpretive Release summarizes the results of the SEC's review of MD&A sections in reports filed by registrants in selected industries in 1988.[476] The MD&A Release purports to provide issuers guidance for MD&A preparation through

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indicating a deterioration in the New England real estate market which were likely to adversely affect BNEC's loan portfolio and net income. SEC v. Bank of New England Corporation, Lit. Rel. No. 12743 (Dec. 21, 1990). There exists a tension between these cases and those confirming that issuers need not disclose simple mismanagement or breach of duty. For cases involving nondisclosure of mismanagement and misleading disclosures of sound management, see infra Section IX.

474 Exch. Act Rel. No. 25788, at n.37.

475 The interpretive guidelines in the 1989 MD&A Release now require full disclosure of the risks associated with participation in high yield financings, highly leveraged transactions and non-investment grade loans and investments. Query: whether the SEC would have characterized ASLA's repurchase transaction as such a high risk venture?

476 Exch. Act. Rel. No. 26831 (May 18, 1989). The 1989 MD&A Release states that only 14 of the 359 companies reviewed passed the SEC's standards; 125 of the remaining companies filed amendments in response to SEC comments. Six registrants were referred to the Division of Enforcement, mainly due to accounting problems which affected the MD&A disclosures.

specific examples of disclosures and observations on the disclosure of various corporate events, including merger negotiations, participation in highly leveraged transactions or non-investment grade loans, and the effects of federal financial assistance upon the operations of financial institutions. The MD&A Release also addresses disclosure issues regarding prospective information, long and short-term liquidity and capital resources, material changes in financial statement line-items and segment basis analysis.

The MD&A Release confirms that the SEC views the MD&A as a quarterly disclosure vehicle for distressed companies. The MD&A Release emphasizes that issuers must update the MD&A on a quarterly basis to include a discussion of all the MD&A items, except the impact of inflation and changing prices on operations for interim periods.

1. Materiality Standard for Known Contingencies

An interesting aspect of the MD&A Release is the SEC advocacy of a separate standard of materiality for prospective information to be reported in the MD&A. The Release requires that registrants describe periodically in the MD&A "known trends, demands, commitments, events or uncertainties" that are "reasonably likely to have a material effect" on an issuer's financial condition or results of operations. The MD&A Release sought to distinguish between forward looking information that registrants are encouraged, but not required, to disclose and "presently known data which will impact upon future operating results," that must be discussed.[477] The MD&A Release suggests that management make two assessments to determine whether prospective information must be disclosed:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot determine the likelihood of occurrence, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[478]

The SEC explicitly states in a footnote that the "reasonably likely to have a material effect" standard for MD&A disclosure is separate and distinct from the probability/magnitude materiality analysis originally articulated by the Second Circuit in

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[477] See Carl Schneider, MD&A Disclosure, 22 Rev. Sec & Comm. Reg. 14 (1989), for an in-depth analysis of this issue.

[478] See Exch. Act. Rel. No. 26831, supra notes 442 and 446 and accompanying text.

Texas Gulf Sulphur and adopted by the Supreme Court in Basic for Rule 10b-5 purposes. This rejection of the probability/magnitude balancing test for determining the materiality of MD&A disclosure contradicts a prior SEC Enforcement Release[479] and a 1988 SEC Interpretive Release regarding disclosure of government inquiries, both of which specifically apply the Texas Gulf Sulphur probability/magnitude balancing analysis to MD&A materiality.[480]

Strangely, the SEC elected to deviate from Basic and the Commission's own past statements outside of a rulemaking context, which would have afforded an opportunity for notice and comment. Issuers may find, however, that the "reasonably likely to occur" probability threshold makes the MD&A standard less burdensome than the Rule 10b-5 probability/magnitude balancing standard. Specifically, the SEC's prior application of the probability/magnitude balancing test suggested that, in certain instances, where the magnitude of the contingent event was so great, the event must be disclosed even though the probability of occurrence was slight or at least less than "more likely than not." The SEC's new articulation of MD&A materiality suggests that no matter how great the magnitude of the contingent event, it need not be disclosed unless management believes that the probability of occurrence is "more likely than not," i.e., greater than 50%.[481]

The 1989 MD&A Release also raises the question whether it is wise to establish separate materiality analyses for MD&A and for Rule 10b-5 purposes. If the SEC desires to treat certain developments differently for MD&A disclosure, it could create specific exceptions to disclosure requirements, much like the Commission did for MD&A disclosure of merger negotiations. On balance, the standard for assessing materiality, however, should remain constant throughout the federal securities laws.

2. Exception for Merger Negotiations

The MD&A Release specifically excludes preliminary merger negotiations from the MD&A requirement to disclose "known events or uncertainties reasonably likely to have material effects" on future financial condition or results of operations. The SEC determined as a matter of policy that the risk of endangering sensitive negotiations through premature disclosure was greater than the immediate informational needs of investors. Hence, where management has a business purpose for maintaining confidentiality, the MD&A will not impose an independent duty to disclose merger

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479 See In the Matter of American Savings and Loan Association of Florida, Exch. Act. Rel. No. 25788 (June 8, 1988).

480 Exch. Act. Rel. No. 25951 (Aug. 2, 1988), discussed infra Section IX.A.

481 Former SEC Commissioner Fleischman has stated his belief that "reasonably likely to occur" means a 40% or more probability of occurrence. See Fleischman Addresses MD&A Issues Before Southern Securities Institute, The SEC Today Vol. 91-51 (Mar. 15, 1991).

negotiations.[482] The SEC also indicated that issuers need not disclose involving major asset acquisitions or dispositions not in the ordinary course of business in the MD&A.

The original purpose of the MD&A was to provide a meaningful discussion of management's views of their business to aid investors in their assessment of line-item changes from year-to-year that might impact the registrant's future financial condition and results of operations. The MD&A was simply not intended to require disclosure of all fundamental business prospects, such as potential mergers. The SEC's analysis of MD&A disclosure of merger negotiations demonstrates how far the SEC's policy has strayed from the original purpose of the MD&A. Apparently the SEC now will require that issuers analyze anticipated fundamental corporate events in the MD&A unless management reasonably believes that disclosure may disrupt the transaction or otherwise harm the issuer's business advantage. Query: whether the SEC's decision to exempt merger negotiations in the MD&A Release signals a retreat by the SEC from its more recent interpretation of the MD&A as a quarterly disclosure vehicle for all material contingencies? We doubt it.

3. Other Items

As noted above, the MD&A Release provides guidance on a number of disclosure topics, including capital expenditures and financing to maintain sales growth and for new products, expiration of government contracts, designation as a potentially responsible party under "Superfund,"[483] changes in revenues and deficiencies in liquidity, and participation in highly-leveraged transactions. The MD&A Release provides detailed examples of suggested disclosure for these various developments and hypothetical scenarios. Those responsible for MD&A preparation should read the MD&A Release in its entirety.

C. Caterpillar, Inc.

In the Matter of Caterpillar, Inc.[484] provides a textbook example of the application of Item 303 and the 1989 MD&A Release to MD&A disclosure issues involving segment reporting, results of operations and known material uncertainties. In the Caterpillar consent order, the SEC found that the MD&A in Caterpillar's Form 10-K for the year ended December 31, 1989 and Form 10-Q for the first quarter of 1990 was deficient due to Caterpillar's failure to discuss the magnitude of Caterpillar's Brazilian subsidiary's

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[482] The Supreme Court in Basic rejected this argument as support for the agreement-in-principle standard of materiality for merger negotiations, stating that "a need for secrecy" public policy rationale was inapposite to the definition of materiality. The Court explicitly left the issue open, however, for consideration under the rubric of the duty to disclose. See Wander & Pallesen, supra at 118.

[483] Given the ramifications of "Superfund" liability and the increased attention being paid to accounting for hazardous waste treatment costs, environmental problems may become the next "hot" MD&A disclosure issue. For further discussion of environmental disclosure obligations, see infra Section XI.

[484] Exch. Act Rel. No. 30532 (Mar. 31, 1992).

contribution to consolidated earnings, the non-operating items which accounted for a greater than usual profit for this subsidiary in 1989, and the uncertainty of maintaining this level of profit for the subsidiary in 1990 due to volatility in the Brazilian economic and political environment.

1. CBSA Impact on 1989 Consolidated Earnings and Uncertainty in Brazil

CBSA, Caterpillar's Brazilian subsidiary, accounted for approximately 23% of Caterpillar's $497 million net profit for 1989. Several non-operating gains, including Brazilian tax loss carry-forwards, export subsidies and interest income due to hyperinflation in Brazil and dollar-cruzado exchange rates, contributed to CBSA's bottom line profits. At least two weeks before the filing of the 1989 Form 10-K, Caterpillar's top management expressed "substantial uncertainty" about CBSA's ability to repeat its 1989 performance and began to separate the impact of the Brazilian operations in their presentation of 1990 projections to the board. This separate analysis of CBSA's results of operations, which continued throughout 1990, represented a departure from management's usual practice of analyzing the company as a whole.

In April 1990, after a new government had come to power in Brazil proposing sweeping economic reforms, Caterpillar's board discussed the uncertainty of the situation and management's belief that CBSA's profits would be substantially lower in 1990 than in 1989. On June 25, 1990, Caterpillar voluntarily issued a press release explaining that 1990 results would be lower than expected and in a telephone conference with analysts that afternoon, revealed CBSA's impact on 1989 consolidated earnings. The next day the trading price of Caterpillar's stock fell 18%.

2. Preparation of the MD&A

Caterpillar was not required to separately report business segments. Therefore, the company's financial statements and accompanying notes did not disclose the disproportionate effect of CBSA's earnings on the consolidated entity. Caterpillar's MD&A did not reveal the substantial impact of CBSA's profits on the company's consolidated results of operations, nor did the MD&A discuss the source of CBSA's profits and the substantial risk that these profits could not be repeated in 1990. Caterpillar's MD&A had been reviewed by the company's top officers and by the legal, economic and public relations departments of the company. The board of directors had even obtained an opinion from Caterpillar's General Counsel that the 1989 Form 10-K complied with all SEC rules and regulations. Despite this extensive review process, Caterpillar's MD&A contained only boiler-plate references to the Brazilian operations.

3. Deficient MD&A

The SEC ruled that:

> Caterpillar's failure to include required information about CBSA in the MD&A left investors with an incomplete picture

> of Caterpillar's financial condition and results of operations and denied them an opportunity to see the company "through the eyes of management."[485]

The SEC concluded that disclosure of the magnitude of CBSA's contribution to Caterpillar's overall earnings and the various items included in CBSA's profits was necessary to give a reader of Caterpillar's financial statements an understanding of Caterpillar's results of operations. Furthermore, the SEC concluded that management could not have concluded that lower earnings from CBSA were not "reasonably likely to occur" or that such lower earnings would not have a material impact on Caterpillar's results of operations for 1990.

The Caterpillar action should serve as a warning to issuers that the SEC intends to vigorously pursue enforcement of the MD&A rules. Regardless of any elaborate procedures for preparing and reviewing the MD&A, boiler-plate descriptions of items will not suffice where management has knowledge of, and has internally expressed concern regarding, events which have had or could have an impact on a company's financial condition or results of operations.[486]

D. Shared Medical Systems Corporation

In Shared Medical Systems Corporation[487], the SEC makes clear that all material disclosures should be included in 1934 Act periodic reports. Press releases or other public disclosures cannot act as replacements for required disclosures and, in fact, may be used as evidence that 1934 Act filings are deficient. In a consent order, the SEC found that Shared Medical Systems ("SMS") failed, as required by Item 303(a) of

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485 Exch. Act Rel. No. 30532, at 152. The SEC specifically referenced the following: Item 303(a) which requires a discussion in the MD&A of a registrant's segments or other subdivisions where such a discussion would be appropriate to an understanding of the registrant's business; Item 303(a)(3)(i) which requires a description of any unusual or infrequent events or transactions that materially affected the amount of reported income from continuing operations; and Item 303(a)(3)(ii) which requires a description of any known trends or uncertainties that the registrant reasonably expects to have a material impact on net sales or results from continuing operations.

486 Linda Quinn, director of the SEC's Division of Corporate Finance, has cautioned that practitioners who read Caterpillar as mandating even more extensive "procedures" in the preparation of a company's MD&A may be missing the point. According to Ms. Quinn, the procedures used by Caterpillar in the preparation of its MD&A were found to be inadequate because they resulted in inadequate disclosure. Ms. Quinn stressed that corporate counsel and issuers should look not only to the discussion in Caterpillar for guidance in MD&A preparation, but also should constantly review the 1989 MD&A Release, which Ms. Quinn stated remains the "best overall summary of the Commissions views". In addition, Ms. Quinn pointed to the 1988 Release discussing the disclosure requirements brought on by the defense industry, which Ms. Quinn stated applies to disclosures relating to any industry when events calling into question business practices or responsibilities come into play. See 25 Sec. Reg. & L. Rep. (BNA) 399 (Mar. 13, 1993). Additionally, see Steckman v. Hart Brewing, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,205 (9th Cir. 1998) (Item 303 "mandates not only knowledge of an adverse trend...and material impact..., but also that the future material impacts are reasonably likely to occur from the present day perspective...Only when future impacts are 'reasonably' likely to occur do they cease to be optional forecasts and instead become present knowledge subject to the duty of disclosure.").

487 Exch. Act Rel. No. 33632 (Feb. 17, 1994).

Regulation S-K, MD&A, to state in its Form 10-K for the year ended December 31, 1986, and in its Form 10-Q for the quarter ended March 31, 1987, that it was experiencing a material slowdown in growth due lower than expected sales activity.

1. The Press Release

On February 17, 1987, SMS disclosed in a press release "that business activity in the latter of the fourth quarter of 1986 and in early 1987 was below expectations and that this may make it more difficult for the company to achieve its growth goals in 1987." However, SMS's Form 10-K for 1986 and Form 10-Q for the quarter ended in March 1987, which were both filed after the press release, failed to state that the company was experiencing a slowdown in growth. In the Company's MD&A in the Form 10-Q for the quarter ended in June 1987, SMS belatedly stated that it was experiencing a "slowdown in growth" which was "primarily attributable to weaker sales activity during late 1986 and the early of 1987."

The Commission pointed to the February press release as evidence that SMS knew, or reasonably expected, that a lower than expected trend in sales activity in late 1986 and early 1987 was likely to have a materially unfavorable impact on SMS's net sales, revenues and earnings during 1987, at the time of filing the 1986 Form 10-K and the first quarter 1987 Form 10-Q.

2. Deficient MD&A

Consequently, on February 15, 1994, the Commission determined that SMS failed to state material information required by Item 303(a) of Regulation S-K, in violation of Section 13(a) and Rules 12b-20, 13a-1, and 13a-13. Accordingly, the Commission accepted an offer of settlement from SMS consenting to cease and desist from violating the subject sections of the 1934 Act, without admitting or denying the Commission's findings.

The Commission's willingness to use enforcement proceedings in Caterpillar and Shared Medical illustrates the increasing importance of including material disclosures in 1934 Act filings. Press releases, or otherwise, cannot replace required SEC disclosures.

E. Liquidity Analysis

As noted earlier, Item 303(a) requires the registrant to discuss in its MD&A, among other information, the liquidity, capital resources, and results of operations of the registrant. Liquidity is defined as "the ability of the enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash."[488] Financial items that are believed to be indicators of the company's liquidity, such as unused credit lines, debt-

[488] Reg. S-K, Item 303(a), Inst. No. 5.

equity ratios, bond ratings, and existing restrictions under debt agreements, must be included in the liquidity analysis.[489]

1. Salant

In Salant Corporation and Martin F. Tynan,[490] the Commission found that Salant Corporation's ("Salant") Form 10-K for the fiscal year ended December 30, 1989 and its Form 10-Q for the first quarter of 1990, failed to fully discuss known uncertainties relating to Salant's liquidity as required by the MD&A rules.

In August 1988, pursuant to a plan of growth and diversification, Salant entered into a credit agreement with a group of five banks to finance Salant's acquisition of Manhattan Industries, Inc., for approximately $99 million. The credit agreement provided Salant with a $100 million secured six-year term loan and access to an additional $90 million in credit until May 1991 through a revolving credit facility.

Beginning in the second half of 1989, and continuing through the filing of Salant's 1989 10-K, there were several indications that Martin Tynan ("Tynan") and other members of Salant's senior management knew that the company's liquidity was declining. First, Salant had to reduce by 57 percent the net worth requirement of its credit agreement for the period ended December 30, 1989.[491] Second, Salant began to seek additional sources of cash to fund current operations. Further, by the end of 1989, Salant had $46 million outstanding on its revolving credit facility. Third, Salant had approximately $37 million in excess inventory at the end of 1989, generally indicating Salant's declining financial condition. Fourth, Salant obtained a fourth amendment to the credit agreement to, among other things, reduce the requirements of various financial ratio tests. Moreover, in the fourth amendment, the bank group required Salant to provide it with additional collateral.[492] Fifth, Salant's actual operating results fell short of its budgeted results. This included, for the first two months of 1990, a $1.7 million loss as well as Salant operating below the minimum net worth requirements of the credit agreement. Sixth, during the first quarter of 1990, Salant, at Tynan's direction, delayed approximately $2 million in payments to certain vendors because it did not have sufficient cash to make the payments. This last practice had preceded Salant's prior bankruptcy filing in 1985. Lastly, certain cash flow forecasts generated prior to Salant's filing of the 1989 Form 10-K raised questions as to whether Salant could continue operations without additional sources of cash.

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489 Exch. Act Rel. No. 33-6349 (Sept. 28, 1981).

490 Exch. Act Rel. No. 34046 (May 12, 1994).

491 Salant ultimately reduced its 1989 year-end net worth requirement from $37 million in the original agreement to $16 million in the fourth amendment.

492 Note that changes in credit agreement provisions reflecting management's internal projections may serve as evidence that management knew or should have known that the trend or uncertainty was likely to be material. Thus, internal paperwork should be carefully considered when preparing the MD&A.

The Commission found that by failing to discuss its decreasing liquidity, how that decline resulted in uncertainties about its future liquidity, and how Salant intended to remedy the problem, Salant failed to comply with the liquidity provision of Item 303 of Regulation S-K. Consequently, the MD&A section failed to give the investor a view of the company "through the eyes of management." The Commission ordered both Salant and Tynan to cease and desist from committing or causing any violation, and committing or causing any future violation, of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

2. America West

On May 12, 1994, the Commission found that America West Airlines, Inc. ("America West") failed to disclose known uncertainties relating to its liquidity, as required in the MD&A sections in its Form 10-K for the fiscal year ended December 31, 1990, and its Form 10-Q for the first quarter of 1991.[493]

From late 1990 throughout 1991, America West experienced severe losses due to decreased passenger traffic levels and increased fuel costs, which subsequently resulted in a severe weakening of the Company's liquidity position. As a result of its liquidity problems, America West violated its financial covenants on four separate occasions during the period 1990 and 1991.

During a January 29, 1991 board meeting, senior management requested and received authority from the board of directors to continually amend the covenant provisions as needed in order to avoid future defaults. In February, America West initiated negotiations with certain lenders for long-term financing in an effort to comply with its future covenant provisions, and to restore its weakened liquidity provisions. In addition, America West also conducted a half-price ticket sale to raise revenues and improve the Company's long-term liquidity. However, the rapid use of the discounted tickets displaced full fare passengers and generated immediate operating expenses which only intensified the Company's liquidity problems. On June 27, 1991, America West filed a Chapter 11 bankruptcy petition.

The Commission concluded that it was not reasonably likely that America West would have been able to generate sufficient cash through financing or otherwise to restore its weakened liquidity and to comply with its financial covenants. Thus, the Company was required to include a discussion of the material uncertainties relating to its liquidity, as well as an objective evaluation of how the known uncertainty would impact upon the financial viability of the Company in the MD&A portion of its 1990 Form 10-K, and the MD&A portion of its first quarter 1991 Form 10-Q. America West, however, failed to make such necessary disclosures. The Commission's Order required America West to cease and desist from committing or causing any violation, and committing or

[493] Exch. Act Rel. No. 34-34047 (May 12, 1994).

causing any future violation, of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13.

F. Bank of Boston

On December 22, 1995, an SEC Administrative Law Judge issued the first fully litigated SEC decision based entirely on allegations of deficient MD&A disclosure.[494] The Commission alleged that Bank of Boston Corp. ("Bank of Boston") violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 in connection with MD&A disclosure in the Bank of Boston's Form 10-Q for the second quarter ended June 30, 1989. Specifically, the Commission found that in its Form 10-Q, Bank of Boston failed to disclose "material facts and known trends and uncertainties concerning the deterioration of its loan portfolio which Bank of Boston reasonable could expect would have a material unfavorable impact upon its financial condition and results from operations."

The record indicated that during the last three quarters of 1988 and the first two quarters of 1989, Bank of Boston experienced a significant deterioration in the value of its domestic real estate loan portfolio. However, Bank of Boston's 1989 first quarter MD&A merely stated that the company "continues to monitor the real estate portfolio closely in light of the current weakness in the real estate market."[495] The MD&A for the second quarter of 1989 stated: "With the further weakening of the real estate market during the second quarter, the Corporation continues to closely evaluate and manage its real estate portfolio."[496] The Commission found, however, that between May 12, 1989, and August 10, 1989, the respective filing dates for the first and second quarter 10-Qs, management had additional, "hard" information about the trend in its real estate portfolio, and other developments, that should have caused management to revise the MD&A discussion to address the effect of this trend on future results.

Specifically, the Commission found that management was required to discuss that it could reasonably expect that the quarterly addition to the reserve in the third quarter would need to be increased materially from the amount that had been the norm for the preceding six quarters. In support of its findings, the Commission cited the Bank's internal reports and memorandums which highlighted management's awareness that the reserve amount would increase significantly. The Commission also cited reviews conducted by the Office of the Comptroller of the Currency ("OCC") of Bank of Boston's domestic real estate loan portfolio. In these reviews, the OCC was highly critical of Bank of Boston's deteriorating real estate portfolio, the accuracy of

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494 Initial Decision Release No. 81, 60 SEC Docket (CCH) 2695 (Dec. 22, 1995) (since the Bank of Boston did not seek Commission review of the initial decisions, the decision was made final and adopted by the Commission as its final decision in Exchange Act Release No. 34-36887, 61 SEC Docket (CCH) 882 (Feb. 26, 1996)).

495 Id. at 2706.

496 Id.

management's risk assessment, and the lack of management's leadership abilities. After the review, the OCC downgraded numerous internally rated loans. The Commission then cited a highly leveraged transaction in which the obligor failed to remain solvent as further evidence of deficient MD&A. Finally, the Commission considered the declining New England real estate market in 1989 which made it "especially necessary for banks to carefully monitor reserves."

Each of these factors contributed to the Commission's conclusion that given all the information available to management prior to the filing of the second quarter Form 10-Q, management reasonably should have expected that a material increase in the Bank's reserve would be required. Applying the 1989 Interpretive Release standard, the Commission found that Bank of Boston was required to disclose "further information" (1) because the deterioration of the real estate loan portfolio was likely to continue, and (2) even if Bank of Boston could not make this determination, it was reasonable to expect a material impact on earnings if the trend continued. Indeed, Bank of Boston's second quarter 10-Q showed a reserve Provision Expense of $36 million and net income of $97.8 million, but in the third quarter, the Provision Expense ballooned to $370 million resulting in an after-tax net loss of $125 million. The second quarter MD&A, however, merely repeated the first quarter disclosure. According to the Commission: "No one who read [the Bank's] second quarter financials in its Form 10-Q would have anticipated what management knew was highly likely to happen, and did happen, to [the Bank's] earnings in the third quarter 1989."[497]

Unfortunately, the Commission did not specify the exact type of disclosure Bank of Boston was required to make in the second quarter stating only that the "failure to provide additional information made the information contained in the Form 10-Q misleading."[498] The Commission did not say that all of its findings should have been disclosed in the MD&A. At the least, however, management should have disclosed that the reserve amount was likely to increase due to the deteriorating real estate loan portfolio caused by the declining trend in the New England real estate market.

The Commission's Order required Bank of Boston to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 126-20 and 13a-13.

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497 Id. at 2698.

498 One practitioner noted that this finding implies that when circumstances change between periods, repeating an earlier statement in the MD&A may be misleading if the effect is to convey that no interim developments have occurred which might materially impact the registrant's financial condition or results of operations. Schulte, Stephen J., Management's Discussion and Analysis of Financial Condition and Results of Operations: A Primer for the Practitioner, in 2 Preparation of Annual Disclosure Documents 219, 242 (Practicing Law Institute, 1996).

G. Sony

In the matter of Sony Corporation and Sumio Sano[499] is a glaring example of the need to separately disclose in the MD&A under-performing major businesses that are included in larger segments. Sony consisted of only two reportable segments, namely, the entertainment and the electronics segments. The entertainment segment consisted of music and movies. Sony Music performed well, but in contrast, Sony Pictures was operating at substantial losses, reaching approximately $967 million by 1994. However, under the guidance of Sumio Sano, the General Manager of Sony's Capital Market & Investor Relations Division, Sony did not disclose in either its consolidated results or segment results the nature of the losses due to Sony Pictures. Instead, Sony focused on the music segment and on recent movie "hits," implying that Sony Pictures was, in fact, as a whole, doing well.[500]

The SEC found in a consent cease and desist Order that Sony violated Section 13(a) of the Exchange Act by failing to provide adequate and appropriate MD&A disclosure. Adequate and appropriate MD&A disclosure must, according to Sony, include in MD&A, on both a consolidated and segment basis, a discussion of the differing trends within a major business unit. The disclosure in the MD&A must include qualitative as well as quantitative information because in the absence of such disclosure, "a company's financial statements and accompanying footnotes may be insufficient for an investor to judge the quality of earnings."[501]

Sony consented to the SEC Order, and agreed to, as part of the settlement, among other things, engage an independent auditor to conduct an examination of its 1998 MD&A presentation.[502] Sony also agreed to adopt Statement of Financial Accounting Standards No. 131 (which it was required to do anyway) beginning with the fiscal year ended March 31, 1998. Statement 131 requires that companies disclose separate operating business data based on how management makes decisions about allocating resources to these separate business units and measuring their performance. Under FAS 131, Sony probably would have had to report separately its motion pictures and music businesses.[503] By failing to ensure that Sony's disclosures were adequate, Sumio Sano was found to be a cause of Sony's violations.

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499 Exch. Act Rel. No. 34-40305 (August 5, 1998).

500 Exch. Act Rel. No. 34-40305, at 3.

501 Id. at 5, quoting SEC Release Nos. 33-6835, 34-26831, IC-16961, FR-36 (May 18, 1989).

502 Id. at 6. Also, see Section IV. H, New Accounting Procedure - SSAE No. 8.

503 The SEC has proposed revisions to Regulation S-X to include FAS 131.

In a separate civil action filed simultaneously with the administrative proceeding, Sony consented to an injunction and the payment of a $1 million civil penalty.[504]

H. MD&A in the Courts

In the past, courts addressed the issue of whether plaintiffs may bring a private action and allege a violation of Item 303 of Regulation S-K. The courts, however, dismissed these claims based on the insufficiency of the pleadings. For example, in Gap Securities Litigation, the court rejected the claim that The Gap should have discussed in the MD&A of its 10-Q filings, the continuing inventory build-up and margin trends, and the causes of these trends. Plaintiffs' failure was, in part, the result of poor pleading and the court's misinterpretation of the MD&A requirements. The plaintiffs alleged a violation of Item 303(a) of Regulation S-K which relates only to annual Form 10-Ks. Consequently, the court summarily dismissed the MD&A as requiring discussion of the alleged omissions in the quarterly Form 10-Qs.

The plaintiffs and the court completely ignored Item 303(b) which provides that interim reports, including Form 10-Qs, "shall include a discussion of material changes in those items specifically listed in paragraph (a) of this Item 303."[505] In the 1989 MD&A Interpretive Release, the SEC stated that Item 303(b) requires discussion of every disclosure requirement contained in Item 303(a), including known trends or uncertainties arising during the interim period which are reasonably likely to have material effects on financial condition or results of operations.[506] Given the eventual inventory write-downs and decrease in earnings, the developments omitted by The Gap may have materially impacted the company's results of operations and the information arguably should have been discussed in the MD&A of its quarterly reports.[507]

In Oran v. Stafford, however, the Third Circuit finally addressed the issue of whether a private right of action exists for alleged violations of Item 303(a) of Regulation S-K where the claim is pleaded well.[508] In holding that no such private right of action exists, the court also noted that a violation of Item 303 is not the equivalent of a Section

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504 SEC v. Sony Corporation, Civil Action No. 1-98CV01935 (LFO) (D.D.C. 1998).

505 17 C.F.R. ¶ 229.303(b).

506 See Exch. Act. Rel. No. 26831, supra note 446 and accompanying text.

507 The district court also summarily disregarded similar MD&A pleadings in Alfus v. Pyramid Technology Corp., 745 F. Supp. 1511 (N.D. Cal. 1990), and Sun Microsystems, Inc. Securities Litig., Fed. Sec. L. Rep. (CCH) ¶95,504 (N.D. Cal. 1990). The plaintiffs in Alfus alleged that Item 303(a) required Pyramid to disclose in its annual report and press releases known adverse data about the future prospects for its products. Likewise, the plaintiffs in Sun alleged that Item 303 required disclosure in a press release announcing second quarter earnings of the impact a competitive product would have on future results. In both these cases, the court stated that Rule 10b-5 did not require disclosure of the omitted information and that Item 303(a) applied only to annual report Form 10-K filings with the SEC. Due to poor pleadings, the court did not address in either of these cases whether the companies should have made the disclosures in the MD&A of their quarterly reports.

508 Fed. Sec. L. Rep. (CCH) ¶ 91,205 (3d Cir. 2000).

10(b) violation as a matter of law.[509] The court reasoned that based on prior case law, the language of the Regulation, and the interpretive releases of the SEC, no private cause of action exists under S-K 303.[510] According to the Oran decision, the disclosure obligations for MD&A differ greatly from the materiality tests for securities fraud established in Basic in that the materiality tests for Rule 10b-5 and SK-303 differ and, the violation of one does not necessarily result in the violation of the other.

Decisions subsequent to Oran have not been consistent on this issue, however. Two district courts have blurred the materiality differences between Rule 10b-5 and SK-303 and have held that allegations claiming a violation of Item 303 could support valid claims under Rule 10b-5, whereas another district court followed Oran.[511]

I. Accounting Procedure–SSAE No. 8

Traditionally, accountants have delivered to underwriters "cold comfort letters" to bring down the Annual Audited Financial Statements in connection with underwritings. Less frequently, cold comfort letters are delivered to parties to a business combination. These cold comfort letters in the context of underwritten offerings provide underwriters with due diligence support.

In the middle of 1998, the AICPA adopted standards in SSAE No. 8 for the examination or review of MD&A.[512] Examinations can only be made with respect to previously audited financial statements, and the report on the examination can be published. Moreover, the new standards also provide for a more limited "review" which can be made of either audited or interim financial statements. An examination report will:

- express an opinion on whether the MD&A, taken as a whole, includes full and complete disclosure;

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509 Id.

510 Id.

511 Compare Scholastic Corp., Fed. Sec. L. Rep. (CCH) ¶ 91,455 (2d Cir. 2001) (although no discussion of whether alleged violations of Item 303 can support a private right of action, the court in effect held that disclosure of upward trends in the return of books from retailers was required under Item 303) and Campbell Soup, Fed. Sec. L. Rep. (CCH) ¶ 91,464 (D.N.J. 2001) with Pacific Gateway Exchange, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,906 (N.D. Cal. 2002) (holding that no private right of action exists for violations of Regulation S-K; "plaintiffs are mistaken when they assert that they can premise a duty to disclose. . .on an alleged failure to comply with Regulation S-K").

512 The full version of Statement on Standards Attestation Engagements is published in the Journal of Accountancy, June 1998 at page 103. In connection with the adoption of SSAE No. 8, the AICPA also adopted amendments to SAS No. 72, reflecting changes required as a result of SSAE No. 8. See SAS No. 86 - Amendment to Statement on Auditing Standards (if the accountant has performed an SSAE No. 8 examination or review, he or she may refer in the comfort letter to that SSAE report) and No. 72, Letters for Underwriters and Certain Other Requesting Parties. See Berkeley, Alan J., Outside Auditors' Examinations of MD&A Presentations: SSAE No. 8, ALI-ABA Postgraduate Course in Federal Securities Laws (1998).

- determine whether all necessary historical financial data is correct; and

- ensure that the underlying information provides a reasonable basis for the MD&A disclosures.[513]

SSAE No. 8 sets forth a number of procedures that the auditor is to use to support the issuance of the examination report. For example, the auditor is required to exercise (a) due professional care in planning, performing, and evaluating the results of his or her examination procedures and (b) the proper degree of professional skepticism to obtain reasonable assurance that material misstatements will be detected. The practitioner should also consider relevant portions of the entity's internal control system applicable to the preparation of MD&A and consider the effect of events subsequent to the balance-sheet date.[514]

These reports have not yet been used often. Indeed, not all accounting firms have offered to do them. If issued, the reports should provide extra protection for company boards, audit committees, and underwriters. The independence, expertise and focus that outside accountants bring to the examination or review should help shield against claims that the MD&A was materially misleading or omitted material disclosures. Perhaps one of the reasons this has not been more widely adopted is because of the concern that the procedures mandated by SSAE No. 8 are not adequate to ferret out undisclosed information, uncertainties, trends or future results.[515] Moreover, how equipped are accountants to report on these issues which generally involve legal questions?

In its Critical Accounting Policies Release proposing additional disclosures in MD&A that would dictate discussion of critical accounting policies, the SEC asked for comments about whether the "new and improved" MD&A requirements should be subject to the auditing process.[516] The SEC expressly recognized that the independent accountant is required to read the MD&A and consider whether it is materially inconsistent with the information or presentation appearing in the financial statements. Implicit in the questions posed by the SEC is the basic issue of whether the proposals, if adopted, cause the MD&A to be in reality a part of, or an extension of, the financial statements and accordingly should be audited. The central question raised is whether MD&A can realistically be "audited" in the traditional sense and whether accountants

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513 Earnings Per Share: Accountants' Review or Examination of Managements' Discussion and Analysis. McLaughlin, Joseph. Insights, Volume 12, Number 10, October 1998.

514 Id. at 107.

515 MD&A Audits: A New Tool for Boards of Directors and Underwriters. Butler, Samuel C. and White, John W. Published in 30th Annual Institute on Securities Regulation, Volume Two. Practicing Law Institute (1998).

516 Critical Accounting Policies Release at 29-31. See section IV.K infra, for a discussion of the Critical Accounting Policies Release. The SEC notes that approximately 50 companies have, according to the underwriting agreements filed with the SEC, used their independent accountants to conduct an examination of MD&A in connection with registered public offerings. Id. at n. 104; see also nn. 99, 100 and 105 therein.

alone are competent to attest to the MD&A which largely involves legal issues that lawyers should address.

Section 404(b) of S-O requires each registered public accounting firm to "attest to, and report on" management's assessment of the effectiveness of the internal control structure and procedures of the company for financial reporting. Management's "assessment" is required by Section 404(a) and requires the SEC to adopt implementing rules (the SEC is not under any time deadline to adopt these rules). The outside auditors "report" will be based upon standards to be adopted by the Public Company Accounting Oversight Board. Considering that there are no standards in place for this report, perhaps SSAE No. 8 will be used as a model.

J. The SEC and Accounting Firms React to Enron's Collapse

On December 12, 2001, the SEC issued a statement regarding the selection and disclosure by public companies of critical accounting policies and practices in light of the issues surrounding the collapse of Enron Corporation.[517] The Commission reminded public companies that MD&A requires disclosure about "trends, events or uncertainties known to management that have a material impact on reported financial information."[518] The Commission further alerted companies to the importance of disclosure using the following guidelines:

- Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in financial statements.
- Management should ensure that disclosure in MD&A is balanced and fully responsive.
- Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies.
- If companies, management, audit committees or auditors are uncertain about the application of specific GAAP practices, the should consult with SEC's accounting staff.[519]

In reaction to the issues raised by the SEC, the accounting firms of Arthur Anderson LLP, Deloitte and Touche LLP, Ernst & Young, KPMG LLP and PricewaterhouseCoopers LLP, with the endorsement of the American Institute of Certified Public Accountants, jointly petitioned the SEC to issue an interpretive release to provide guidance for public companies in preparing disclosures for inclusion in annual

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[517] Cautionary Advice supra.

[518] Id.

[519] Id.

reports on Form 10-K and other reports.[520] The firms suggested that the interpretive release address three areas that would expand the disclosure necessary to improve the transparency of financial reporting, including:

- liquidity and capital resources including off-balance sheet arrangements;
- certain trading activities that include non-exchange traded contracts accounted for at fair value; and
- effects of transactions with related and certain other parties.[521]

In response, the SEC issued a statement on January 22, 2002 about Management's Discussion and Analysis of financial condition and resulting operations. The release provided steps that issuers should consider in meeting their current disclosure obligations.[522] The Commission addressed the three areas specifically identified by the firms in their petition.[523] The first of these areas, namely, liquidity, capital resources and off-balance sheet arrangements, has been superceded by the Commission proposals of November 2002 which are discussed below at Section L. The other two areas are discussed immediately below.

1. Disclosure about Certain Trading Activities that Include Non-Exchange Traded Contracts Accounted for at Fair Value

The Commission asked for additional MD&A disclosure by companies that are engaged, to a material extent, in trading activities involving commodity contracts (indexed to measures of weather, prices for energy storage, etc.) that are accounted for at fair value but where, due to a lack of market price quotations, fair value estimation techniques must be used. The SEC advised these companies to provide comprehensive information about the trading activities, the contracts, modeling methodologies, assumptions and variables, and the different potential outcomes. Furthermore, the Commission proposed that companies provide a schedule that "disaggregates realized and unrealized changes in fair value; identifies changes in fair value attributable to changes in valuation techniques; disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market

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520 Petition to U.S. Securities and Exchange Commission for Issuance of Interpretial Release (Dec. 31, 2001) available at http://www.sec.gov/rules/petitions/petndisc/-12312001.htm (last modified Jan. 3, 2002).

521 Id.

522 Commission's Statement about Management's Discussion and Analysis of Financial Condition and Resulting of Operations, Release Nos. 33-8056; 34-45321; FR-61 (Jan. 22, 2002), available at http://www.sec.gov/rules/other/33-8056.htm (last visited Jan. 24, 2002).

523 See also Mark D. Wood, "New Focus on MD&A Disclosure Needed in Post-Enron Environment," Katten Muchin Zavis Rosenman Client Advisory (Feb. 2002).

prices or are estimated; and indicates maturities of contracts at the latest balance sheet date (e.g., within one year, within years one through three, within years four and five, and after five years)."

2. Disclosure about Effects of Transactions with Related and Certain Other Parties

The SEC advised companies that their MD&A disclosure should contain detailed discussions of material related party transactions to the extent needed to provide investors with an understanding of their current and prospective financial positions and operating results. Going further, the SEC asked companies to consider including discussions regarding all material transactions with related persons or entities, as well as other parties with whom the company or the related parties have relationships that allow such other parties to negotiate transaction terms that may not be available from clearly independent parties on an arm's length basis. The SEC recommended that companies include in these discussions information regarding the nature, purpose and economic substance of, and risks associates with, the transactions. This MD&A disclosure is in addition to, and not in lieu of, the related party transaction information that must be provided pursuant to Item 404 of Regulation S-K ("Certain Relationships and Related Party Transactions") and in financial statement footnotes.

K. The May 2002 SEC Proposals Concerning Critical Accounting Policies

1. Introduction

As part of its continuing improvement of MD&A disclosure, the SEC in May 2002 proposed expanding MD&A to include two new areas, namely, first, the identification and comprehensive description of critical accounting policies used in preparing the financial statements, and, second, the identification and comprehensive description of the initial adoption of an accounting policy that has a material impact on the financial presentation.[524] Before describing these proposals, it is important to recognize a number of central features of the proposals primarily because they represent a significant departure from past disclosure practices and chart a new course; the proposals would:

- Require detailed disclosure of management's thought process in preparing the financial statements and in assessing future business risks.

- Require detailed disclosure of the impact/significance of critical financial estimates on the financial statements, including liquidity and capital resources, as well as, if appropriate, on the line items in the presentation.

[524] Critical Accounting Policies Release.

- Require a sensitivity analysis based on both future possible changes in the critical estimate and quantitative disclosure relating to historical changes in a company's critical accounting estimates in the past three years.

- Require for the first time the necessity to include in SEC filed documents forward-looking statements.[525]

- Deviate from maintaining the integrity of the financial statements: under the proposals, the MD&A would become the plain English explanation for critical judgments made in the preparation of financial statements. Indeed, the Critical Accounting Policies Release implies a dissatisfaction with the disclosure contained in financial statements presently prepared under GAAP. For instance, in describing the proposal to disclose the initial adoption of a material accounting policy, the SEC states:

  > "The disclosure provided in the notes to the financial statements, however, may not adequately describe, in a qualitative manner, the impact of the initially adopted accounting policy or policies on the company's financial presentation. We are therefore proposing additional MD&A disclosure to further describe, where a material impact exists, the initial adoption of accounting policies."[526]

If adopted, users of financial statements cannot rely on the financial statements without reading and understanding the financial statements as supplemented and explained by the MD&A. If the proposals are so crucial, should, for example, lenders to privately–held corporations require similar disclosure? Note also the absence of any audit attestation for the new and improved MD&A; the SEC expressly asked commentators on the proposals to respond to this issue. As stated earlier, can the MD&A realistically be audited in the traditional sense and can it be done without the integral participation of a lawyer?[527]

2. Critical Accounting Policy Disclosure

The starting point to an understanding of the proposals is to determine whether an accounting estimate requires disclosure; to do this two questions must be asked:

"1. Did the accounting estimate require us to make assumption about matters that were highly uncertain at the time the accounting estimate was made?

2. Would different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably

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[525] Critical Accounting Policies Release, p. 38.

[526] Critical Accounting Policies Release, p. 32; see also pp. 6, 10, 30.

[527] See supra, IV.I.

likely to occur from period to period, have a material impact on the presentation of our financial condition, changes in financial condition or results of operations?"[528]

If the answers to both of these questions are "yes", the accounting estimate is considered a "critical accounting estimate" requiring comprehensive explanation.[529] Once a company determines that it has a critical accounting estimate, it must include in its MD&A:

- "A discussion that identifies and describes:
  - the critical accounting estimate;
  - the methodology used in determining the critical accounting estimate;
  - any underlying assumption that is about highly uncertain matters and any other underlying assumption that is material;
  - any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or the assumptions described;
  - if applicable, why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period; and
  - if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation;
- An explanation of the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company's financial statements affected by the accounting estimate;
- A quantitative discussion of changes in overall financial performance and, to the extent material, (the impact on liquidity or capital resources) and line items in the financial statements if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in the most material assumption(s) underlying the

[528] Critical Accounting Policy Release, p. 4.

[529] "Critical Accounting Estimate" is defined in proposed amendments to §229.330(c)(2)(iii) (Critical Accounting Policies Release p.60; other new defined terms are "accounting estimate," "near-term" and "reasonably possible").

accounting estimate or by using the reasonably possible range of the accounting estimate;

- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes, and the effect on line items in the financial statements and overall financial performance;

- A statement of whether or not the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the audit committee of the company's board of directors [and if not, state the reasons why not];

- If the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects; and

- A discussion of the accounting estimate on a segment basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading."[530]

These disclosures would have to be made in the annual yearly audited financial statements and in interim financial statements. The quarterly updates, however, would not require discussion of past historical material changes in the critical accounting estimates.[531] The Commission states that it believes the number of critical accounting estimates will vary by company, but it expects very few companies to have none at all and the vast majority to have somewhere in the range of three to five. The Commission expressly cautions against the use of a long list of accounting estimates since such a list might obscure the critical ones.[532] As an aid to understanding the SEC's aims, the Critical Accounting Policies Release contains three examples of the disclosure that would be mandated if the proposed rules were adopted. These examples are helpful in gaining an appreciation of what the rules would require, but they appear to involve fact patterns that do not normally occur. Moreover, the examples do not shed any light on how giant corporations, operating in a number of different business segments, will determine how much to disclose. For such companies, strict application of the proposals could create an MD&A section almost as long or longer than the financial statements themselves.

3. Disclosure of Initial Adoption of Accounting Policies.

Under the second prong of the proposals, the SEC would require a company to describe in detail the adoption of an accounting policy if it will have a material impact on

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530 Critical Accounting Policies Release at 12-13.

531 Id. at 31.

532 Id. at 14.

the company's financial condition, changes in financial condition or results of operation.[533] The SEC argues that the traditional disclosure of the adoption of a new accounting policy, usually in the first note to the financial statements, may not be adequate in a qualitative manner. To cure this, the Commission proposes that the MD&A should be the vehicle to describe the policy in plain English and to quantify the impact of the policy. The proposed disclosure would be required in filed annual reports, annual reports to stockholders, registration statements and proxy statements. The disclosure would consist of:

- the events or transactions that gave rise to the initial adoption;
- the accounting principal that has been adopted and the method of applying that principal;
- the impact, qualitatively, on the financial presentation;
- if the company had a choice between acceptable accounting principles, an explanation of why it made the choice it did including a discussion of the alternatives, including, where material, qualitative disclosure of the impact on the financial presentation that the alternatives would have had; and
- an explanation of why the policy was adopted if there is no accounting literature existing on the issue.[534]

The key issue raised by this proposal is how to determine whether the policy will have a "material" impact on the financial statements.

4. Safe Harbor, Disclosure Presentation, Foreign and Small Business Issuers

The Commission indicates that its various safe harbor rules for forward-looking information are applicable to the disclosures required under these proposals. These statutory provisions and rules, however, contain a number of material exceptions to the safe harbors that should be revisited in light of these new proposals. For instance, the safe harbor under the Reform Act does not apply to initial public offerings where it might be most needed.[535]

As to presentation, the required information would have to be included in a separate section of the MD&A so that it is highlighted. Furthermore, as the Critical Accounting Policies Release repeatedly states the MD&A discussion "must be presented

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[533] The adoption of an accounting policy that results solely from new accounting literature issued by a recognized accounting standard setter is an exception to this requirement.

[534] Critical Accounting Policies Release, at 32-33.

[535] Id. at 37-38.

in clear, concise format and language that is understandable to the average investor". Boiler plate is to be avoided as well disclosures that consist principally of disclaimers of legal liability.[536]

The proposals would also apply to foreign private issuers with some added complications if the issuer presents its financials in non-US GAAP.[537] Furthermore, the proposals will apply to small business issuers but they provide some relief to such issuers who disclose business plans instead of publishing a full MD&A.[538]

Finally, comments should be received on or before July 19, 2002.

5. Assessment as of January 2004 of the Critical Accounting Policy Proposals

Because these proposals depart so significantly from past disclosure and financial statement presentation, the comments to them will be extremely helpful in assessing whether they should be adopted at all or adopted with material changes. Before the SEC was able to respond to the comments, however, the S-O Act took center stage and the Commission was obligated to adopt the rules to implement that legislation. Many issuers, nevertheless, enhanced their MD&A disclosure (and in some instances their financial statements) to discuss more fully their critical accounting policies – not to the extent of the proposed rules but certainly more fulsome disclosure than they have previously made. Now that the SEC has adopted almost all of the rules it was obligated to enact under the S-O Act, the Commission will undoubtedly address these problems and most likely adopt some or all of them.[539]

The SEC provides guidance concerning critical accounting estimates in the 2003 MD&A Release.[540] According to the 2003 MD&A Release, companies should consider enhanced discussion and analysis of critical accounting estimates and assumptions that supplement, but do not duplicate, the description of accounting policies in the notes to the financial statements.[541] While the notes in the financial statements generally describe the

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536 See e.g., Instruction 4 to paragraph (c) of proposed Section 229.303 (Critical Accounting Policies Release, at 62).

537 Critical Accounting Policies Release, at 34-36.

538 Critical Accounting Policies Release, at 36-37.

539 In a statement reported in November 2003, Christine Davine, a partner with Deloitte and Touche LLP, said that she doesn't expect the SEC to adopt a final rule any time soon on the disclosure of critical accounting policies. She advised that companies should continue to rely on the cautionary advice provided by FR-60, and added that if companies do a really good job with their disclosure, the SEC may choose not to go forward with a final rule. However, Don Walker, the senior assistant chief accountant in the Division of Corporation Finance, in a reported statement, said that registrants are not giving much quantitative information in their disclosure. SEC Institute Panelists Review Major Reporting Developments, The SEC Today Vol. 03-210 (Nov. 4, 2003).

540 Release No. 33-8350 (Dec. 19, 2003), available at http://www.sec.gov/rules/interp/33-8350.htm.

541 Id.

method used to apply an accounting principle, the SEC suggests that the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle or the variability that is reasonably likely to result from its application over time, including:[542]

- Why their accounting estimates or assumptions could change. The reason may be that there is an uncertainty attached to the estimate or assumption, or that it is difficult to measure or value;

- An analysis, to the extent material, of such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to be changed in the future;

- An analysis of the sensitivity of critical accounting estimates and assumptions to change, based on other outcomes that are reasonably likely to occur and would have a material effect; and

- Quantitative, as well as qualitative, disclosure when quantitative information is reasonably available and will provide material information to investors. For example, if reasonably likely changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on the financial condition or operating performance of the company, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of the estimates of long-term rates of return, quantified.

L. Disclosure Concerning "Off-Balance Sheet" Arrangements

On January 28, 2003, the SEC adopted rules under Section 13(j) of the Securities Exchange Act of 1934, added by Section 401(a) of the S-O Act, to regulate the mandatory disclosure of off-balance sheet arrangements in MD&A. Section 401(a) of the S-O Act requires the SEC to issue rules providing for periodic reports that "disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial conditions. …"[543] In general, the rules provide for a lower threshold that triggers disclosure of off-balance sheet arrangements, require the disclosure to be set apart in a designated section of MD&A and require additional disclosure relating to aggregate contractual obligations.

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542 Id.

543 Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182; 34-47264 at http://www.sec.gov/rules/final/33-8182.htm (last modified Jan. 28, 2003).

Registrants are also required to provide an overview of certain contractual obligations in a table format.

1. Definition of Off-Balance Sheet Arrangements

The rules define the term "off-balance sheet arrangement" to target the means by which companies typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully transparent to investors. The term includes any contractual agreement to which an unconsolidated entity, under which the registrant has:

- Any obligation under certain guarantee contracts;[544]
- A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
- Any obligation under certain derivative instruments;
- Any obligation under a material variable interest[545] held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

2. Disclosure Threshold

The threshold for disclosure of off-balance sheet arrangements is when an off-balance sheet arrangement either has, or is reasonably likely to have, a current or future effect on the registrant's financial condition, change in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. This threshold is consistent with the existing disclosure threshold under which information that could have a material effect on financial condition, changes in financial condition or result of operations must be included in MD&A.

3. Disclosure About Off-Balance Sheet Arrangements

Under the rules, a company would have to disclose, in a separate section of its MD&A:

- the nature and business purpose of the off-balance sheet arrangements;

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[544] This term is defined generally by the FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, November 2002 ("FIN 45").

[545] This term is defined generally by the FASB Interpretation No. 46, Consolidation of Variable Interest Entities, January 2003 ("FIN 46").

- the importance of its arrangements to its liquidity, capital resources, market risk support, credit risk support and other benefits;

- overall magnitude of the off-balance sheet activities, the specific material impact of the arrangements on a registrant and the circumstances that could cause material contingent obligations or liabilities to come to fruition;

- the amount of revenues, expenses and cash flows arising from the arrangements;

- the nature and total amount of any interests retained, securities issued and other indebtedness incurred; and

- the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the arrangements that are, or may become, material and the triggering events or circumstances that could cause them to arise.

4. Tabular Disclosure of Contractual Obligations

The SEC now requires that companies (other than a small business issuer) disclose, in a tabular format, its contractual obligations aggregated by type, for at least the periods specified in the table below. The SEC reasoned in the release that aggregated information about a registrant's contractual obligations in a single location would provide useful context for investors to assess the short- and long-term liquidity and capital resource needs and demands. The rules as adopted dropped the requirement to disclose contingent liabilities, but the rules do require the disclosure of contractual obligations. Registrants must provide the information as of the latest financial year end balance sheet date in substantially the following form:

	Payments due by period				
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
[Long-Term Debt]					
[Capital Lease Obligations]					
[Operating Leases]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP]					
[Total]					

5. Presentation of Disclosure

The disclosure of off-balance sheet arrangements are to be in a separately-captioned section of MD&A. A registrant may place the tabular disclosure of known

contractual obligations in an MD&A location that it deems appropriate. Moreover, the MD&A discussion should be presented in a language and a format that is clear, concise and understandable. Boilerplate disclosures do not specifically address the registrant's particular circumstances and operations will not satisfy MD&A requirements. The registrant may cross-reference to information in footnotes to the financial statements.

6. Application to Foreign Private Issuers

The MD&A disclosure requirements apply to foreign private issuers that file annual reports on Form 20-F or Form 40-F. Although off-balance sheet disclosures are required in quarterly reports as well as annual reports, because foreign private issuers do not file "quarterly" reports, the rules do not apply to Form 6-K reports. Unless a foreign private issuer files a Securities Act Registration Statement that must include interim period financial statements and related MD&A disclosure, it will not be required to update its MD&A disclosure more frequently than annually.

7. Safe Harbor for Forward-Looking Information

Some of the disclosure required by the rules involve forward-looking information. To encourage companies to provide the analysis necessary for investors to understand the impact of off-balance sheet arrangements, the SEC has included within the rules a safe harbor for forward-looking information. The proposed safe harbor would explicitly apply the safe harbor protections (Sections 27A of the Securities Act and 21E of the Exchange Act) to forward-looking information that is required to be disclosed.

M. Conclusion

The SEC's releases in late 2001, 2002 and 2003 have refocused attention on MD&A. Moreover, the adopted rules regarding off-balance sheet arrangements further emphasizes the importance of MD&A. It is clear that the Commission construes and will enforce the MD&A as a quarterly disclosure vehicle for material corporate developments, especially "bad news,"[546] and to describe managements analysis of key accounting assumptions.

The SEC's enforcement actions demonstrate that issuers should consider internal paperwork which may provide evidence that management knew or should have known

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[546] See James J. Maiwurm, Annual Disclosure in a Declining Economy - Some Year-End Reminders, Insights, Jan. 1991, at 3. Query: whether issuers who anticipate exceptionally positive financial developments could incur liability for failure to fully disclose such favorable events in the MD&A? Probably not; however, the SEC takes a strong opposing position regarding this issue. Although the 1989 MD&A Release does not explicitly dismiss the disclosure of positive corporate developments, most examples in the 1989 MD&A Release involve either (1) the disclosure of adverse business developments or (2) the tempering of good news with the negative side effects of relevant transactions. See also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9. While there is no affirmative duty to disclose in MD&A uncharged misconduct, management must consider the likelihood of a charge and the potential effect on the financial situation of the company.

that the trend or uncertainty was likely to be material. Moreover, the SEC's 2000 Audit Risk Alert emphasized MD&A as a hot issue in need of further clarification by the Commission.[547] For example, the SEC's 2000 Audit Risk Alert even provided a list of current developments in the economy and business world which most likely affect registrants and require disclosure in MD&A. Although there are relatively few court decisions on this subject, the decisions decided after the Third Circuit's Oran opinion have equated faulty MD&A disclosure with faulty Rule 10b-5 disclosure.

One frequently quoted phrase by regulators is that "good MD&A trumps faulty financial statements." There is much truth to this statement; those who prepare MD&A should pay heed.

V. REGULATION FD AND CURRENT PRACTICES INVOLVING ANALYSTS

A. Background

Communications between the issuer and analyst serve a significant market function in ensuring the dissemination of information to the marketplace. As noted by the Supreme Court: "the value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information and thus the analysts' work redowns to the benefit of all investors."[548]

True, meetings and discussions with analysts serve an important function in evaluating and disseminating information for public use. Indeed, most issuers cannot avoid the free flow of information to analysts; otherwise, their stock prices will suffer from inadequate analyst coverage upon which the "street" and money managers depend. Issuers, however, face risks in communicating with analysts and these dialogues create a number of problems. First, selective disclosures to analysts may be viewed as unlawful tipping in violation of Rule 10b-5.[549] The general rule for issuers when dealing with analysts is that it is improper for a corporate executive to reveal material, non-public information if he or she acts (i) in breach of an independent fiduciary duty and (ii) for the personal benefit of the insider.[550] Second, information conveyed to analysts about fluid business situations can turn out to be misleading, such as "early warning" signals, and the practice of reviewing and/or correcting analysts' reports might make issuers responsible

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547 See Office of the Chief Accountant, "Letter: 2000 Audit Risk Alert to the American Institute of Certified Public Accountants," http://www.sec.gov/offices/account/audrsk2k.htm, October 13, 2000.

548 Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983) (quoting 21 SEC Docket 1401, 1406 (1981)).

549 Former SEC Chairman Arthur Levitt stated in an October 18, 1999 address to the Economic Club of New York that the "behind-the-scenes feeding of material non-public information from companies to analysts is a stain on our markets." Levitt's entire speech can be viewed on the SEC Web site at www.sec.gov/news/speeches/spch304.htm (the "Levitt Speech").

550 Dirks, 463 U.S. 646.

for the accuracy of the entire report and establish a duty to keep the information current.[551] Third, since the break in the market bubble in early 2001, analysts have been under severe pressure to "clean up their act" to provide objective investment advice and to disclose any conflicts of interest.

In response to these problems, the SEC and the SRO's have taken decisive action. In August 2000, the SEC adopted Regulation FD (Fair Disclosure) to combat issuers' selective disclosure to market analysts and institutional investors.[552] The rule, which took effect on October 23, 2000, requires that if a company discloses to market participants any non public material information, it must broadly and publicly disseminate that same information to both the investing public and analysts at the same time.[553] A major development in the interpretation of Regulation FD took place in November 2002, when the SEC issued three cease and desist orders and a report of investigation as the first reported decisions under Regulation FD, as discussed herein.

In 2002 and 2003, a host of regulatory bodies initiated major reforms that will largely change the environment in which analysts operate. These reforms include:

- the adoption of Regulation AC by the SEC
- new rules by the SROs regulating the conduct and disclosure of member firm analysts; and
- finally, blockbuster court actions by the SEC and other regulatory agencies against ten leading investment banking firms resulting in payments of approximately $1.4 billion and consent decrees causing the firms to separate their investment banking operations from research ("Analyst Court Consents")

In large part, these reforms will significantly limit the participation of analysts in the underwriting process and limit the ability of analysts to acquire material undisclosed information from issuers.

1. The Events and Law Leading to the Adoption of Regulation FD

Prior to the adoption of Regulation FD, the Supreme Court in the Dirks case established the line between permissible and impermissible disclosure. In Dirks, Raymond Dirks, a well known investment analyst was informed by a former employee of Equity Financing Corporation that the company was involved in massive financial fraud.

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551 Robert B. Robbins, Corporate Communications, Insights, Apr. 1994, at 10. See also James J. Junewicz, Securities Disclosure: Handling Wall Street Analysts, Insights, January, 1995, at 9-16.

552 Securities and Exchange Commission Final Rule: Selective Disclosure and Insider Trading, available at http://www.sec.gov/rules/final/33-7881.htm (hereinafter "Regulation FD"); 17 CFR 243.100-103.

553 Id.

Dirks investigated the allegations and exposed the company's fraud, but not before revealing the company's wrong-doings to his own clientele. The SEC concluded:

> "In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from Equity Funding insiders. Tippees such as Dirks who receive non-public, material information from insiders become subject to the same duty as [the] insiders."[554]

As noted by the Supreme Court, the SEC's theory of liability was "rooted in the idea that the anti-fraud provisions require equal information among all traders."[555]

The Court, however, expressly rejected the notion that all traders must enjoy equal information before trading and ruled that those who receive material non-public information from insiders are not banned from trading unless: (1) the insider breached a fiduciary duty for personal gain and (2) the recipient knew or should have known of the breach.[556] The SEC has never been happy with this result – believing that all investors require equal information. Regulation FD was crafted to avoid the Supreme Court's rejection of the concept that the anti-fraud provisions require equal information: Regulation FD was adopted as a disclosure rule and not an anti-fraud rule. This section will examine the role of the analyst in offerings, the relationship between the issuer and analyst during both the pre and post-Regulation FD periods, and the Regulation itself.

Despite the Court's efforts to establish a clear line between permissible and impermissible disclosure, the SEC continued to push for equal access to information among all market participants as it initiated at least one enforcement action (and threatened others) against selective disclosure, relying on a theory, which "substantially dilutes" the potency of Dirks.[557] This theory ultimately emerged as Regulation FD.

It has been argued, that the SEC's fixation on the abolition of selective disclosure will negatively impact the market in two respects: First, because issuers may no longer offer any type of one-on-one earnings advice, issuers may decide to remain silent and dry up all information previously available in the market via private discussions with analysts; and second, the enforcement of Regulation FD may result in more market volatility as analysts note that the rule "could make for more dramatic single-day movements as news hits the markets all at once, rather than trickling out more gradually."[558]

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554 463 U.S. at 655.

555 Id. at 659.

556 Id. at 670.

557 Donald C. Langevoort, The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability, Insights, June 1994, at 23.

558 Frye-Louis Capital Management, Inc., "Market Outlook: More Volatility Anyone?," October 17, 2000, at 6.

2. New Landscape and Rules for Analysts

On the civil side, issuers have also been sued by investors claiming entanglement between the issuer and analyst and the failure of the issuer to update analysts' reports. Issuers and analysts have also faced a series of class actions suits where investors claimed that issuers and analysts defrauded investors by issuing overly optimistic research reports, thereby manipulating the issuer's stock price subsequent to an IPO. Former SEC Chairman Arthur Levitt called on self-regulatory agencies to require "meaningful," not "boilerplate," disclosure when an analyst's employer has a relationship with the firm the analyst recommends.[559] At the Ray Garrett Corporate and Securities Law Institute in April 2001, Acting Chairman Laura Unger questioned how analysts can maintain their independence in the face of potential conflicts between research and investment banking.[560]

In the aftermath of the Unger speech and the significant market drop during 2000, the potential conflict of interest analysts face became a front burner topic especially because many analysts work for firms that underwrite and/or own the securities covered by their analyst reports. Similarly, in a statement made on July 2, 2001, the NASD proposed that analysts be required to disclose potential conflicts of interest when they recommend a security in public or on television. In February 2002, both the NYSE and NASD proposed to amend their rules to address conflicts of interest that are raised when research analysts recommend securities in public communications.[561] The SEC also proposed that the NYSE and NASD rules be amended to disclose analysts' compensation, and thus minimizing potential conflicts of interest.[562]

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559 Rachel Witmer, Levitt Lambastes Analysts, Firms for "Gamesmanship," Selective Disclosure, Sec. Reg. & L. Rep. Vol. 31, No. 41 at 1390 (Oct. 1999), quoting the Levitt Speech, supra.

560 How Can Analysts Maintain Their Independence?, (April 19, 2001) available at www.sec.gov/news/speech/spch477. The Wall Street Journal reported that the New York Attorney General's office began an investigation into stock research practices and whether analysts are presenting unbiased information to investors. Wall St. J. p. C-15, June 7, 2001. See Charles Gasparino, "Outlook for Analysts: Skepticism and Blame," p.C1, June 13, 2001; Jeff D. Opdyke, Guidelines Aim to Polish Analysts' Image, Wall St. J., p.C1, col. 4 (reporting that the SIA has adopted a set of best practices. For further information, see Securities Industry Association, "Best Practices For Research" available at www.sia/com/publications/pdf/best.pdf). Raymond Hennessey & Lynette Khalfani, "Analysts' Link to IPOs Mean Losses for Investors, Study Finds, Wall St. J., C14, col. 4 (describing a four-year study by Investors.com).

561 NASD and NYSE Rulemaking, Release No. 34-45908, at http://www.sec.gov/rules/sro/34-45908.htm (May 10, 2002) [hereinafter NASD and NYSE Rulemaking]. The NYSE and NASD have subsequently filed with the SEC Amendments Nos. 1 and 2 to the proposed rule changes. See NASD and NYSE Rulemaking Release No. 34-47912, at http://www.sec.gov/rules/sro/34-47912.htm (May 22, 2003) and NASD and NYSE Rulemaking Release No. 34-47110, at http://www.sec.gov/rules/sro/34-47110.htm (Dec. 31, 2002).

562 Rachel McTague, SIA Says SRO Proposals on Analysts Should Be Altered; Insider Policy Harmed, Sec. Reg. & Law Rep., Vol. 34, No. 16. (April 2002).

Beginning in June 2001, the SEC released an alert notifying investors to evaluate more than analyst reports when deciding whether to buy or sell a security.[563] According to the SEC Investor Alert, investors should do the following three things before buying a security: (1) identify the underwriter; (2) research ownership interests; and (3) discover whether any lock-ups exist in connection with the initial offering of the stock.

In response, the Securities Industry Association (SIA) stated at a briefing, on April 12, 2002, that the proposed rules should be significantly altered, particularly with regard to the rules that would require disclosure of analysts' compensation.[564] The SIA believed that the proposed rules could undermine decades of insider trading policy because the rules would force firms to disclose their compensation for non-public transactions, which could potentially tip the market to the existence of merger or other activity.[565] on March 10, 2003, a panel of the SIA called for the SEC to adopt "one comprehensive set of rules governing research analysts conflicts of interests."[566] The panel pointed out that a series of incremental regulatory proposals and changes to the rules have led to certain inconsistencies and ambiguities in the two sets of SRO rules.[567]

In a letter of comment, dated April 30, 2002, to the SEC, the Committee on Federal Regulation of Securities responded to these same proposed rules by raising, among others, the following issues:

- The proposed NASD and NYSE rules would slow down or stop the flow of information to investors.

- The requirement that a firm reasonably expects to receive compensation from a subject company within three months following publication of a report raises significant Chinese Wall and signaling issues.[568]

The criticism and the concerns fell on deaf ears as the SEC approved the proposals to amend NYSE Rule 472 and NASD Rule 2210 on May 10, 2002.[569]

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563 SEC Cautions Investors Not to Rely Solely on Analyst Recommendations, Sec. Reg. & Law Rep., Vol. 33, No. 26. See also SEC, "Investor Alert: Analyzing Analyst Recommendations," at http://www.sec.gov/investor/pubs/analysts.htm.

564 Id.

565 Id.

566 SIA Panel Calls for SEC to Adopt One Set of Rules on Research Analysts' Conflicts, Sec. Reg. & Law Rep., Vol. 35, No. 12. p. 488 (Mar. 24, 2003).

567 Id.

568 Letter from the Committee on Federal Regulation of Securities to Jonathan G. Katz, Secretary, United States Securities and Exchange Commission (April 30, 2002 (on file with author)).

569 NASD and NYSE Rulemaking, supra note 527. See Martin L. Budd and Shaun T. Wooden, Analysts' Conflicts of Interest, 35 Rev. of Sec. + Com. Reg. 119, June 6, 2002.

The approved rules, which apply to the member firms of the NYSE and NASD:

- Will prohibit analysts from offering or threatening to withhold a favorable research rating or specific price target to induce investment banking business from companies. The rule changes also impose "quiet periods" that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering or within 10 days after a secondary offering for an inactively traded company;

- Will prohibit research analysts from being supervised by the investment banking department. In addition, investment banking personnel will be prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm's legal/compliance department monitor those communications. Analysts will also be prohibited from sharing draft research reports with the target companies, other than to check facts after approval from the firm's legal/compliance department (companies will not be able to preview recommendations and other sensitive data);

- Will bar securities firms from tying an analyst's compensation to specific investment banking transactions. Furthermore, if an analyst's compensation is based on the firm's general investment banking revenues, that fact will have to be disclosed in the firm's research reports;

- Will require a securities firm to disclose in a research report if it managed or co-managed a public offering of equity securities for the company or if it received any compensation for investment banking services from the company in the past 12 months. A firm will also be required to disclose if it expects to receive or intends to seek compensation for investment banking services from the company during the next 3 months;

- Will bar analysts and members of their households from investing in a company's securities prior to its initial public offering if the company is in the business sector that the analyst covers. In addition, the rule changes will require "blackout periods" that prohibit analysts from trading securities of the companies they follow for 30 days before and 5 days after they issue a research report about the company. Analysts will also be prohibited from trading against their most recent recommendations;

- Will require analysts to disclose if they own shares of recommended companies. Firms will also be required to disclose if they own 1% or more of a company's equity securities as of the previous month end;

- Will require firms to clearly explain in research reports the meanings of all ratings terms they use, and this terminology must be consistent with its plain meaning. Additionally, firms will have to provide the percentage of all the ratings that they have assigned to buy / hold / sell categories and the

percentage of investment banking clients in each category. Firms will also be required to provide a graph or chart that plots the historical price movements of the security and indicates those points at which the firm initiated and changed ratings and price targets for the company; and

- Will require disclosures from analysts during public appearances, such as television or radio interviews. Guest analysts will have to disclose if they or their firm have a position in the stock and also if the company is an investment banking client of the firm.

Individual brokerage firms also developed new rules to address the issue of analyst conflicts of interest. For example, Merrill Lynch established a policy prohibiting equity analysts from purchasing securities in companies the firm covers in order to ensure the objectivity of its research and analyst reports.[570]

Furthermore, New York Attorney General Eliot Spitzer conducted a ten-month investigation into Merrill Lynch & Co.'s research practices and had threatened to bring criminal charges that the firm misled investors with overly optimistic research.[571] On May 21, 2002, Merrill Lynch announced that it would pay $100 million in penalties to New York and other states and alter the way in which it monitors stock analysts.[572] New York State will receive $48 million and the remaining $52 million will be divided among the other 49 states and an organization representing stock securities officials, which will receive $2 million.[573] Although Merrill Lynch did not admit or deny wrongdoing by paying the fine, the settlement could help investors allege that they were misled by the firm.[574] This development over conflicts of interest involving corporate research not only will lead to the way Wall Street rates stocks for investors but also was the precursor for the Analyst Court Consents.[575] Attorney General Spitzer has indicated that he expects other firms to come forward to voluntarily seek settlements with his office.[576]

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570 New Merrill Lynch Policy Prohibits Analysts From Buying Shares in Companies They Cover, 33 Sec. Reg. & Law Rep.

571 Charles Gasparino, Merrill, Spitzer Near Settlement In Research Care, Wall St. J., Apr. 18, 2002 at C1.

572 Charles Gasparino, Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts, Wall St. J., May 22, 2002, at A1.

573 Id. at A12

574 Id. at A1.

575 Gasparino, Apr. 18, 2002 at C1.

576 Gasparino, May 22, 2002 at A12. Attorney General Spitzer has also launched a wide-ranging investigation into the practices involving research conflicts and new-stock allocations at Salomon Smith Barney. Paul Beckett, Citigroup Ousts Carpenter as Head of its Salomon Unit, Wall St. J., Sept. 9, 2002, at C1. On October 31, 2003, the U.S. District Court for the Southern District of New York approved a revised version of the $1.4 billion global settlement reached in April 2003 between securities regulators and ten Wall Street investment banks (See SEC v. Bear, Stearns & Co., et al., Fed. Sec. L. Rep. (CCH) ¶ 92,432 (S.D.N.Y. 2003)). The initial plan had

While some of the mandates found in Section 501 of the S-O Act concerning the adoption of rules governing analyst conflicts were satisfied by the NASD and NYSE rule provisions existing at the time of the enactment of the S-O Act,[577] other mandates required further amendments to the SRO rules. On July 29, 2003, the SEC approved proposed amendments to the NYSE and NASD rules relating to research analyst conflicts of interest.[578] The SEC notes in its release "that while the NASD and NYSE rules may differ to some degree in their texts, the provisions are intended to operate in substantially the same way."[579] As of September 23, 2003, the rules, which apply to the member firms of the NASD and NYSE, now generally require the following:

- A compensation committee of the member firm, which does not include members of the broker-dealer's investment banking department, will review and approve the compensation of the broker-dealer's analysts that are primarily responsible for the preparation of the substance of research reports. The compensation committee may not consider the analyst's contribution to the member's overall investment banking business in determining the analyst's compensation package.

- The manager or co-manager of a securities offering may not issue a research report for fifteen days prior to and after the expiration of lock-up agreements, thereby prohibiting so-called "booster shot" research reports.

- Analysts may not participate in "pitches" or other communications for the purpose of soliciting investment banking business.

- A member firm must provide notice to customers that it is terminating coverage of an issuer that is the subject of a research report. The final report must also include a final recommendation or rating, unless it is impracticable to do so.

- Prepublication review and approval of the research reports by persons within a member firm not directly responsible for research is prohibited. Moreover, prepublication communications concerning the contents of a research report

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required that payments to a restitution fund be made through a registry system run by the U.S. courts, but that system is managed by an affiliate of one of the defendants. Under the revised settlement, the distribution and investor education accounts will be set up at the Federal Reserve Bank of New York. John Herzfeld, Court Approves $1.4B Settlement of Charges Against Wall Street Analysts, 35 Sec. Reg. L. Rep. 1883 (2003).

577 See NASD and NYSE Rulemaking, supra note 527.

578 NASD and NYSE Rulemaking, Exchange Act Release No. 34-48252 (Jul. 29, 2003), available at http://www.sec.gov/rules/sro/34-48252.htm. For further guidance concerning research analysts and research reports, see Notice to Members 04-18, Research Analysts and Research Reports: NASD and NYSE Provide Further Guidance on Rules Governing Research Analysts' Conflicts of Interest, Mar. 2004, at http://www.nasdr.com/pdf-text/0418ntm.pdf

579 Id.

between all non-research personnel and the research department must be intermediated by legal or compliance staff.

- Member firms must disclose whether the member, any of its affiliates or the research analyst, received, or may receive, any compensation from the issuer that is the subject of the research report or a public appearance. Any compensation that was received in the prior twelve months must be disclosed in research reports and public appearances.

- Member firms must disclose prospective investment banking compensation if the member firm expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.

- Those persons engaged in investment banking activities within a member firm may not directly or indirectly retaliate, or threaten to retaliate, against a research analyst who publishes a research report or makes a public appearance that may adversely affect the member's present or prospective investment banking business.

- In addition to the quiet periods imposed on underwriting managers and co-managers for forty calendar days following an initial public offering and ten calendar days following a secondary offering, the rules now provide for a twenty-five calendar day period after the date of the offering during which a member that has agreed to participate as an underwriter or dealer (other than as a manager or co-manager) of an issuer's initial public offering may not publish or otherwise distribute or make a public appearance regarding that issuer.

- Legal or compliance personnel must pre-approve all securities transactions of persons who oversee research analysts and that have direct influence or control with respect to the preparation of reports or establishing or changing a rating or price target of a subject company's equity securities.

- Research analysts will be subject to additional registration, qualification, and continuing education requirements.

Furthermore, the new SRO rules except small firms from the so-called "gatekeeper provisions," which prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department. A small firm is a member firm that for the previous three years has averaged ten or fewer investment banking transactions or underwritings as manager or co-manager and has generated less than five million dollars in gross investment banking revenue from such transactions.

Although still too early to tell definitively, it appears that the increased scrutiny on the work of research analysts and the new regulations and standards imposed on them,

with the related increase in research costs, may lead to cutbacks in the research departments of the various firms.[580] Even after all of these rule changes, and the adoption of Regulation Analyst Certification, which is discussed in the following section, the issue of analysts' conflicts of interests continues to make the headlines and remains fluid and unpredictable with heavy state involvement.[581]

3. Regulation AC (Analyst Certification)

In February 2003, the SEC adopted Regulation Analyst Certification (AC), which requires research analysts to certify the truthfulness of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to the specific recommendations or views expressed in those reports and appearances.[582] In its proposal of the rule, the SEC explained that such certifications and disclosures would promote the integrity of research reports and would therefore encourage investor confidence in such reports.[583] Regulation AC was proposed to address the conflicts of interest faced by research analysts and their firms. Research analysts are viewed by investors as important sources of information, however, their independence and objectivity have often been swayed by relationships with investment banking firms and compensation arrangements.[584]

Regulation AC requires that research reports distributed by brokers, dealers and certain other persons provide:

- A statement by the research analyst certifying that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and issuers; and

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580 Citigroup, as well as other firms including Goldman Sachs and Merrill Lynch, made cuts in their research staffs in 2003. Eight Research Analysts Dismissed by Citigroup, Times Digest (May 24, 2003).

581 See Spitzer Calls to Improve Transparency on Performance of Stock Picks, 34 Sec. Reg. & L. Rep. 1863, 1863 (Nov. 18, 2002); Massachusetts Seeks $1.9 Milion Fine, Change in CSFB's Analyst-Banker Practices, 34 Sec. Reg. & L. Rep. 1763, 1764 (Oct. 28, 2002). Even after the consent decrees, the pot boils as demonstrated by two separate incidents that required apologies from two settling parties. After seemingly making light of the charges brought against his firm by the SEC, Philip Purcell, chairman and CEO of Morgan Stanley had to issue a letter SEC Chairman William Donaldson stating, "I deeply regret any public impression that the (SEC's complaint against Morgan Stanley) . . . was not a matter of concern to retail investors. Morgan Stanley views seriously the allegations." Wall St. J., May 2, 2003.

582 Final Rule: Regulation Analyst Certification, Securities Act Release No. 33-8193, Exchange Act Release No. 34-47384 (Feb. 20, 2003), available at http://www.sec.gov/rules/final/33-8193.htm (hereinafter "Regulation AC"). Regulation AC is effective as of April 14, 2003. Further guidance from the SEC concerning Regulation AC may be found in Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, Fed. Sec. L. Rep. ¶ 86,955 (Aug. 6, 2003).

583 Proposed Rule: Regulation Analyst Certification, Securities Act Release No. 33-8119 (Aug. 2, 2002), available at www.sec.gov/rules/proposed/33-8119.htm.

584 Id.

- A statement by the research analyst certifying whether the analyst's compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in the research report.

If the analyst received related compensation, the statement must include the source, amount and purpose of such compensation, and further disclose that such compensation may influence the recommendation in the research report.

Furthermore, a broker or dealer who publishes, circulates or provides a research report prepared by a research analyst is required to "make a record" within thirty days after each calendar quarter in which the research analyst made any public appearance,[585] that includes the following:

- A statement by the research analysts certifying that the views expressed in all public appearances during the calendar quarter accurately reflected the research analyst's personal views at that time; and

- A written statement by the research analyst certifying that no part of their compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed during any such public appearance.

If the broker or dealer is unable to obtain such statements from the research analyst, the broker or dealer will be required to disclose in all research reports prepared by that analyst for the next 120 days that the research analyst did not provide the required certifications.[586]

On August 6, 2003, the SEC published its Responses to Frequently Asked Questions Concerning Regulation Analyst Certification.[587] The responses address the form of certifications, supervision and oversight of analysts, research reports, third party research, associated persons and covered persons, notification to associated persons, public appearances, foreign broker-dealers and analyst compensation. Some of the more pertinent SEC responses are discussed below:[588]

- If a research analyst sends a draft research report that already contains the analyst's certification to a supervisor for review and approval, and if the

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585 Regulation AC, supra note 548. Regulation AC defines "public appearance" as "any participation by a research analyst in a . . . radio or television or other interview in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer." See also Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, Fed. Sec. L. Rep. ¶ 86,955 (Aug. 6, 2003) (participation by a research analyst in a telephone interview with a member of the media constitutes a "public appearance").

586 Regulation AC, supra note 548.

587 Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, supra note 555.

588 Id.

supervisor makes edits or changes to the draft report, must it be sent back to the research analyst for re-certification?

- The research analyst who is primarily responsible for the preparation of the content of the research report must certify the final version of the research report.

- If the supervisor materially changes or edits the draft research report (e.g., reclassifies a rating) after certification by the research analyst, the report would have to be re-certified by the analyst.

- If the research analyst were no longer able to certify the research report as a result of changes made by the supervisor, distribution of the report would violate Regulation AC. However, the research report could be distributed if another natural person who is primarily responsible for the preparation of the report's content, such as the supervisor, certified the report in accordance with Regulation AC.

- Are communications prepared for non-discretionary investment advisory account clients that discuss past performance or the basis for previously made investment decisions similarly excluded from the definition of research reports?

  - No. Written communications to non-discretionary investment account clients where the advisor provides an analysis that is sufficient to support an investment decision are not excluded from the definition of research report because non-discretionary investment account clients may act on such communications, even where the communications are backward-looking.

- Are periodic reports or communications prepared for the beneficial owners of unit investment trusts and limited partnerships that discuss past performance considered research reports under Regulation AC?

  - No. Similar to Regulation AC's treatment of backward-looking communications with investment company shareholders, periodic reports or communications with beneficial owners of unit investment trusts or limited partnerships that discuss past performance will not be considered research reports.

- Does Regulation AC apply to independent third party research prepared by a research provider that is neither a broker-dealer nor an associated person of a broker-dealer, but which a broker-dealer repackages and provides to its clients under the broker-dealer's name or brand?

- The third party exception in Regulation AC contemplates that the third party research will be clearly and unambiguously identified as such.

- The exception is not available if the third party research is provided to clients under the broker-dealer's own name or brand.

- Concerning one of the exclusions from the definition of "covered person," can a broker-dealer's written policies and procedures ("research independence wall") ever be sufficient in itself to exclude an associated person from the definition of "covered person" where there is a common officer who is in a position at the associated person to influence its research?

    - No. Regulation AC requires both structural and informational separation as indicia of the absence of influence upon research.

    - In order for an associated person not to be considered a "covered person," both prongs of the independence criteria must be satisfied.

- Can a separately identifiable department ("SID") or organizational unit within a broker-dealer be considered an associated person that is not a "covered person" if the independence criteria are satisfied?

    - No. A broker-dealer that publishes, circulates, or provides a research report (even if generated by a separately identifiable department within the broker-dealer) must comply with Regulation AC.

    - So even if a broker-dealer establishes a sufficient research independence wall between its asset management and other divisions, and there are no overlapping officers or employees who can influence research by the asset management department, Regulation AC will still apply to research generated by the asset management division and published by the broker-dealer.

- Is a password-protected conference call or Webcast in which a research analyst participates with clients considered a public appearance?

    - Yes. Participation by a research analyst in a conference call or Webcast with clients, whether or not password-protected, is a public appearance under Regulation AC.

B. Analysts Involved in Initial Public Offerings.

1. Benefits of Analyst Involvement

Heretofore the analyst was indispensable to an issuer in the context of an IPO as the public had little basis to make informed investment decisions. Issuers recognized this and, indeed, often selected an underwriter who had a rated analyst. Moreover, the analyst was frequently involved in the offering process, including the roadshow. Analysts, moreover, aside from getting a company's name before investors, played a major role in an underwriter's due diligence process by identifying weaknesses in product, management or business strategies because of the analyst's knowledge of the industry and the competition. The analyst also advised on how a company's strengths and weaknesses should be disclosed in the company's prospectus.

Also significant was the analyst's involvement in developing earning projections. As one commentator pointed out:

> [I]nstitutional customers, in particular, will not buy IPO shares without [earnings] estimates ... Estimates therefore are provided orally to investors, either at road shows or by the sales force on the telephone. The issuer typically will not take responsibility for these estimates, leaving it in many cases to the investment bankers working on the IPO to supply estimates based on discussions with the issuer and access to internal projections. Investment bankers, however, are not experienced in coming up with earnings estimates and sales persons and customers alike may regard such estimates as "tainted" . . .
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> The analyst, on the other hand, is experienced in coming up with earnings estimates and has a track record of credibility with sales people and customers. The analyst is also more likely to identify unrealistic assumptions built-in to the issuer's internal projections. For this reason, analysts are increasingly permitted access to the issuer's internal projections . . .[589]

Because of the importance of analysts to the offering process, underwriters were frequently selected to lead an offering based on the ability or reputation of the firm's

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589 Joseph McLaughlin, The Changing Role of the Securities Analyst in Initial Public Offerings, Insights, August 1994, at 7. In 2003, the SEC has been preoccupied with adopting rules to implement S-O. Nevertheless, the staff of the Commission has been devoting some time to the rules regulating the public offering process. One idea on the drawing board to require the use of projections in the IPO prospectus largely because projections are used by the underwriters in the offering process.

analysts. Of course, this was a two-way street, and analysts may be more willing to cover a particular company if the analysts' firm is selected to manage the underwriting.

Under the new rules adopted in 2002 and the Analyst Court Consents, the role of analysts in IPOs has been severely limited. The following are undertakings in the Analysts Court Consents that apply only to the ten consenting firms, but may become universal:[590]

- The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups;

- The firms' senior management will determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking;

- Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance;

- Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions;

- Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows.[591] During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction;[592]

- The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances; and

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[590] The Securities Industry Association recommended to the SEC that certain language in the proposed NYSE and NASD rules (see Section V.5.A, supra) be conformed to the terms of the settlement. SIA Panel Tells SEC Pending Proposals Should be Aligned with Settlement Terms, Sec. Reg. & Law Rep., Vol. 35, No. 20. p. 848 (May 19, 2003).

[591] Note that this provision does not prohibit analysts from commenting on transactions but only restricts commentary that is directed by the investment bankers.

[592] Bear Stearns issued an apology after an incident in which the firm inadvertently used an analyst to promote an initial public offering not long after agreeing to this settlement. Bear Stearns Issues Apology Over Incident of Using Analyst in Roadshow Presentation, 35 Sec. Reg. & L. Rep. 838, 838 (May 19, 2003).

- An oversight/monitoring committee or committee, which will be comprised of representatives of Research management will be created to (a) review all changes in rating and material changes in price targets contained in any firm's research reports; (b) conduct periodic reviews of research reports to determine whether changes in rating or price targets, if any should be considered; and (c) monitor the overall quality and accuracy of the firm's research reports.[593]

Research personnel, importantly, may assist the firm in confirming the adequacy of disclosure in offering or other disclosure documents for a transaction based on the analysts' communications with the company and other vetting conducted outside the presence of investment banking personnel. This means that analysts can participate in due diligence. The communication of this information by the analyst to investment banking personnel can only be made in the presence of underwriters or other counsel on the transaction or internal legal or compliance staff.[594]

As of June 2003, it is too early to predict the extent to which analysts will participate in IPOs. This is especially true because there are so few IPOs as of the first half of 2003. I believe that analysts will not be completely divorced from the process, however. Underwriters will need to involve their expert analysts in the due diligence process because of the analysts knowledge of the industries involved and also to improve disclosure. Issuers, moreover, will continue to engage underwriters who have prominent analysts covering their industry even though the analysts cannot participate in the pitch.

2. Costs of Analyst Involvement

Once the offering is completed, the analyst has in the past published a research report on the issuer subsequent to the "cooling down" period, which has been extended to 40 days. It is at this point that issuer and analyst alike generally are concerned that the analyst is "tainted" or possesses material non-public information having participated in the due diligence process. It is also at this point that issuer and analyst risk enforcement by the SEC as well as civil suits.

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[593] This outline only encompasses certain aspects of the consent decree. Other aspects, particularly with regard to the payment of fines and other monetary penalties, the educational funds and the supplying of independent research, are not discussed in this article.

[594] Other exceptions to the separation of investment banking from analysts include, among others: the ability of investment banking personnel to seek the views of research personnel regarding the merits of a proposed transaction or a potential candidate for a transaction. The reverse is also true; research personnel may initiate communications with investment banking personnel relating to market or industry trends, conditions or developments. Any communications between research and investment banking personnel must not be made for the purpose of having research personnel identify specific potential investment banking transactions. Further, in response to a request by a commitment or similar committee or subgroup thereof, research personnel may communicate their views about a proposed transaction or potential candidate for transaction to the committee or subgroup outside of the presence of such investment banking personnel.

The SEC, as discussed below, has expanded the "personal benefits" test established by the Dirks Court and has argued that even enhancement to reputation which does not result in pecuniary benefit is sufficient for a finding of insider trading. To my knowledge, the SEC has not prosecuted analysts on this theory.

Issuers also face exposure to claims based on entanglement. Traditionally, the entanglement theory holds that if a company puts its imprimatur, expressly or impliedly, on an analyst's report, the company will be deemed to have adopted the report and be responsible for its accuracy, and will have a duty to update it. The entanglement problem will be significantly reduced under the rules adopted in 2002 by the SRO's severely curtailing an analyst's ability to have issuers preview and comment upon analyst reports prior to publication. Nevertheless, there is probably still some potential for entanglement situations to occur. For example, plaintiffs have brought class action suits alleging that analysts and their firms defrauded investors by issuing reports containing overly optimistic earnings forecasts and other projections, called "booster shots" thereby manipulating the issuer's stock price immediately after an IPO. This entanglement theory has been described as a "devil's bargain" whereby weak companies are brought public and the company's stock price is inflated until issuers' officers and directors can sell their personal holdings.[595]

The entanglement cases name analysts as individual defendants and sometimes suggest a complex conspiracy between issuer, analyst and underwriter to defraud investors. As noted in one 1994 complaint:

> Defendants accomplished their scheme and common course of conduct through the issuance of a series of interrelated and interdependent false and misleading reports to shareholders, filings with the SEC, financial statements and press releases to the public as well as approving the issuance of [and reprinting] false and misleading analysts' reports which misrepresented the true facts regarding Coastcast's business, new products, manufacturing expertise, and future business prospects and created a false impression of continuing growth and future profitability. The individual Defendants all benefited from the illegal course of conduct by selling Coastcast stock owned by them at artificially inflated prices . . .[596]

As the above complaint illustrates, the "devil's bargain" suggests an intricate level of market manipulation over a sustained period of time. Several of the suits alleging this form of entanglement were voluntarily dismissed. It is surprising that as of

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[595] Johnathon C. Dickey, The New "Entanglement" Theory: Securities Analyst are Sued in Class Action Complaints, Insights, March 1995, at 3.

[596] Stark v. Present, No. 94-5712, at p. 17 (C.D.Cal., filed Aug. 22, 1994).

May 2003 there is an absence of court decisions on this issue despite the widespread public furor over analyst/investment banking conduct during the market bubble. This is even more surprising because analysts issue more favorable earnings forecasts and recommendations for their firm's underwriting clients than for issuers with whom they have no preexisting relationship.[597]

3. Cost Benefit Analysis

Issuers should continue to permit analysts to participate in the due diligence phase of an IPO. While there is some risk of selective disclosure (which has not really borne out in the reported decisions), there are sound business reasons for their involvement in the IPO process which counterbalances these risks and which makes an SEC argument of "personal benefit" less likely. As one author has noted:

> [T]he IPO issuer has eminently reasonable corporate business purposes in permitting an analyst full access to its internal information. These include permitting the underwriters to conduct more effective due diligence . . . increasing the underwriter's confidence level in the issuer's business plan and projections, and assuring that the analyst's earnings estimates ... are in turn based on all available information about the issuer. Indeed, these business purposes are in full accord with the public policy of the Securities Act, which is to ensure full disclosure to investors in securities distributed in the course of registered public offerings.
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> By contrast, the corporate officers working on the IPO derive no personal benefit from the disclosure to the analyst. Even taking the SEC's broad views of 'personal benefit' into consideration, this may be one of the few examples of a 'completely business-justified disclosure' that should therefore be 'immunized from liability.'[598]

While talk continues to focus on liability based on entanglement, the cases, as described below, demonstrate there is a remote risk and the adoption of Regulation FD and the SRO analyst regulations should reduce this risk even further.

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[597] Lin and McNichols, Underwriting Relationships in Analysts Research Reports, Stanford, March, 1993. See also Roni Michaely and Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, April 1996.

[598] Joseph McLaughlin, The Changing Role of the Securities Analyst in Initial Public Offerings, Insights, August 1994, at 11.

Finally, an issuer can take additional measures to guard against selective disclosure or entanglement law suits. For example, an issuer can designate a handful of corporate officers who can monitor written or oral information supplied to the analyst. An issuer can also adopt a written policy statement indicating how far they will participate with the analyst in the due diligence process and that the company will only comment upon facts.

C. Analyst Participation in Public Offerings of Already Public Companies

Analysts in the majority of offerings involving already public issuers generally participate in the due diligence process and contribute the same insights to the process as discussed above. However, analysts generally do not obtain projections from the company and the need for a "Chinese wall" between analysts and investment banking firm is even greater than in the IPO setting because the analyst is already in communication with investors and the company's stockholders. Because of this and to avoid the analyst being restricted in his or her advice, they are not generally brought "over-the wall" until late in the registration process.

Some commentators have noted that analysts should refrain from publishing detailed reports about a company if a company is making a public offering. While there are limitations imposed on analysts circulating reports during an offering, analysts should probably avail themselves of Rules 138 and 139 of the Securities Act which define the circumstances under which a report is not deemed to be an offer for the sale of securities.

Rule 139 provides that with respect to an issuer who proposes to file or who has filed a registration statement, a publication by a broker or dealer of an opinion with respect to the registrant will not be deemed to be an offer to sell securities even though such broker or dealer is a participant in the distribution of such securities if:

> [t]he registrant meets the registrant requirements of Form S-3 ... and such information, opinion or recommendation is contained in a publication which is distributed with reasonable regularity in the normal course of business; or ...
>
> [for non Form S-3 issuers] such information, opinion or recommendation is contained in a publication which: (i) is distributed with reasonable regularity in the normal course of business, and (ii) includes similar information, opinions or recommendations with respect to a substantial number of companies in the registrant's industry or sub-industry, or contains a comprehensive list of securities currently recommended by such broker or dealer; ... (2) such information, opinion or recommendation is given no materially greater space or prominence in such publication than that given to other securities or registrants; and (3) an opinion or recommendation as favorable or more favorable as to the registrant or any class of its securities was published by the broker or dealer in the last publication of such

broker or dealer addressing the registrant or its securities prior to the commencement of participation in the distribution.[599]

D. Pre-Regulation FD Cases

1. Selective Disclosure

In the aftermath of the Supreme Court's decisions in Chiarella v. United States[600] and Dirks v. SEC,[601] a duty to disclose or refrain from trading on the basis of material, non-public information arises only when such trading constitutes a breach of fiduciary duty. In Dirks, the Court ruled that "whether disclosure is a breach of duty ... depends in large on the purpose of the disclosure . . . Thus, the test is whether the insider personally will benefit, directly or indirectly, from the disclosure."[602] The Court defined "personal benefit" as a "pecuniary gain or a reputational benefit that will translate into future earnings."[603]

In March 1991, the SEC applied the Dirks "personal benefits" test in SEC v. Stevens.[604] In Stevens, the SEC charged a corporate executive of Ultrasystems, Inc., with unlawful tipping when he called a few analysts who provided research coverage of the company to let them know of an anticipated earnings decline. The SEC alleged that Stevens placed these calls "to protect and enhance his reputation as a corporate manager," and therefore the calls "had direct, tangible benefit to his status as a corporate manager."[605]

After Stevens' calls, two of the analysts called their clients, who then sold Ultrasystems' stock prior to Ultrasystems' issuance of a press release announcing its lower than expected revenues and earnings. The SEC alleged that the loss avoided by these clients was of at least $126,455. Stevens agreed to pay the $126,455 as well as to be permanently enjoined from violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.

Stevens stretches the "reputational benefit" test of Dirks to its limit. There was no allegation that Stevens received any type of substantial reputational benefit that

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599 Rule 139 of the Securities Act.

600 445 U.S. 222 (1980).

601 463 U.S. 646 (1983).

602 Id. at 662.

603 Id. at 663.

604 48 S.E.C. Docket 739 (S.D.N.Y. Mar. 19, 1991); see also SEC v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977).

605 48 S.E.C. Docket 739 (S.D.N.Y. Mar. 19, 1991).

"translates into future earnings." The danger of the Commission's rationale in Stevens is that virtually all selective disclosures are likely to have been made on some element of personal motivation.[606] Thus, any executive, even one who is driven by a desire to serve the corporation, may be charged with deriving a "reputational benefit" when he or she communicates with analysts. Steven's monetary liability, representing the trading profits of remote tippees, further serves as a significant *in terroram* deterrent for executives who deal with analysts.

The SEC continued to fight selective disclosure and promote equal access to material information. At the 1999 Ray Garrett Institute, Commissioner Laura S. Unger stated:

> "The recent concerns expressed by the Commission and its staff on selective disclosure have centered on a scenario where there is suspicious market-moving trading activity occurring shortly after, or even during, analyst calls. At the very least, such activity may undermine the confidence of investors in the fairness of our markets."
>
> …"which is why our Office of General Counsel is currently reviewing insider trading law to determine whether it should recommend that the Commission propose rulemaking to address a number of insider trading-related topics, including selective disclosure by issuers to analysts and institutional investors."[607]

On October 14, 1999, the Wall Street Journal reported that Abercrombie & Fitch ("Abercrombie"), the clothing retail chain, may have leaked information negating overly-optimistic "whisper estimates" to Lazard Freres, leading Lazard Freres clients to get out of Abercrombie stock before official news of sluggish sales was announced.[608] When the stock went into a deep decline, other analysts and investors scrambled for an explanation, only to find out the information from Lazard Freres, and not from the company itself. Whether any investors will file a suit based on improper trading methods remains to be seen, as does any possible SEC action against either Abercrombie or Lazard Freres.

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606 Edward H. Fleischman, Ferreting in the Interstices of SEC Attitudes to Securities Analysts, Speech at the Eighteenth Annual Securities Regulation Institute, University of California, San Diego (January 24, 1991). Former SEC Commissioner Fleischman suggested that every corporate officer who communicates with analysts could be viewed as seeking to "build" or "preserve" or "redeem" or "maintain" his or her reputation with analysts.

607 Remarks by Laura S. Unger, Commissioner U.S. Securities & Exchange Commission at the 19th Annual Ray Garrett Jr. Corporate and Securities Law Institute dated April 23, 1999, entitled "Corporate Communications Without Violations: How Much Should Issuers Tell Their Analysts and When" (Web site http://www.sec.gov/news/speeches/spch273.htm). See also Brian Lane's Remarks at the same Institute. entitled "The Securities Act Reform Project Improving Capital Formation in Our Markets" (Web site http://www.sec. note 4.gov/news/speeches/spch275.htm).

608 Susan Pulliam, Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data, Wall St. J., p.C1 (October 14, 1999).

2. Entanglement Cases

The entanglement theory has presented two distinct problems for issuers involved in dialogue with an analyst. First, an issuer may become responsible for what is contained in an analyst's report, including the analyst's own projections, even when the company does not want to comment on some of the findings included in the analyst's report. Second, as a result of an analyst's report being attributable to the company, the company may have a duty to update and correct material errors or omissions contained in the analyst's report. One key factor in determining the level of entanglement is whether the statement can be called "mere puffery," or if it is an adoptive statement. The new SRO rules limiting analysts' ability to preview reports with issuers should significantly reduce the number of entanglement cases.

In the leading case of Elkind v. Liggett & Myers, Inc.,[609] the Second Circuit addressed the issue of whether an issuer had a continuing duty to correct analyst reports when the defendant company instituted a policy of regularly meeting with analysts and reviewing their reports. The court held that management did not assume a continuing duty to correct the analysts' projections because while company personnel would correct factual errors in the reports, it had generally not commented on earnings projections. The court explained that:

> [T]he controversy before us is whether Liggett sufficiently entangled itself with the analysts' forecasts to render those predictions 'attributable' to it . . . We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views.[610]

After reviewing the facts, the Second Circuit affirmed the district court's finding that Liggett did not place its "imprimatur, expressly or impliedly, on the analysts' projections."[611] The court warned, however, that:

> [C]orporate pre-release review of the reports of analysts is a risky activity, fraught with danger . . . . A company which undertakes to correct errors in reports presented to it for review may find itself forced to choose between raising

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609 635 F.2d 156 (2d Cir. 1980).

610 Id. at 163.

611 Id.

> no objection to a statement which, because it is contradicted by internal information, may be misleading and making that information public at a time when corporate interests would best be served by confidentiality.[612]

One difficulty plaintiffs encounter in pleading entanglement is that the courts have required specific facts which definitively link analysts' statements to insiders of the company. In Raab v. General Physics Corp.,[613] stockholders of General Physics sued claiming the company had misled investors through false statements to analysts and the media. The district court dismissed plaintiffs' complaint for lack of particularity. The Fourth Circuit affirmed the dismissal, and held that plaintiffs had not pled specific facts from which the analysts' report could be attributed to the company. The court concluded that "soft" or "puffing statements" are generally not material because the market price is not driven by such vague declarations. The court concluded that the company's statement that profits should be in line with analysts' current projections did not constitute a guarantee that earnings would be forthcoming in particular amounts. The court considered this forecast immaterial.[614]

A Second Circuit opinion adopted a similar line of reasoning. In San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris, plaintiffs alleged that the cigarette maker failed to disclose plans to lower prices on its flagship Marlboro brand.[615] Plaintiffs alleged that failure to disclose this information rendered several statements

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612 Id. See also Plevy v. Haggerty, Fed. Sec. L. Rep. ¶ 90,309 (D. Ca. 1998); Kidder Peabody Securities Litigation, 10 F.Supp.2d 398 (S.D.N.Y 1998) (evidence of entanglement not sufficient because no direct involvement in generating the analysts' reports shown); Syntex Corp., 95 F.3d 922 (9th Cir. 1996) (company must put their imprimatur, express or implied, on analysts' projections to create inference of entanglement). But see Seagate Technology II, Fed. Sec. L. Rep. (CCH) ¶ 98,530 (N.D. Cal. 1995) (where court cited Elkind to support ruling that guidance alone does not make a company liable for analyst's forecast). See also Burlington Coat Factory, 114 F.3d 1410 (3d Cir. 1997) (Reports of Chief Accounting Officer's expression of feeling "comfortable" with analysts' estimates of earnings per share imputed enough imprimatur to create entanglement). Note that in May 2002 the NYSE and NASD adopted rules prohibiting member firm analysts from previewing reports with target companies except in limited situations. See supra Section V.A.2.

613 4 F.3d 286 (4th Cir. 1993).

614 Id. See Fishbaum v. Liz Claiborne, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,676 (2d Cir. 1999), citing San Leandro and stating that the case involved "soft' optimistic projections that could not support a securities fraud claim." Id. at ¶ 93,195. See also U.S. Interactive, Inc. Securities Litigation, where the District Court of the Eastern District of Pennsylvania held that statements in offering documents concerning a company's competitive position were not material, were mere puffery and would not have been viewed as significant by reasonable investors. Fed. Sec. L. Rep. (CCH) ¶ 92,015 (E.D. Pa. 2002). Furthermore, individual defendants were not liable for statements issued by analysts because the investors failed to plead facts showing that a particular defendant both made the statement to the analyst and controlled the content of the report. Id. But see Cabletron Systems, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,202 (1st Cir. 2002), where the court held that it is not necessary for investors to show that analysts were "controlled" by the issuer. Investors needed to merely demonstrate that the issuer and the analyst were sufficiently "entangled." Id.

615 Fed. Sec. L. Rep (CCH) ¶ 99,017 (2d Cir. 1996).

made in analyst meetings and press releases misleading, including statements that the company would deliver consistent income growth. The Second Circuit affirmed the dismissal of the complaint, stating that Philip Morris' announcement that it expected Marlboro to perform well and was "optimistic about its earnings" was mere puffery.[616]

California case law has also been very favorable to issuers by making it difficult for plaintiffs to plead entanglement.[617] In Time Warner Securities Litigation,[618] the plaintiffs alleged that statements made by unidentified Time Warner insiders in discussions with analysts and newspaper reporters misled the public by suggesting that Time Warner would reduce certain outstanding debt. In upholding the district court's dismissal pursuant to Rule 9(b), the Second Circuit ruled that the circumstances constituting fraud must be stated with particularity and noted that "at a minimum, the [plaintiff] must identify the speaker of the allegedly fraudulent statements."[619] Following Time Warner, a number of California district courts have required plaintiffs to plead specific facts to withstand a motion to dismiss and have articulated which facts plaintiffs must set forth in their complaint. In Fisher v. Acuson Corp., the Court cited Time Warner and noted that:

> [T]he heightened pleading requirements of Rule 9(b) require plaintiffs who are claiming that insiders are liable for third party financial analyst's statements to show adoption by alleging the following: (1) specific reports and the name of the insider who adopted them; (2) specific interactions between the insider and the analyst; and (3) dates on which the interactions occurred.[620]

The "heightened" pleading requirements of Fisher appears to be the current trend in entanglement cases.[621] Courts have continued to be antagonistic towards holding companies responsible for statements of analysts.[622]

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616 Id. at 93,982.

617 The District Court of the Northern District of California dismissed a fraud claim based on statements by analysts. The investors failed to attribute the analyst statements to the issuer or to indicate that the analysts and the issuers were entangled. Pinnacle Systems, Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 92,230 (N.D. Cal. 2002).

618 9 F.3d 259 (2d Cir. 1993).

619 Id. at 265. Echoing the Dirks court, the Second Circuit noted that "the function of financial reporters and security analysts is to determine the truth about the affairs of publicly-traded companies." Id.

620 1995 WL 261439, *6 (N.D. Cal); See also Stack v. Lobo, 903 F.Supp. 1361 (N.D. Cal. 1995); Cypress Semiconductor, Fed. Sec. L. Rep. (CCH) ¶ 98,462 (N.D. Cal. 1995). But see Rasterops Corporation, Fed. Sec. L. Rep. (CCH) ¶ 98,467 (N.D. Cal. 1994) (court ruled that plaintiffs need only allege insiders provided false information, approved drafts of analyst's reports and circulated reports to investors).

621 Indeed, the California courts still appear to be moving in the same direction. See Shuster v. Symmetron, Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,437, 96,868 (N.D. Cal. 1997) (court dismissed complaint, with leave to amend,

However, an issuer is still at risk if the particularity requirements for an analyst's report based on an issuer's statements are fulfilled. DSP Group, Inc. Securities Litigation reflected a situation where defendant-company's managers allegedly made inaccurate statements to analysts during routine quarterly meetings, creating a potential for securities fraud entanglement as the analysts conveyed the misinformation to the market.[623] Furthermore, plaintiffs met the particularity requirements by identifying specific analysts' reports, dates of conversations between managers and analysts, and other specific communications between the parties.

Similarly, the 9th Circuit reversed the dismissal in Cooper v. Pickett based on the district court's misinterpretation of the particularity requirement.[624] The 9th Circuit focused on (i) the falsity of defendant-company's representations at the time the statements were made, and (ii) the general accuracy to which plaintiffs described the fraudulent transactions. Defendants attempted to argue that Plaintiffs needed to plead and describe a specific fraudulent transaction, but the court held that the complaint "'identifie[d] the circumstances of the alleged fraud so that defendants [could] answer'" and thus "declined to require that a complaint ... allege specific shipments ... customers ... times [and] dollar amounts."[625]

E. Regulation FD.[626]

On August 18, 2000, Katten Muchin Zavis (now Katten Muchin Zavis Rosenman (KMZR)) released a client advisory entitled "SEC Adopts New Rules Regarding Selective Disclosure of Information by Issuers and Insider Trading." The following section of this article is a revised partial reproduction of the KMZR Client Advisory.

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after citing the Fisher requirements stating "plaintiff pleads only that various employees communicated with [the analyst] without setting forth what statements were made and why they were false or misleading"). See also Gross v. Summa Four, Inc. et al., Fed. Sec. L. Rep (CCH) ¶ 98,999 (D.N.H. 1996) (where court ruled that absence of guarantees, specificity or time frame made companies' predictable statements immaterial).

622 The District Court of Maryland in Manugistics Group, Inc. stated that an executive stating that he "was comfortable" with analysts' expectations was not actionable, where no facts were plead leading to the conclusion that he had actual knowledge that he was making any false statements. "Neither the corporate documents nor the same of 1% of the [executive's] holdings or other alleged 'insider sales' suffices." Manugistics Group, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,638 (1999).

623 Fed. Sec. L. Rep (CCH) ¶ 99,525 (N.D. Cal. 1997).

624 122 F.3d 1186 (9th Cir. 1997).

625 Cooper v. Pickett, 122 F.3d 1186, 1196 (9th Cir. 1997), quoting Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994).

626 Regulation FD became effective on October 23, 2000.

1. The Rule and its Purpose

On August 10, 2000, the Securities and Exchange Commission adopted Regulation FD (Fair Disclosure), which is designed to eliminate selective disclosure of material information by public companies. This new rule reflects the SEC's current view that "the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets." The SEC originally proposed this rule in December 1999 and received nearly 6,000 comments, in large part from individual investors. A number of changes suggested by commentators were incorporated by the SEC into the final rule. Although the Regulation, as adopted, corrected some of the flaws in the proposal, it is subject to pointed criticism. Regulation FD has and will have a significant impact on communication between public companies and market professionals.

Regulation FD is designed to prevent companies from disclosing information selectively – e.g., only to certain analysts or institutional investors – before making broad public disclosure by a press release or SEC filing. The Regulation requires that public companies make all intentional disclosures of material information on a widespread, public basis and that, if they unintentionally disclose material information selectively, they quickly remedy the selective disclosure through public release of the information. The Regulation does *not* impose upon companies any new general duty to disclose material information in the absence of selective disclosure. It will, however, have a major effect on ongoing communications with analysts and other securities industry professionals, particularly the now common practices of reviewing analyst reports and conducting calls and meetings with selected analysts or institutional investors, and participating in investor conferences, where nonpublic financial information is discussed.

> ***Regulation FD requires that, whenever an issuer, or any of its senior officials or other employees or agents who normally communicate with investors and analysts, discloses material nonpublic information to certain enumerated persons, such as securities analysts or institutional investors, the issuer must either (a) simultaneously (for intentional disclosures), or (b) promptly (for non-intentional disclosures) make public disclosure of that same information.***

Regulation FD applies to companies with securities subject to the Securities Exchange Act of 1934, which include all companies with equity listed on a national securities exchange, Nasdaq or the OTC Bulletin Board, as well as closed-end investment companies. However, the Regulation does not apply to any other investment companies or to foreign governments or foreign private issuers.

(A) What is "Material Nonpublic Information" subject to the Regulation?

To answer the fundamental questions of what information is "material" and "nonpublic," Regulation FD refers companies and investors to the following traditional standards established by the courts:

- Information is considered "nonpublic" if "it has not been disseminated in a manner making it available to investors generally."

- Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision," or if it would have "significantly altered the 'total mix' of information made available."

The determination as to whether information is material requires a very difficult judgment to be made by the person considering disclosure of the information. For example, this judgment must be made in light of the SEC's pronouncement in August 1999 in SAB 99 that assessments of materiality, for financial statement purposes, require consideration of both "quantitative" (i.e., numerical thresholds) and "qualitative" factors. SAB 99 indicates that, among other things, expected market reaction should be taken into account in considering whether information is material. This has created considerable uncertainty and may very well reflect a poor policy choice.[627] Often, statements that, when made, did not seem significant may appear material with the benefit of hindsight. The SEC's indication in the Regulation FD Adopting Release (hereinafter "FD Adopting Release") that it does not intend to second-guess mistaken judgments about materiality made in "close calls" has not provided companies with much comfort in this regard.

The SEC unfortunately provided a non-exhaustive list of types of information or events that will often, but not necessarily in all cases, be material. These include:

- earnings information (this has caused more confusion than help);

- mergers, acquisitions, tender offers or similar transactions;

- developments regarding new products, customers or suppliers;

- changes in management;

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[627] On the one hand, the Northern District of Illinois held that certain alleged accounting violations were not actionable because the amounts involved were too small as a matter of law. Allscripts, Inc., Fed. Sec. L. Rep. (CCH) ¶ 91,481 (N.D. Ill. 2001). On the other hand, the District Court of the District of Columbia held that a fraud action was not subject to dismissal because the materiality concept requires only that certain omitted facts would have been significant in the deliberations of a reasonable actor. Media General, Inc. v. Tomlin, Fed. Sec. L. Rep. (CCH) ¶ 91,517 (D.D.C. 2001).

- events regarding a company's securities, such as stock splits and public or private offerings;

- changes in audits or audit reports; or

- bankruptcies.

Perhaps the most troubling aspect of the release adopting Regulation FD is the discussion by the SEC of materiality in the context of analyst guidance. According to the FD Adopting Release:

> When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer will likely have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.

On the other hand, if a senior official provides a market professional with non-material information that the analyst uses to complete a "mosaic of information," the company would not, according to the SEC, be in violation of Regulation FD. The SEC claims that it does not intend to discourage analysts from "sifting through and extracting" information that may not be of interest to the ordinary investor. Nonetheless, it is clear that any guidance regarding financial forecasts or models should be considered material under the Regulation. Moreover, based upon the SEC's statements in the release, a company official is most likely violating Regulation FD even if he or she merely states, "I am comfortable with street expectations" to an analyst without making the same statement publicly. As a result, companies will need to use caution in discussing with analysts their earnings models, whether in private conversations or at investor conferences, and in reviewing analyst reports, if they elect to do either.

(B) **To what disclosures does the Regulation apply?**

- Regulation FD applies to disclosures made to certain enumerated persons by a company's senior officials or any other officers, employees or agents of the company who normally communicate with investors and analysts, when the person making the disclosure knows, or is reckless in not knowing, that the information disclosed was *both* material *and* nonpublic.

- Senior official" means any director, executive officer, investor relations or public relations officer, or other person with similar functions.

- The SEC has made clear that a company can be held liable for selective disclosure of material nonpublic information made by any other person who acts at the direction of a senior official.

- The Regulation does not apply to communications made in connection with most registered securities offerings (e.g., "roadshow" presentations to potential investors in a public offering). Regulation FD does, however, apply to regular communications that happen to occur during a registration, such as regularly scheduled conference calls with analysts.

(C) Who are the "Enumerated Persons' to whom Regulation FD applies?

Regulation FD covers only disclosures made by a company to analysts and other securities market professionals, including broker-dealers, investment advisors, investment companies and hedge funds, and to holders of the company's securities when it is reasonably foreseeable that the security holders will trade on the information.

Regulation FD does not apply to:

- communications with the press or rating agencies (where the ratings are made publicly available) or ordinary-course business communications with customers and suppliers; or

- disclosures of material information to persons who are bound by duties of trust or confidence not to disclose or use the information for trading, such as outside legal counsel and independent auditors.

- Under the Regulation, companies and their officials may also share material nonpublic information with outsiders when those outsiders expressly agree, orally or in writing, to keep the information confidential (e.g., with parties engaged in discussions with a company regarding a potential merger transaction).

(D) What are "Intentional" and "Non-Intentional" disclosures?

- Disclosure is considered intentional when the person making the disclosure either knew, or was reckless in not knowing, prior to making the disclosure that he or she would be communicating material nonpublic information. *If an intentional disclosure is made, broad public disclosure must also be made simultaneously. Therefore, Regulation FD provides, in effect, that companies are prohibited from intentionally selectively disclosing material information to analysts or other securities industry professionals.* According to the SEC, in the case of selective disclosure due to a mistaken determination of

materiality, the company will be liable only if "no reasonable person under the circumstances" would have made the same determination.

- Non-intentional disclosure occurs when the person making the statement reasonably believed it was immaterial or already public. *If a non-intentional disclosure is made, Regulation FD requires "prompt" public disclosure. Prompt disclosure is disclosure made within 24 hours, or by the start of the next trading day (applicable in the case of non-intentional disclosure made on a Friday or weekend), whichever is later, after a senior official of the company learns that the information has been disclosed and knows, or is reckless in not knowing, that the selectively disclosed information is material and nonpublic.*

- See the Secure Computing decision below at Section G.

(E) **How do companies make the public disclosure required by Regulation FD?**

A company can comply with its obligation to make public disclosure by filing a current report on Form 8-K containing the disclosed information under Item 5 or by furnishing (rather than filing) the information to the SEC on Form 8-K under new Item 9. The SEC maintains that the filing or furnishing of information on a Form 8-K solely to satisfy the requirements of Regulation FD will not, by itself, be deemed an admission of materiality.

- A company has alternatives to filing a Form 8-K:

- A company may make public disclosure by disseminating a press release containing the information through a widely circulated news or wire service, such as Dow Jones, Bloomberg, Business Wire, PR Newswire or Reuters.

- A company may make public disclosure by disseminating information through any other method, or combination of methods, of disclosure that is reasonably designed to provide broad public access and does not exclude access to members of the public – such as announcement at a press conference to which the public is granted access (by personal attendance or by live telephonic or electronic transmission). In order to afford broad public access, a company must provide notice of the disclosure in a form that is reasonably available to investors, such as a press release. Although a company may also post information on its website, that posting by itself

generally will not be considered to be a sufficient means of public disclosure under Regulation FD.[628]

The SEC states that, in evaluating public disclosure under Regulation FD, it will take into account facts and circumstances in determining whether the method used was reasonably likely to widely disseminate the information.

(F) **How is Regulation FD enforced?**

- If a public company fails to comply with Regulation FD, the SEC has authority to bring an administrative action seeking a cease-and-desist order or a civil action seeking an injunction or civil money penalties.

- There is no private liability under Regulation FD, and no private liability under Rule 10b-5 will arise *solely* from a company's failure to file or make public disclosures required by Regulation FD. As the SEC clearly notes in the FD Adopting Release, however, the actions that constitute violations of Regulation FD can still give rise to 10b-5 liability. For example, liability for "tipping" and insider trading may exist if selective disclosure is made by a person who receives a "personal benefit" in exchange for making the disclosure. A company could also potentially be held liable under 10b-5 for adopting, or entangling itself with, analyst forecasts. Thus, Regulation FD does not provide insulation from any 10b-5 liability that might otherwise exist. Further, a company may be liable under 10b-5 if any public disclosure made under Regulation FD contains false or misleading statements or omits material information.

- Failure to comply with Regulation FD will *not* result in a public company's loss of eligibility to use short-form registration for a securities offering (e.g., on Form S-3) or affect stockholders' ability to resell pursuant to Rule 144 under the Securities Act of 1933.

- In November 2002, the SEC issued three cease and desist orders and one report dealing with Regulation FD; They are discussed below at Section G.

(G) **What are KMZR's recommendations for compliance with Regulation FD?**

Regulation FD was recently adopted. There are now a few cases, as discussed in Section V. G, and the SEC has issued some telephone interpretations. We recognize that many companies have been being inundated by wide-ranging recommendations from various sources, some of which simply may not be

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[628] Former SEC General Counsel Ralph Ferrara has described the 8-K Item 9 filings of a number of issuers. Ralph C. Ferrara and Ellen D. Marcus, "Item 9 Trends: A Window on Regulation FD in Action," 6 no. 16 Andrews Sec. Litig. & Reg. Rep. 15, March 28, 2001.

practical. We believe that appropriate responses to the Regulation may differ from company to company. We urge every public company to work with its legal counsel and investor relations professionals to understand the scope of the Regulation and to establish its own plans for complying with the Regulation and for staying apprised of developments. These efforts should include a review of current company practices, considering the types of information that previously have been requested by, and provided to, analysts and institutional investors.

Nevertheless, we have some initial general recommendations:

- Companies with comprehensive written disclosure policies should carefully review and, if necessary, modify them to ensure that they are consistent with the requirements of Regulation FD.

- Companies that do not currently have comprehensive written disclosure policies are strongly recommended to adopt such policies that are consistent with the requirements of Regulation FD or, at a minimum, adopt detailed guidelines for compliance with Regulation FD.

- Each company should consider including in its disclosure policy (or Regulation FD compliance guidelines):

    - limitations on who is authorized to talk to analysts and investors on behalf of the company;

    - clear limits on the permitted scope of communications during private sessions with analysts or other market professionals or at investor conferences;

    - specific procedures to inform designated company officials if material information is inadvertently selectively disclosed and, in any such case, to rapidly make the requisite public disclosure;

    - a requirement that more than one company representative participate in conversations with analysts and institutional investors;

    - a requirement that, before any authorized representative discloses any information that is in a "gray area" as to materiality, the representative should review the proposed disclosure with designated company officials, including internal legal counsel and, where appropriate, outside counsel;

    - a requirement that earnings calls and other conference calls with analysts and institutional investors be webcast and/or opened up to the public and media on a "listen only" basis, with advance public notice of the calls, and then be made available for replay on the company's website for a limited time period; and

- specific policies regarding reviewing (or not reviewing) drafts of analyst reports to avoid giving financial guidance or other material information that would have to be publicly disseminated.

- Companies should also consider regular public dissemination of forward-looking data that has been typically provided to analysts. By providing more information to the public, perhaps even between regularly scheduled earnings conference calls, we believe companies will be able -- based on the SEC accepted mosaic concept -- to have more productive one-on-one calls or meetings with analysts; analysts and investors can drill down for more details concerning the already public information. To the extent companies publish forecasts or other prospective information, they should be certain to take advantage of the "safe harbor for forward-looking statements." Any safe harbor language should be carefully crafted and tailored to the particular statements being made. "Boilerplate" language should be avoided.

- Increased Web site disclosure benefits both the company's analysts and individual investors. The internet serves as a great vehicle to disseminate information quickly to a widespread audience. For example, a company may wish to create a template to be posted on its Web site that includes "all material elements of the issuer's projected financial statement and sets forth the assumptions underlying the issuer's projections."[629] By delivering the information to analysts and investors simultaneously, it becomes the information recipient's job to formulate projections.

- Those individuals who administer a company's disclosure policy or are authorized to talk to analysts on behalf of the company should be properly trained and should clearly understand the requirements of Regulation FD.[630]

- The November 2002 SEC decisions, discussed below at Section G, offer additional guidance for complying with Regulation FD.

2. SEC Telephone Interpretations of Regulation FD

On October 19, 2000, just prior to the rule's effective date, the SEC published answers to several Regulation FD questions and subsequent interpretations were issued in December 2000, May 2001 and July 2001.[631]

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[629] For more details on establishing a website template, see Bruce Alan Mann, Want that new FD to be easier? Try a projection template, Business Law Today, 26, 29 (September/October 2001).

[630] John Huber and colleagues at Latham & Watkins have assembled the advice of a member of public relations and law firms to their clients on how to comply with Regulation FD. John J. Huber, Thomas J. Kim, Brian G. Cartwright, Kirk A. Davenport, Erica H. Steinberger, "The SEC's Regulation FD – Fair Disclosure," May 4, 2001 pp. at 85-92.

Confirmation of Forecasts: The SEC indicated that Regulation FD allows selective confirmation by an issuer of its own forecasts only if the confirmation does not convey any new material information. The materiality of the confirmation depends on the amount of time that has passed since the forecast was made, as well as any intervening events that may have taken place during that time.[632]

Notice of Conference Calls: Under Regulation FD, material nonpublic information may be disclosed through conference calls open to the general public or by Webcasting. The SEC requires the companies to give adequate advance notice of any conference call, and any such notice must contain the time, date and dial-in information for the call.[633]

Public Filings Other than Form 8-K: Form 8-K is not the only form which satisfies the disclosure requirements under Regulation FD. Companies may satisfy their obligation under the rule by including the material information in any public filing on EDGAR, such as a 10-Q or proxy statement, however, companies should highlight that information in the filing.[634]

Waiting Period Following Disclosure: As soon as the public filing is made, the issuer may selectively disclose such information in private meetings with analysts. The issuer must only confirm that the filing precedes the private conversations.[635]

Agreement to Maintain Confidentiality: An issuer may disclose material nonpublic information to an analyst if the analyst expressly agrees to maintain a confidential relationship.[636]

Disclosures Made to Employees: Disclosures made to employees are not subject to Regulation FD as the Regulation only applies to disclosures made to persons "outside the issuer."[637]

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631 See SEC Staff Releases Interpretive Guidance for Regulation FD, at www.sec.gov/news/guidefd.html (Oct. 19, 2000, Dec. 6, 2000, May 30, 2001 and July 2001) (hereinafter referred to as the "Regulation FD Telephone Interpretations"); Katten Muchin Zavis Rosenman, Client Advisory, "SEC Answers Questions Regarding Regulation FD (Fair Disclosure)," (Oct. 23, 2000).

632 Katten Muchin Zavis Rosenman, Client Advisory, "SEC Answers Questions Regarding Regulation FD (Fair Disclosure)," (Oct. 23, 2000).

633 Id.

634 Id.

635 Id.

636 Id.

637 Id.

3. April 2001 SEC Roundtable

Regulation FD's effect on issuer/analyst relations has been the subject of considerable debate. Many commentators have speculated that the rule has resulted in a chilling effect on analysts' access to vital corporate information. Accordingly, analysts have expressed concern that there may be greater risks of error in preparing earnings estimates as a result of being barred from private conversations with issuers.[638]

Moreover, during this adjustment period, analysts' daily jobs are arguably more difficult and time consuming. For example, during the pre-Regulation FD period, if an analyst had a specific question about a public company, he or she would use corporate contacts to quickly talk to the issuer and adjust any calculations. Now, however, analysts must sit through long conference calls with other analysts and "Main Street" investors. The analysts must now listen to all mundane questions as they are forced to weed through corporate data looking for figures, upon which they can base earnings estimates. For Wall Street professionals and corporate executives, the once-mundane conference call is a necessity to either give or gather corporate information despite its frustrating characteristics.[639]

There have been a number of studies of the effects of Regulation FD, but none of them is conclusive especially in light of the volatile markets we have had since the Regulation's adoption.[640] To demystify the effects of Regulation FD, the SEC held a Roundtable discussion in New York on April 24, 2001. Acting Chairman Laura Unger convened the Roundtable and Commissioner Hunt participated. The presenters included representatives from issuers, information disseminators and the media, analysts, institutional investors and the bar, including the author. There was a lively discussion extensively reported in the press. As could be anticipated, there were pro and con positions on (i) whether Regulation FD has been a cause of the market's recent volatility, (ii) whether issuers are releasing less information, (iii) whether analysts are finding it more difficult to build a mosaic picture, (iv) what are the real costs of compliance, (v) the ease or difficulty of compliance and (vi) whether more guidance from the SEC is necessary. My take away was that (i) it is too early and we do not have enough information to determine whether Regulation FD has been a factor (and, if so, to what extent) in the market's volatility, (ii) there is more widely dispersed information being made available, but the information is below the quality of information communicated prior to Regulation FD's adoption, (iii) the professional disseminators and the media

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638 Jeff Opdyke, The Big Chill: Street Feels Effect of "Fair Disclosure" Rule, Wall St. J., Oct. 23, 2000, at C1.

639 Id.

640 National Investor Relations Institute, Corporate Practices Survey 2001, http://niri.org/publications/cdps 2001.pdf (March 7, 2001); Association for Investment Management and Research, Regulation FD e-Survey Summary, www.aimr.org/pressroom/01releases/regFD_survey.html (March 26, 2001); the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association asked its members to evaluate the operations of Regulation FD; the preliminary results can be found at www.abanet.org/buslaw/fedsec/comnews.html, see Preliminary Survey.

generally love Regulation FD and (iv) issuers have found some problems with Regulation FD but are not unduly unhappy with it while analysts and institutional investors admit they can live with Regulation FD but do genuinely believe they are receiving less quality information.

My presentation to the Roundtable focused on three issues:

- because of the almost unlimited scope of Regulation FD, it is too early to assess the Regulation's full impact;
- in the Release adopting Regulation FD, the SEC unnecessarily added confusion and uncertainty to the concept of materiality; and
- the SEC's goal of more public disclosure of material information -- especially forecasts – would be advanced if either the courts or the SEC untangled the duty to update doctrine.

Too Early To Tell: As a disclosure rule, Regulation FD cuts across almost all aspects of securities laws. I do not think this was fully appreciated when the Regulation was adopted and, consequently, we have not yet had enough experience to evaluate how the rule operates over its full spectrum. Three examples will illustrate this. First, disclosures made at annual stockholders meetings and in annual reports to stockholders are subject to Regulation FD. I do not believe that at the time of adoption anyone realized that if anything material was going to be revealed at an annual meeting of stockholders, the full panoply of Regulation FD disclosure had to be followed.[641] Moreover, a general counsel discussed with me the following scenario, namely, the company's practice had been to issue its year-end earnings release and have an analyst conference call in mid February, mail its annual report to its stockholders in late February or early March and file its 10-K with the SEC in late March. The question was whether, because the annual report contained complete financials and the MD&A and was thus more detailed than the year-end earnings release, could the annual report be sent to stockholders without complying with Regulation FD? Probably not, even though it would be hard to argue that the company was making improper selective disclosure by mailing its annual report to its stockholders. Second, the broad reaches of Regulation FD have not been fully integrated with Regulation M-A.[642] Care must be taken that both Regulations must be satisfied even though they have different timing and filing requirements. Third, Regulation FD applies to private placement disclosure but does not to disclosure made "in connection with a securities offering registered under the

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641 SEC, Division of Corporate Finance: Regulation FD Telephone Interpretations (Question 4, Oct. 2000).

642 Stephen Glover, Should M&A Lawyers Worry About Regulation FD?, The M&A Lawyer, Oct./Nov. 2000, at 24; Erica H. Steinberger & John J. Huber, The Effect of Regulation FD on Mergers, Acquisitions and Proxy Solicitations and the Requirements of Regulation M-A, The M&A Lawyer, Oct./Nov. 2000, at 1.

Securities Act…"[643] We simply have not had robust private or public markets to test whether the Regulation's different approaches to these offerings will work.

The SEC's Assault on Materiality: The central defect with Regulation FD is not necessarily the Regulation itself but the SEC's overzealous attempt to extend the concept of materiality beyond the Supreme Court's definition. Had the SEC stopped with the Court's definition of materiality as set forth in the TSC Industries and Basic decisions[644], it would avoided the mischief it created by attempting to enlarge it. In at least three ways, the SEC went beyond TSC/Basic:

The laundry list of seven items contained in the FD Adopting Release[645] has only added confusion rather than sunshine. To include the simple phrase "earnings information" in the list along with bankruptcies, creates the impression that any earnings information is material.

The paragraph in the FD Adopting Release that takes special pains to emphasize that anyone who provides analysts with earnings guidance "takes on a high degree of risk under Regulation FD" goes far beyond what was necessary to avoid selective disclosure of material information.[646]

The citation to SAB 99 is confusing. Does the SAB apply "only" to financial statements or does the SEC view it as a general definition of "materiality?"[647] In either case, SAB 99 is not a rule and when published was not subject to comment and review under the Administrative Procedure Act.[648] Its focus, moreover, dealt with known misstatements in financial statements and how to deal with them. The laundry list of considerations in SAB 99 that may make a small misstatement material are really concerned with intentional or manipulative conduct (e.g., "masks"; "hides"; "changes a loss into income"; affects compliance with regulatory requirements or loan covenants; increases management's compensation or conceals "an unlawful transaction."[649] Unfortunately the language in SAB 99 is both too broad and unnecessary to combat the evil the SAB was designed to eliminate.

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643 Rule 243.100(b)(2)(iv).

644 FD Adopting Release 33-7881, at 8 and nn. 38 - 39, Aug. 15, 2000 (citing TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976) and Basic v. Levinson, 485 U.S. 24 (1988)).

645 FD Adopting Release, at 8.

646 Id.

647 Id.

648 The courts have, however, deferred to SAB 99.

649 SEC Staff Accounting Bulletin: No. 99-Materiality, at 3-4; Aug. 12, 1999.

In the FD Adopting Release, the SEC acknowledges the existence of the mosaic doctrine but it is exceedingly difficult to separate non-material mosaic pieces of information from, for example, "earnings information." This, I believe, is the reason lawyers have been conservative and cautious in the disclosure advice they are giving to their issuer clients.[650] Further evidence of the defects in the FD Adopting Release is contained in the Staff's telephone interpretations. In Interpretation 1, the Staff clearly retreats from the advice given in the FD Adopting Release concerning the avoidance of providing earnings guidance: the SEC answers "Yes" to the question "Can an issuer ever confirm selectively a forecast it has previously made to the public without triggering the rule's public reporting requirements?" Moreover, former General Counsel Harvey Goldschmid (one of the architects of Regulation FD) is reported to have stated "I think the final SEC Release [on Reg. FD] is a little too strict on earnings guidance."[651]

The quest for specific bright lines to define materiality is doomed to failure. The SEC institutionally cannot provide a bright line that could be used as a roadmap for those willing to engage in manipulative or fraudulent conduct.[652] If the SEC did provide more guidance on materiality, I fear it would only enlarge materiality and cause more confusion and uncertainty. As the old proverb goes, "don't wish for it, you might get it."

We should not despair, however, that the SEC will not provide us with further guidance concerning the parameters of materiality. I sincerely believe that we can live with the Supreme Court's definition, if the SEC refrains from enlarging or amplifying it. When the Supreme Court heard the Basic case in 1988, many argued that the Court should have provided a brightline test and they were disappointed when the Court declined to do so. These advocates feared that in the wake of the Basic decision the necessity to conduct a fact-specific materiality analysis would preclude dismissal of many Rule 10b5 actions on a motion to dismiss or a motion for summary judgment. This apprehension did not materialize, however, and is reflected in Section II, B., supra. The Courts have continued to apply traditional materiality concepts and have continued to dismiss Rule 10b5 cases on motion.

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650 In a meeting between SEC Director of Corporation Finance, Alan Beller, and the National Investor Relation Institute (NIRI), Mr. Beller described the practice of companies providing selected analysts with "color," or more detailed information, following a news announcement but before a broadly attended conference call, as "highly risky." He reasoned that while the Company may assume the information it is providing is non-material, when compounded to the news being disclosed, it may take on material significance. Guidance on Restricted Access Discussions Surrounding News Announcements, Executive Alert (Nat'l Investor Rel. Inst.) Apr. 24, 2002. Statements such as Mr. Beller's often make reliance on the mosaic doctrine difficult and have the unfortunate consequence of taking away the decision-making role of lawyers because of the second-guessing involved in advising issuer clients regarding disclosures.

651 Sec. Reg. & Law Rep., vol. 33, no. 19, May 14, 2001, at 723.

652 The SEC has, however, created at least two such lines when the public policy considerations in favor of doing so are overwhelming and the risk to investors is slight. The first is contained in the 1989 Interpretative Release where an exception for MD&A purposes is made for merger negotiations.

The Need to Clarify the Duty to Update: To further the goal of encouraging more disclosure of quality, timely and forward-looking information, the courts or the SEC should adopt the position that there is no duty to update previously disclosed information that was true when released and has become inaccurate.[653] Although some courts have recognized a duty to update, I believe a credible argument can be made that almost all of the courts are finding ways to narrow the duty – even if they acknowledge it exists -- to the point where they have basically accepted the notion that there is no duty to update except in egregious situations. Despite my reading of the cases, however, issuers are reluctant to provide more forward-looking information because it is difficult to counsel them as to whether a duty to update exists and if so, when that duty becomes operative other than in required SEC filings.[654]

Many thought that the Reform Act eliminated the duty to update but a number of commentators and the SEC have not accepted this proposition. In the telephone interpretations, the SEC responded to the question of whether Regulation FD created a duty to update by stating "No" and going on to say "Regulation FD does not change the existing law with respect to any duty to update."[655] This stance simply forces us to look at the case law prior to the adoption of the Reform Act. As I have stated, the black letter case law is unclear (even though the results of the decisions appear to negate the duty to update) and thus issuers have been reluctant to provide forward-looking information. This could be remedied by the Supreme Court or the SEC. It is supported, moreover, by the "Bespeaks Caution" doctrine since reliance cannot be justified if updating has been disclaimed. If an issuer makes clear when it discloses information that it does not plan or take on a responsibility to update it, and does so in plain understandable language, this should be sufficient to defeat duty to update claims.

4. Commissioner Unger's Response to the April 2001 Roundtable

In December 2001, Commissioner Laura S. Unger responded in a report to the issues raised at the Roundtable ("Regulation Fair Disclosure Revisited").[656] After

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653 See generally Sullivan & Cromwell, Regulation FD – Designing Disclosure Policies to Reduce the Risk a "Duty to Update" Will Apply to Earnings and Other Guidance: (Feb. 12, 2001). In May 2001, a SEC Task Force urged as a public policy more disclosure of forward looking information as being in the public interest. For further information regarding the SEC Task Force, see Report of an SEC-Inspired Task Force, chaired by Jeffrey E. Garten, Dean of the Yale School of Management, "Strengthening Financial Markets; Do Investors Have The Information They Need?" (May 2001).

654 Without additional protections, imposing the duty to update has the potential to heighten the risk of a securities lawsuit to issuers. Steven E. Bochner and Samir Bukhari, Securities Disclosure: Revisiting the Duty to Update in Light of Regulation FD, Insights, Jan. 2002, at 2. These authors also point out the challenges of determining materiality and disclosure obligations and explain that the uncertainty regarding the duty to update has led to inconsistent disclosure practices among public companies. Id.

655 Regulation FD Telephone Interpretations (December 6, 2000).

656 Laura S. Unger, Regulation Fair Disclosure Revisited, (December 2001), available at http://www.sec.gov/news/studies/regfdstudy.htm (last visited Feb. 11, 2002).

summarizing the presentations at the Roundtable, Commissioner Unger made the following recommendations:

- The Commission should provide more guidance on materiality.
    - The Commission should consider issuing an interpretive release to make its position on materiality under Regulation FD clearer.
    - The Commission's guidance on materiality should focus on clarifying the meaning of "earnings information" as used in the Adopting Release.
    - If enforcement action is warranted, the Commission should consider issuing a Section 21(a)[657] report. This report would provide the Commission an opportunity to express its views.
- The Commission should make it easier for issuers to use technology to satisfy Regulation FD.
    - The Commission should explore with the self-regulatory organizations ("SROs"), including the New York Stock Exchange and the National Association of Securities Dealers, Inc., ways to amend their rules to expand the range of tools that would satisfy both Regulation FD and SRO information dissemination requirements.
    - The Commission should embrace technology to expand opportunities for issuers to disseminate information online. The Commission should also encourage users to post written transcripts of webcast presentations and to archive webcasts and transcripts on their websites.
- The Commission should analyze what issuers are saying post-FD.
    - The Commission should examine both the amount of information being disclosed and the type of information issuers are providing in Form 8-K filings, webcasts, press releases and through other modes of dissemination.
    - If the Commission determines that Regulation FD has caused companies to cutback on making future projections, it should consider using authority under the Private Securities Litigation Reform Act of 1995 to expand the safe harbor to encourage more forward-looking disclosure.

[657] Section 21(a) of the Security Exchange Act of 1934 authorities the commission, in its discretion, to publish information "concerning any . . . violations" and to investigate "any facts, conditions, practices or matters which it may deem necessary or proper."

F. ABA's Committee on Federal Regulation of Securities Report on Regulation FD

On February 1, 2002, the American Bar Association's Committee on Federal Regulation of Securities issued a report on Regulation FD.[658] The Committee identified a number of problems with FD including:

- interference with ordinary business communications not designed to provide a market advantage;
- confusion about applying the concept of materiality;
- over breadth in scope, resulting in more regulation than necessary to protect investors against selective disclosure; and
- inefficiencies and unnecessary burdens on capital formation transactions and restructurings, which were not the source of abuse to begin with.

To address these issues, the Committee proposed (1) a change in the approach to materiality, (2) recalibration changes and (3) technical changes.[659] The Committee believed that these changes would enhance FD's effectiveness, correct its deficiencies and continue to promote he free flow of information to the marketplace.

1. Change in the Approach to Materiality

To address the confusion about applying the materiality concept, the Committee recommended a change in the materiality trigger of Regulation FD. It suggested these alternative approaches:

- Use the standard of materiality in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), without SAB 99. This standard has been applied for over 20 years and market participants are familiar with it.
- Adopt a standard that is narrower than the TSC Industries standard and not based on "materiality" – for example, facts of "special significance" as used under the American Law Institute's Federal Securities Code.

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658 Report on Regulation FD: Media Summary, Committee on Federal Regulation of Securities (ABA Sec. of Bus. Law) Spring 2002, at 11.

659 Id. at 14.

- Specify an exclusive list of unquestionably significant items that would be subject to FD, such as the list of potentially material items in FD's adopting release.[660]

2. Recalibration Changes

The Committee recommended changes to recalibrate FD to focus primarily on the communications that present the potential for selective disclosure. These changes could potentially help FD work efficiently and narrow its scope by exempting:

- ordinary course of business communications not designed to convey a market advantage;

- private placements, including Rule 144A transactions;

- cash tender offers and cash mergers; and

- information disseminated to lenders or to prospective lenders in connection with the syndication of commercial loans, or pursuant to contractual reporting obligations to commercial lenders or in connection with the restructuring of debt.

3. Technical Changes

The Committee also recommended technical modifications to the way FD is applied and interpreted:

- Recognize electronic media, including a company's Web site and use of accessible push technology, as a permissible stand-alone form of public dissemination if the issuer reasonably believes it will be adequate. Posting information on a Web site for all to see or disseminating information to persons who are able to subscribe to receive electronic notices on an open basis effectively offsets the opportunity for selective disclosure and provides broad, non-exclusionary access.

- Revise the public dissemination requirement to give credit to good faith effort. The Commission has interpreted the public dissemination requirement with such rigor that even a good faith effort to make information public can result in a violation of FD. For example, despite a company's best intentions, a press release may not be adequate if it is not broadly disseminated. In addition, the Commission should give greater flexibility to the notice requirement to recognize the practicalities of each situation.

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[660] Id. at 15.

- Change the meaning of "intentional" from the current hair-trigger definition to one based on a premediation standard. The current definition, particularly when coupled with the Commission's traditionally broad views of a "knowledge" standard, causes almost every statement, even an inadvertent response, to be deemed intentional. Additionally, allow issuers to remedy a selective disclosure "promptly," whether the disclosure is intentional or not. "Promptly," which means as soon as reasonably practicable, is used in many Commission rules.

- Permit a longer period of time to remedy selective disclosure if it occurs overseas or after trading hours in the primary market.

- Work with the New York Stock Exchange and the NASDAQ Stock Market to reconcile their rules, which require listed companies to announce material information in a press release, with FD, which provides that the proper use of electronic media is adequate.

- Confirm that embargoing information with analysts and information barriers work under FD.[661]

G. The First Cases Under Regulation FD

In November 2002, the SEC issued its first decisions under Regulation FD. The Commission issued three cease and desist orders and one Report of Investigation. Prior to their release, there was considerable publicity about at least two of the companies – Motorola and Raytheon – while the remaining two – Siebel Systems and Secure Computing – were not generally publicized. The decisions are very fact intensive and do in fact provide good guidance as to how the SEC interprets and will enforce Regulation FD.

1. Raytheon [662]

On February 7, 2001, Raytheon conducted an investor conference where it reiterated annual earnings per share ("EPS") guidance, but did not provide any quarterly EPS guidance. After the investor conference, the Chief Financial Officer, Franklyn A. Caine, directed his staff to contact each sell-side analyst whose estimates are included in Thomson Corporation's First Call Service and request copies of the analysts' quarterly model of Raytheon. Caine then arranged and conducted a one-on-one call with each analyst. Caine made these calls while knowing that Raytheon had not provided public quarterly earnings guidance for 2001, that the analysts' first quarter 2001 EPS estimates

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661 Id. at 15.

662 In the Matter of Raytheon Company, Securities Exchange Act of 1934 Release No. 46897 (Nov. 25, 2002), at http://www.sec.gov/litigation/admin/34-46897.htm.

generally exceeded Raytheon's internal estimate and that the analysts' 2001 quarterly earnings estimates reflected a less seasonal quarterly distribution than 2000 results.

Significantly, before Caine conducted these one-on-one conversations, analysts covering Raytheon attributed a general "seasonality" to Raytheon's quarterly earnings pattern where the first quarter generally was the weakest and the fourth quarter generally was the strongest. According to this pattern, Raytheon produced earnings in an ascending slope where profits increase on a quarterly basis throughout the year. In 2000, the slope was steep in that Raytheon generated one-third of its earnings in the first half of the year. Prior to their one-on-one conversations with Cain, analysts projected that Raytheon's 2001 earnings distribution would be more evenly distributed and less seasonal than in 2000. During these conversations with analysts, Caine communicated that in 2001 Raytheon's earnings would likely have the same seasonal distribution as in 2000 and that Raytheon would generate one-third of its EPS in the first half of the year and the remaining two-thirds in the second half of the year. Caine also told certain analysts that their estimates for first quarter earnings or revenue for particular divisions were "too high," "aggressive" or "very aggressive." After the conversations, each analyst lowered his or her first and second quarter EPS estimates and increased EPS in the second half of the year. Subsequently, more than two million shares of Raytheon's stock was sold by one firm's sales force, whose analyst had received one of the on-on-one telephone call. The price of Raytheon's B stock fell approximately 6%, from $32.80 to $30.84, and the price of Raytheon's A Stock fell approximately 3%, from $31.30 to $30.50. Ultimately, Raytheon's selective disclosures enabled the company to beat the analysts' consensus 2001 first quarter EPS estimate by $.01.

Raytheon was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. Caine was also ordered to cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulations FD.

2. Secure Computing [663]

In early 2002, Secure Computing Corporation entered into an original equipment agreement with one of the nation's largest computer networking companies (the "buyer") whereby Secure's product would be integrated into the buyer's product. Neither Secure nor the buyer made any public announcement of the deal. The agreement between the parties required that Secure receive the buyer's consent before Secure could announce the transaction. In early March 2002, Secure held an executive staff meeting, with Chief Executive Officer John McNulty participating via telephone, in which the executives expressed concern that the information regarding the agreement might leak to the public because the buyer's sales force was selling the product to beta customers. On March 6, at the buyer's request, Secure posted a page on its own website providing information and

[663] In the Matter of Secure Computing Corporation, Securities Exchange Act of 1934 Release No. 46895 (Nov. 25, 2002), at http://www.sec.gov/litigation/admin/34-46895.htm.

software downloads for the buyer's sales force and for customers who were evaluating the product. Secure's main website page did not reference the deal or provide a link to this web address. But as of March 6, 2002, McNulty knew that neither the buyer nor Secure had issued a public announcement of the agreement.

On March 6, McNulty conducted a conference call with a portfolio manager and a salesperson at a brokerage firm. McNulty and Secure's director of investor relations (the "IR Director") participated in the conference call. During this call, the IR Director mistakenly advised McNulty that he could disclose information about the agreement with the buyer to the portfolio manager and salesperson presumably because the information had been put on Secure's web page and was therefore public. McNulty's disclosure was the first time the salesperson from the brokerage firm had heard of the agreement. After the call, McNulty later confirmed to the managing partner of the brokerage firm the existence of the deal. Shortly thereafter, the IR Director informed McNulty that he had disclosed nonpublic information. McNulty telephoned the managing partner of the brokerage firm and requested that the information be kept confidential. That day, Secure did not make a general public announcement of the software agreement.

The next day, on March 7, Secure set out to try to obtain the consent of the buyer to make a public announcement but the buyer did not agree. McNulty also conducted conference call with four additional institutional investors during which McNulty confirmed that Secure had a deal with the buyer. That same day, Secure's stock price increased by 7% from the previous day on volume that was 130% higher. Following the close of the market, Secure eventually released the information regarding the agreement. In the days following the announcement, Secure's stock price continued to increase so that between March 5 and March 11, the stock price rose 35%. The SEC's Order states that although the March 6 disclosure of material and nonpublic information was not intentional, the March 7 disclosure was selective and violated Regulation FD because Secure and McNulty failed to make simultaneous public disclosure of the information to the public.

Secure Computing was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. McNulty was also ordered to cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulations FD.

3. Siebel Systems [664]

On November 5, 2001, the Chief Executive Officer of Siebel Systems, Inc. (the "CEO") made positive comments about the company's business and about the company's optimistic outlook because its business was returning to normal to the attendees of an

[664] In the Matter of Siebel Systems, Inc., Securities Exchange Act of 1934 Release No. 46896 (Nov. 25, 2002) at http://www.sec.gov/litigation/admin/34-46896.htm.

invitation-only technology conference hosted by Goldman Sachs & Co. that was not web cast. These statements contrasted with public negative statements that the CEO had made about the company's business three weeks earlier in which he characterized the market for information technology as tough. and indicated that the company expected business to remain that way for the rest of the year. The company's investor relations staff knew, even if the CEO did not, that the conference would not be simultaneously broadcast to the public. On the day of the conference, the company's stock price closed 20% higher than the prior's day close and the trading volume was more than twice the average daily volume. There also appeared to some significance to the fact that Goldman Sachs provided Siebel with an advance list of the attendees of the technology conference and that the Goldman Sachs provided the company with a list of questions that the analyst planned to ask the CEO. Among the questions was whether the company had "any evidence that the software market [was] getting any better or worse."

Siebel was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. Siebel also agreed to pay a $250,000 civil penalty, without admitting or denying the SEC's allegations.

4. Motorola [665]

The SEC has investigated whether the director of investment relations at Motorola, Inc. (the "IR Director") selectively disclosed information about the company's quarterly sales and orders during private telephone calls with sell-side analysts in March 2001, but did not commence a formal enforcement action. Previously, in a February 23, 2001 press release and public conference call, Motorola disclosed only that sales and orders were experiencing "significant weaknesses" and that Motorola was likely to miss its earnings estimates for the quarter and have an operating loss for the quarter if the order pattern continued. Following this announcement, most analysts lowered their estimates. Nevertheless, after reviewing the analysts' models and research notes, the IR Director concluded that the analysts still were overstating Motorola's likely quarterly results. Therefore, between March 6 and March 12, 2002, the IR Director directly contacted approximately 15 analysts to discuss their models. On at least ten of these calls, the IR Director told analysts that when Motorola uses the terms "significant" or "significantly" it intends a rate of change of 25% or more. All of the analysts directly contacted directly by the IR Director revised their models following the calls.

Before making the phone calls, the IR Director sought and obtained the advice of Motorola's in-house legal counsel responsible for SEC reporting and disclosure issues. Counsel specifically advised the IR Director that he could contact selected analysts, reiterate the information that had been disclosed previously and provide quantitative

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665 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934; Motorola, Inc., Securities Exchange Act of 1934 Release No. 46898 (Nov. 25, 2002), at http://www.sec.gov/litigation.investreport/34-46898.htm.

definitions for certain qualitative terms. Counsel based that legal advice on the conclusion that providing a quantitative definition for the term "significant" was not material. Counsel also concluded that Motorola's particular definition of the word was public for Regulation FD purposes

The SEC made the following observation about this case:

- The information selectively disclosed by Motorola clearly was material;
- Senior officials of issuers should be particularly cautious during private conversations with analysts;
- After-the-fact private communications of material, non-public information to securities professionals are not a proper way to supplement a prior public disclosure that the issuer determines to have been misunderstood or misinterpreted;
- When communicating with securities industry professionals, issuers may not use "code" words to selectively disclose information that they could not selectively disclose expressly; and
- In issuing the report rather than commencing a formal enforcement action, the SEC credited Motorola's reliance on counsel in the context of the case concerning Regulation FD issues because the legal advice was sought and given in good faith (the SEC also cautioned that reliance on counsel will not necessarily provide a successful defense in all future cases and that availability of any reliance on counsel argument turns on all the facts and circumstances of the case).

5. The teachings of the November 2002 Regulation FD Cases [666]

Each of the decisions is very fact intensive but they do provide very helpful guidance. The takeaways are:

- First and foremost, it is clear that materiality will be judged in hindsight. In each decision, the SEC based its materiality determination upon what the recipients of the information did after receiving it and the effect on the price and volume of the issuer's stock following the private disclosure (especially Siebel where the materiality issue was a close call).

- These cases are easy for the SEC to prepare: the phone calls to analysts are documented by time and in one instance by a transcript and the market reaction and actions taken by the analysts after the calls are also easily documented.

- The SEC has reemphasized that it considers earning guidance to be problematic (Motorola and Raytheon).

- Purposely seeking out analysts in one-on-one calls to correct information that may have been misunderstood is extremely dangerous. The method to correct previously disclosed misunderstood information is not through selective calls but a general public release (Motorola and Raytheon).

- Avoid "code words" – "significant" means 25% (Motorola).

- Reliance on counsel's advice will probably not prevail in the future and, more importantly, the SEC expressly noted in Motorola that an issuer's chief financial officer or investment officer may not be able to rely on counsel's

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[666] The teachings of these first cases were reemphasized in In the Matter of Schering-Plough Corp. and Richard J. Kogan, Exchange Act Release No. 34-48461 (Sept. 9, 2003), available at http://ww.sec.gov/litigation/admin/34-48461.htm. Schering publicly disclosed in its Form 10-Q that an adverse ruling in patent litigation concerning of one of Schering's primary Claritin patents "would likely have a rapid, sharp, and material adverse effect on the Company's results of operations beginning at the occurrence of such an event and extending for an indeterminate period of time thereafter." After the adverse patent decision was issued and publicly announced, Schering's CEO scheduled private meetings with analysts and portfolio managers and provided them, according to the SEC, with material, nonpublic information regarding Schering's earnings prospects. This information was almost immediately documented in internal memoranda, research notes, or voicemail communications between meeting participants and non-participants, or communicated to portfolio managers at internal meetings. These internal communications triggered rapid selling that ultimately resulted in a stock price decline of over 17 percent from October 1 through October 3, 2002 on volume averaging more than four times the stock's typical daily volume.

Two teachings stand out from the Schering-Plough enforcement proceedings: (1) the CEO affirmatively sought out these investors; and (2) the CEO provided these investors, "through a combination of spoken language, tone, emphasis, and demeanor," earnings guidance that included "material, nonpublic information" that was more detailed than the earlier very negative public disclosure by Schering. According to the SEC, the "company had never publicly commented on Wall Street analysts' earnings estimates for the quarter nor provided any other quantitative guidance suggesting that estimates were too high."

advice since they may have a "keener awareness than company counsel of the significance of information to investors."

- Monitoring market action after a private disclosure can help a company determine whether the information disclosed was material; if the market reacts, it's more likely that the information was material and an immediate public release should be considered. This avoids a Regulation FD violation (Secure Computing). In fact, the SEC in Secure Computing noted that the initial selective disclosure did not violate Regulation FD (presumably because the information was thought to be public) and had Secure Computing immediately disclosed the information publicly, a Regulation FD would not have occurred. Unfortunately for Secure, its officers continued to make selective disclosures before making a public announcement.

- As reflected by Secure Computing, confidential business transactions can cause serious FD problems. Secure clearly had a dilemma because it was under a contractual restriction prohibiting disclosure and yet because of the beta testing it had to post certain sensitive information on its web site. In the future, care should be taken when negotiating similar contractual relations to permit public disclosure if required by Regulation FD or some other alternative should be contractually adopted. Note also that non prominent web site disclosure may not satisfy Regulation FD.

- Non-webcasted analyst conferences can be dangerous (Siebel) especially when the company knows who will be present and the questions to be asked.

- Soft business information can be material – "the Company was optimistic because its business was returning to the normal" in contrast to public negative statements made three weeks earlier (Siebel). Note that immediately prior to the conference (without the knowledge of Siebel but after a private discussion with Siebel's CFO and IR Director), the analyst in charge of the conference circulated for internal use only a memo indicating that the Siebel CEO may set a "positive tone … it seems as if business activity has increased." The SEC also goes to pains to demonstrate that the CEO's personal knowledge was based on internal non-public information concerning the Company's sales pipeline. According to the SEC, "the disclosures were based on non public information that was internal to and reflected trends in the Company's business." The talking points provided to Siebel's CEO were carefully crafted to include only publicly available information. For some unexplained reason, however, the CEO deviated and announced the "good news" in contrast to his previous negative statements.

- In projecting a full year's business, the Company was providing material information and not mosaic information (Raytheon).

H. Conclusion

The SEC's issuance of the first cases under Regulation FD provide guidance on how the rule will be interpreted and enforced. In the future, moreover, it is likely that penalties for violation of Regulation FD will be more severe. Despite turmoil surrounding analyst activities, analysts should continue to participate in the due diligence process in both initial public offerings and offerings for publicly-held companies. Issuers should also adopt written policy statements indicating their level of involvement with analysts and their stance on reviewing analysts' reports under the May 2002 SRO rules governing member firm analysts.[667] Issuers should also adopt internal guidelines which clearly articulate who is responsible for communication with analysts, and who will review any materials supplied to analysts. Companies should make certain that the designated individuals understand the requirements of Regulation FD particularly in light of the SEC's November 2002 decisions. Furthermore, to ensure the rapid and requisite public disclosure, procedures to inform designated company officials if material information is inadvertently selectively disclosed should be immediately adopted; as stated above some market monitoring system should be considered. Finally, in response to the new rules, companies may also wish to regularly disseminate data, such as monthly sales figures previously reserved for analysts, to the public at large. Perhaps if issuers publicly disclose a larger array of detailed information (e.g., projected tax rates, cap x, r&d expenses, etc.) analysts may be better equipped to calculate earnings estimates, draw conclusions based on the statistics and trends, and quiz the issuer about the disclosed information without creating FD problems.[668] The public disclosure, moreover, of more comprehensive information packages on a periodic basis may mitigate market volatility.[669] Hopefully, additional SEC publications and releases in the future will aid issuers and analysts in understanding the application of Regulation FD to their everyday business actions and decisions.

VI. ROAD SHOWS

Road Shows are an integral part of the public offering process and other securities transactions. They serve a useful function as the issuer and its principal officers are displayed before potential investors. This leads to incisive questioning by experts and produces, in some respects, a more negotiated transaction.

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667 See supra V.A.2. Regulation FD generally negates the prior practice of giving "comfort" to analysts projections. See however Ronald O. Mueller & Gavin A. Beshe, "Securities Disclosure – Cold Comfort: The Risks of Expressing "Comfort" With Analysts' Estimates," Insights, vol. 12, no. 7, July 1998; Malone v. Microdyne Corp. See 26 F.3d 471 (4th Cir. 1994) (comfort statements non-actionable unless they rise to a level of a guarantee), contra Pressetek, SEC Rel. no. 34-39472 (Dec. 22, 1997) (very unusual facts).

668 Edward D. Herlihy, Paul K. Rowe & Craig M. Wasserman, Wachtell, Lipton, Rosen & Katz, "Regulation FD and the New Channels of Financial Communications: Its Bark is Much Worse Than Its Bite", October 20, 2000. If an issuer follows this approach, it is essential that realistic safe harbor language be used and up front disclosure is made concerning updating.

669 See id.

A. Disclosure of Information at Road Shows

Lawyers generally play a small or non-existent part in the preparation or execution of the road show. Cautious issuer counsel frequently advises the client to confine its presentations at the road show to material included in the registration statement, to refrain from making predictions, and not to distribute other materials.[670] Very little case law or formal SEC rulings exist dealing with statements made at road shows. Many of the class action securities fraud suits brought in the past few years have specifically alleged that the road show was used as a vehicle to create demand for the securities by painting an extremely positive picture of the issuer and by having the issuer and underwriter both make forecasts that the issuer would enjoy continued profit growth.

In Hyperion Securities Litigation,[671] the plaintiffs attempted to bolster their allegations of securities fraud through excerpts of information--scripts and slides -- used during the road shows. The court agreed that the "road show scripts were more optimistic about risks and returns than the prospectuses." Despite this, the court, looking at the total mix of information available and applying the "Bespeaks Caution" Doctrine, held that the plaintiffs could not "predicate their claims on inferences drawn from statements made during the road shows if, as here, those inferences are contradicted by specific disclosures in the prospectus."

As a result of the Analyst Court Consents, analysts from the ten consenting investment banking firms cannot participate in road shows.[672]

B. Electronic Road Shows

Between the filing date and the effective date of a registration statement, offers which constitute a prospectus may only be made through the filing of a preliminary prospectus. According to §2(10) of the 1933 Act, a prospectus is "any . . . communication, written or by radio or by television, which offers any security for sale or confirms the sale of any security." It is therefore important that road shows, which generally consist of a series of presentations by an issuer and its underwriters to seek interest in a public offering, remain outside the definition of a prospectus. In a move toward the acceptance of technology, the staff of the SEC ruled that it would not treat the

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670 Commentators have noted that materials other than the preliminary prospectus or corporate documents (Forms 10-K, 10-Q, and 8-K reports) should be collected at the end of the presentation. For a general discussion of the procedural do's and don'ts of roadshows, See The Road Less Traveled: The Advent of Electronic Roadshows, Insights, vol. 11, no. 7, July 1997.

On a related subject, see generally SEC Rel. No. 33-7516, Mar. 23, 1998, describing the SEC's views on the "Use of Internet Web sites To Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore."

671 Fed. Sec. L. Rep. (CCH) ¶ 98,906 (S.D.N.Y. 1995).

672 See Analyst Court Consents, Addendum A, 11.a.; see also the discussion concerning the role of analysts in investment banking activities as Section V. A-C.

video transmission of a road show presentation to a restricted audience as a prospectus. By concluding that the electronic transmission of a road show is not a prospectus, the SEC would not subject the transmission to the type of review reserved for prospectuses. This ruling will enable road shows to reach a vast audience in a shorter period of time. Additionally, the SEC is beginning to examine the issue of internet road shows.[673]

In its No-Action letter to the SEC, the Private Financial Network ("PFN")[674] proposed to transmit road shows for public offerings to its subscribers, either live or on a delayed basis.[675] PFN stated that these transmissions of road shows would help issuers channel timely and consistent information about themselves and their securities to investors who otherwise could attend the shows, but might find it expensive or difficult to do so. PFN stated that the video transmission of a road show would only be considered a prospectus if it constituted radio or television within the meaning of §2(10) of the 1933 Act. PFN argued that §2(10) refers to broadcasting, not to the use of radio or television technology for closed circuit or other "controlled retransmission of non-prospectus materials."[676] PFN noted that closed circuit television transmissions of road shows are tantamount to live presentations where parties interact face to face.[677]

The SEC indicated that it would not consider the transmission of a road show presentation a prospectus if the following requirements are followed:

- prior to the video transmission, each PFN subscriber must receive a filed prospectus from the issuer or underwriters of the security;
- the video transmission must be made to a restrictive audience (only PFN subscribers) who would agree not to videotape, copy, or further distribute the presentation;
- the issuer and underwriters must take reasonable steps to ensure that the information in the road show presentation is not inconsistent with the filed prospectus (that each subscriber received);
- each transmission must be preceded and followed by visual statements referring viewers to the prospectus for more information and there also must

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673 See, for a general discussion of the No-Action Letters relating to internet road shows to date, Stephen J. Schulte and Steven J. Spencer, IPO Road Shows in the Electronic Age: SEC No-Action Letters Adressing Use of the Internet and Closed Circuit Systems, Aspen Law & Business Corporation, June 15, 2000.

674 PFN is a wholly owned subsidiary of MSNBC Interactive LLC, a joint venture of the National Broadcasting Co., Inc. and Microsoft Corporation. PFN has fewer than 100 subscribers who are principally registered broker/dealers and investment advisors.

675 Private Financial Network, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶¶ 77,332, 77,675 (Mar. 21, 1997).

676 Id. at ¶ 77,676.

677 For a general discussion of PFN, see The Road Less Traveled, supra, at 5-7.

be repeated visual statements that the transmission cannot be videotaped or copied or used in any manner to sell securities to the public.

The SEC expanded its position in accepting other forms of communication for the use of electronically transmitting roadshows in its No-Action Letter to Net Roadshow, Inc.[678] After the filing of a registration statement, Net Roadshow proposed to provide via the Internet a Web site of roadshows for viewing by qualified investors and underwriting banks. Net Roadshow proposed that to access the Web site and to maintain the integrity of the roadshow as not a prospectus within the meaning of Section 2(a)(10) of the Securities Act, the following preconditions occur:

- the qualified investor must contact the investment bank for an access code to view the roadshow;
- the internet roadshow would be the exact same roadshow as the live presentation;
- the preliminary prospectus could be printed from the Web site;
- before accessing the roadshow, the potential viewer would be advised of, and must agree to, the contents of a standard red herring and the prohibition on distributing any roadshow materials;
- periodic text would flow across the screen of prominent sections; and
- Net Roadshow's fee would not vary with the success or failure of the underlying offer.

Based on the above factors, the SEC indicated it would take a no action position, and that such transmissions would not constitute a prospectus under 2(a)(10) of the Securities Act.[679]

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678 Net Roadshow, Inc. SEC No Action letter, Fed. Sec. L. Rep. (CCH) ¶ 77,367 (Sept. 8, 1997).

679 See also Bloomberg, SEC No Action Letters Ind & Summaries (WSB) #120197011 (December 1, 1997) (SEC takes a no action position over Bloomberg offering similar internet roadshow services). More recently the SEC stated in an interpretative memorandum that, for purposes of the registration requirements only, offshore Internet offers of securities and solicitation activities would not be considered to be made "in the United States" if Internet offerors implement measures similar to those outlined in the Net Roadshow No-Action Letter which are reasonably designed to ensure that such offshore Internet offers are not targeted to the United States or to U.S. persons. See SEC Rel. No. 33-7516 (Mar. 23, 1998).

The SEC visited the issue of Internet roadshows in 1999 when Activate.net Corp. requested a no-action letter for its business of transmitting road shows for public offerings over the internet under the facts and circumstances described below:[680]

- Access to the road shows must be via underwriter given passwords only. The underwriters will agree not to assign passwords unless a registration statement is on file with the SEC, that passwords will only be given if the viewer is someone who the underwriter would customarily invite to a live road show, and each viewer will have been provided with a copy of the statutory prospectus.

- The presentation would be exclusively controlled by the managing underwriters for the offering, and no questions from prospective investors can be pre-screened or edited.

- Activate.net Corp represented that it would not hold any investor or customer funds, participate in the negotiation or structuring of any transactions in which securities are to be offered or sold, prepare any substantive disclosure transmitted during the roadshows, or be responsible for the solicitation of any prospective investors.

Noting that "because regulatory responses to legal issues raised by technological developments may evolve," and therefore its no-action position "may be reevaluated in the future," the Staff of the SEC issued a no-action letter to Activate.net Corp.[681]

In November of 1999, the SEC issued a no-action letter to Charles Schwab & Co., Inc., stating that while it's position "rests on policy considerations alone, including the Commission's goal of reducing selective disclosure of material, offering-related information typically provided during roadshows,"[682] it would not recommend action against Schwab for offering internet road shows with the following requirements:

- password-protected environment;

- available only to accounts that have significant trading experience (at least 24 trades per year) *or* asset accumulation of at least $500,000 equity in household investment positions and to independent registered investment advisers;

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680 Activate.net Corp. request for No-Action Letter. Fed. Sec. L. Rep. (CCH) ¶77,626 (1999).

681 For a discussion of the SEC's response to Activate.net, see, Electronic Road Show Transmission Over Internet Not a Prospectus, Staff Agrees, Securities Regulation & Law Report, Vol. 31, No. 38 (Oct. 1999) at 1318. See, also, Internet 'Road Show' Isn't Prospectus, SEC Says, Corporate Counsel Weekly, No. 39 (Oct. 1999) at 2.

682 SEC No-Action Letter to Charles Schwab & Co., Fed. Sec. L. Rep. (CCH) ¶ 77,650 (dated November 15, 1999).

- only road shows dealing with initial public offerings of securities would be communicated over the internet, and only then after the registration statement had been filed and a preliminary prospectus was distributed;

- the preliminary prospectus will be easily available from the screen displaying the road show, and a statement on the screen will encourage viewers to look at the prospectus;

- Schwab will, to the extent it engaged third-party vendors to promote its internet road shows, abide by the safeguards put upon the third-parties (other than limitations on the qualifications of persons entitled to view the presentation, if they are more restrictive than Schwab's own restrictions); and

- only one version of the live road show will be available on the internet.

The potential benefits of internet roadshows closely track those of PFN, as above.

In February, 2000, however, the SEC, in an attempt to clarify its position, retreated from its broad stance set forth in the Schwab no-action letter[683]. In this follow up letter, the SEC limited its acceptance of Schwab's transmittal of electronic roadshows to the Schwab customers described above to situations where all of the following conditions are met:

- the roadshow may not exclude any material information (e.g., earnings projections) that is intended to be included in any other presentation of the roadshow;

- only one version of the live road show may be available on the internet; and

- the content of the electronically transmitted roadshow must be consistent with the content of the statutory prospectus relating to the offering.

Even with the limitations imposed by the SEC's February, 2000 follow-up letter to Schwab, the SEC's acceptance of electronic road shows will undoubtedly have a substantial effect upon how issuers and underwriters reach prospective investors. These rulings allow American companies and the financial industry to benefit from technology that has never been available before, allowing for a "rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread, and equitable manner."[684]

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683 Charles Schwab & Co., SEC No-Action Letter, Fed Sec. L. Rep. (CCH) ¶77,814 (February 9, 2000)

684 Net Roadshow SEC No Action Letter, supra, at ¶ 77,850.

C. Simultaneous Same Sector IPOs

In 2000, J.P. Morgan lead three separate public offerings and pitched all three deals to investors simultaneously by taking each company on a 10 day roadshow where investors could participate in all three offerings as opposed to the usual one offering.[685] This is a progressive strategy because all three public offerings concerned biotech firms and usually the pushing of so many similar offerings at once by one firm, J.P. Morgan, results in a "cannibalistic effect" as investors often become diluted and invest in only one company in a specific sector.[686] Dilution, however, was not the result of the three simultaneous biotech offerings, rather, some investors, who would normally only invest in one company, invested in multiple companies during the 10-day roadshow.[687] Accordingly, simultaneous same sector IPOs may become a more common occurrence after the success of J.P. Morgan's new strategy.[688]

VII. PLAIN ENGLISH

According to Former SEC Chairman Arthur Levitt, disclosure "has two aspects: the information that is made available to investors, and the information that actually gets across to investors."[689] Information is made available to investors through various disclosure documents, including the prospectus. The SEC wants to make certain that the information contained in these disclosure documents actually reaches investors. In the last few years, there has been a mass migration of investors into our markets, and for that reason, the SEC stresses now more than ever the importance of making disclosure documents more readable. In 1995, Former Chairman Levitt appointed a Task Force on Disclosure Simplification (the "Task Force"). In 1996, the Task Force reported that prospectuses are generally unreadable and contain too much legal jargon. The Task Force found that material information was often buried in an avalanche of trivial information. In its Report on Disclosure Simplification, the Task Force concluded that "today's prospectus has become a legal document to shield against liability, rather than a useful and informative disclosure document."[690]

In an effort to promote clear and accurate disclosure, the SEC has recently adopted and implemented the plain English rule which requires registrants to use plain English principles in the organization and language of the cover page, summary, and risk factors section of

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685 See J.P. Morgan Utilizes Unique Roadshow Strategy for IPOs, Corp. Finan. Wk. Aug. 28, 2000, at 4.

686 Id.

687 Id.

688 Id.

689 SEC Proposes Rules Requiring "Plain English" in Prospectuses, BNA's Corporate Counsel Weekly, Jan. 22, 1997, at 1.

690 Fed. Sec. L. Rep. (CCH) ¶ 85,738, 87,525 (1996).

prospectuses.[691] Many critics of the rationale underlying the rule fear that such "simple" language in such a complex document will expose companies to more liability. The Capital Markets Committee of the Securities Industry Association ("SIA") has taken the position that the stylistic use of plain English should be voluntary, rather than mandated. The SIA noted that "any interpretation of whether or not the words in a prospectus are in plain English necessarily is subjective."[692] The SIA further asserted that the "SEC is not designed or equipped to regulate the use of the English language in this way."[693]

Despite this criticism, the SEC disagrees with the notion that companies will be subject to more liability. In fact, the SEC believes that because plain English results in less confusing and ambiguous disclosure, potential liability will actually be reduced. While the precise language in the document may change, the information will not. In essence, plain English requires drafters to (a) know their audience, (b) know what material information needs to be disclosed, (c) use clear writing techniques to communicate information, and (d) design and structure the document so that it is easy and inviting to read.[694]

A. Know Your Audience

The SEC suggests that you identify the investor groups to whom you are writing. It is important to consider the educational background and financial sophistication of the potential investors. While your audience may include analysts and other industry experts, you must keep in mind that your least sophisticated investors are the people who have the greatest need for a disclosure document they can understand. Therefore, you should tailor your writing style to the audience you plan to reach.

B. Know What Material Information Needs to be Disclosed

In essence, you are required to make a judgment as to the importance of the information that you give and the order in which you present it. You must present all material information in a logical and organized fashion. The cover page should highlight key information about the offering such as the name of the company, the type of security offered, the price and amount offered, and to whom an investor should contact to purchase the securities. The cover page should not contain repetitive information and should be inviting to the potential reader. The summary section should contain a clear, concise, and coherent snapshot description of the most significant aspects of the offering.

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691 See SEC Rel. No. 33-7497 (Jan. 28, 1998). The Rule went into effect and required compliance as of October 1, 1998. Securities Act rule 421(d), within Regulation C, is the Plain English rule.

692 SIA Committee Urges SEC "Plain English" Initiative Should be Voluntary, BNA's Securities Regulation and Law Report, May 2, 1997, at 610.

693 Id.

694 Note that the SEC considered, but declined to adopt rules limiting the length of the summary and the number of risk factors included, or requiring registrants to prioritize risk factors. See SEC Rel. No. 33-7497 (Jan. 28, 1998), at 10.

In addition, the risk factor section should also be written in Plain English without the use of boiler plate language or legalese.

C. Use Clear Writing Techniques to Communicate Information

The plain English rule systematically outlines the structure, design, and language style to be used in prospectus writing.

The new Rule requires (1) the front and back cover pages, (2) the summary, and (3) the risk factors section of prospectuses to comply substantially with six principles of plain English:

- active voice
- short sentences
- definite, concrete, "everyday" language
- tabular presentation or bullet lists for complex material
- no legal jargon or highly technical business terms
- no multiple negatives

In addition to these six plain English principles, the new Rule provides standards which are designed to guide issuers in writing the entire prospectus:

- descriptive headings and subheadings should be used
- reliance on defined terms and glossaries must be avoided
- vague and imprecise "boilerplate" language should be avoided, especially in the risk factors section
- complex information should not be copied directly from legal documents without providing a clear and concise summary explanation
- disclosure repeated in different sections of the document should be avoided
- complex, legalistic presentations (e.g., cascading margins, use of cross references which disrupt text flow) should be avoided

The SEC notes the importance of avoiding dense pages of text. It recommends using a dual column design, because white space relieves the eye and encourages the investor to read the document. The SEC recommends using pictures, charts and graphs as long as they are clear and not misleading. Also, the SEC notes that a question and answer format to answer common questions of investors is most helpful. In addition, drafters should use personal pronouns such as "we" and "you" instead of "the company" or "the shareholder" in order to communicate directly with the readers and engage their attention. The SEC has definitely taken a step in the right direction, and hopefully the

use of these simple stylistic strategies will help to make disclosure more effective and reduce any potential liability.[695]

VIII. CHANGES TO REGULATION S

Regulation S ("Reg S"), which was adopted by the SEC in 1990, contains a general statement that the registration requirements of Section 5 of the 1933 Act do not apply to offers or sales of securities that occur outside the United States. In addition, Reg S provides two safe harbors from registration requirements of the 1933 Act. The first safe harbor is available to the issuers, underwriters, and other market participants involved in the initial distribution process of securities. The second safe harbor applies to offshore resales by people not involved in the distribution process. The principle behind Reg S is that offshore sales of securities do not require the strict reporting requirements that are applicable to domestic sales of securities. In recent years, however, the SEC has become aware of several abusive practices occurring under Reg S where securities are placed offshore temporarily in order to evade registration requirements.[696] Often, issuers rely upon Reg S to sell securities outside of the U.S. to avoid the SEC's strict reporting requirements, and after a short waiting period, the securities are resold back into the U.S.

In an effort to eliminate the abusive practices occurring with offshore sales of securities, the SEC has recently adopted a set of amendments to Reg S which affect offshore sales of equity securities of U.S. issuers.[697] The Reg S amendments:

- classify equity securities, including convertible securities, placed offshore by domestic issuers under Regulation S as "restricted securities" within the meaning of Rule 144;

- align the Regulation S restricted period (renamed the "distribution compliance period") for these equity securities with the Rule 144 holding periods by lengthening it from 40 days to one year, the period during which persons relying on the Regulation S safe harbor may not sell these equity securities to U.S. persons (unless pursuant to registration or exemption);

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695 For more information about Plain English, see Div. of Corp. In., Before & After Plain English Examples and Sample Analyses, Apr. 4, 1998; and see also the SEC's draft of "A Plain English Handbook: How to Create Clear SEC Disclosure Documents." The draft may be found online at the SEC's Web site at http://www.sec.gov. You may also request a hard copy of this draft by calling the Office of Investor Education and Assistance at 1-800-SEC-0330. In addition, for helpful writing hints, see Elements of Style by William Strunk, Jr. and E.B. White (Macmillian, 3d rev. ed. 1981).

696 See SEC Rel. No. 33-7190 (Feb. 20, 1997) (discussing the problematic practices that have occurred since the adoption Regulation S).

697 See Securities Act Rel. No. 7505 (Feb. 17, 1998).

- impose certification, legending, and other requirements, now only applicable to sales of equity securities by non-reporting issuers, on all domestic U.S. issuers' equity securities sold under Regulation S;

- require purchasers of these equity securities to agree not to engage in hedging transactions with regard to such securities unless such transactions are in compliance with the Securities Act;

- make clear that offshore resales under Rule 901 or 904 of equity securities of these issuers that are "restricted securities," as defined in Rule 144, will not affect the restricted status of those securities[698]; and

- Require issuers to report information on Reg S sales occurring after January 1, 1999 on Form 10-Q or Form 10-K, not on Form 8-K within 15 days of the sale as previously had been the case.

While these amendments are welcomed by many who believe the abuses of Reg S need to be eliminated, the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association has a different view. The members of the Committee have recognized the abusive practices cited by the SEC, but they emphasized that they believed that most of the abuses cited did not involve truly offshore transactions, but, rather "were essentially domestic transactions with only a superficial and tenuous claim to offshore status."[699] The Committee argued that the proposed changes to Reg S were too restrictive and not warranted by the perceived abusive practices. Only time will tell if the SEC will be successful in its attempt to curb the excessive abuse that has occurred under the former Reg S.

IX. MANAGEMENT MISCONDUCT AND GOVERNMENT INVESTIGATIONS

Incidences of management misconduct and the possibility or inception of government investigations of alleged wrongdoing present unique disclosure problems and raise complex issues regarding materiality, causation, the federalization of state corporate law and self-incrimination.[700] An August 1988 SEC Interpretive Release warned issuers involved in the "Pentagate" government contracting scandal that, because investors may consider questionable conduct and related government investigations material information, these events could trigger line-item disclosure obligations under the federal securities laws.[701]

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698 Id.

699 ABA and NYSBA Reflect on Regulation S Proposals, Federal Securities Law Reports, May 14, 1997, at 7.

700 For a more complete discussion of materiality and disclosure of "qualitative" information, see George Branch & James Rubright, Integrity of Management Disclosures Under the Federal Securities Laws, 37 Bus. Law. 1447 (1982). See also John F. Olson, Qualitative Materiality — Should Management's Personal Problems Be Disclosed to Shareholders?, Insights, Sept. 1987, at 3.

701 Exch. Act Rel. No. 25951 (Aug. 2, 1988).

Several judicial decisions hold that certain corporate improprieties, previously considered immaterial "qualitative" events for disclosure purposes, may in fact have a potentially adverse quantitative impact on the financial condition of the issuer. The Supreme Court's rejection in Basic of a "constructive immateriality" concept in the mergers context makes a public policy rationale for declaring managerial misconduct per se immaterial susceptible to challenge. Although an issuer has no general duty to disclose, these cases indicate that issuers should seriously consider disclosing corporate misconduct and government investigations thereof (i) pursuant to certain line-item disclosure requirements, (ii) within the ambit of the MD&A if there is a reasonable probability that such developments may adversely affect the issuer's results of operations, or (iii) if required to keep other disclosures from being misleading.[702] Specifically, if a significant portion of an issuer's earnings result from questionable management activity or if the company's financial viability depends on the continuance of that activity, any discussion of those earnings or the issuer's future prospects could be rendered misleading without disclosure of the improper practices.

Since 1991, "beneficial ownership" under §16 of the Exchange Act has been determined by reference to the same definition under Section 13(d), namely, a person or group that has or shares voting or disposition powers. Using this definition, a 1998 decision imposed §16(b) to recapture liability upon a financial advisor who became a member of a "group" by entering into an agreement with certain statutory "insiders" to maximize the value the statutory insiders would receive under a bankruptcy plan of reorganization. The advisors bought and sold stock of the issue within a six month period believing they were into insiders and, indeed, filed a Schedule 13D disclosing all the relevant information. The court, however, found that the advisors became members of a statutory insider "group" because the agreement granted them a right of first refusal over stock held by the insiders and also provided the advisors with a share of the profits from appreciation in the insiders' stock.

A. The 1988 SEC Interpretive Release

In August 1988, the SEC issued an Interpretive Release (the "1988 Release") outlining the disclosure obligations of companies affected by the government's well-publicized inquiry into the "Pentagate" defense contract procurement scandal.[703] Although the Release was prompted by and appeared to be limited to the "Pentagate"

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[702] Note that the Private Securities Litigation Reform Act of 1995 requires that independent auditors look for and assess management's response to indications of potential illegality. See Harvey L. Pitt, Karl A. Groskaufmanis and Vasiliki B. Tsaganos, Director Duties to Uncover and Respond to Management Misconduct, Insights, June 1997, at 5. Where a corporation does not have a proven track record of responding to indications of potential illegality, the auditors may not be able to conclude that the company took appropriate and prompt action in response to then-existing indications of possible illegal actions. Such a result obviously would lead to drastic consequences. See, also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9. While there is no affirmative duty to disclose in MD&A uncharged misconduct, management must consider the likelihood of a charge and the potential effect on the financial situation of the company.

[703] Exch. Act Rel. No. 25951 (Aug. 2, 1988).

probe, commentators agreed that the SEC policy statements applied to all manners of management wrongdoing and government investigations thereof.[704]

The SEC emphasized in the 1988 Release that for the MD&A, traditional registration and reporting line-items[705] and transactional filings such as tender offers and proxy documents require disclosure of government inquiries if an issuer reasonably expects the investigation to have a material impact on the company's business practices or financial condition. According to the SEC, Securities Act Rule 408 and Exchange Act Rule 12b-20 mandate disclosure of alleged misconduct if such disclosure is necessary to keep these filings from being materially misleading. In addition, the SEC indicated that registrants must disclose government inquiries of alleged wrongdoing in the MD&A which could cause a significant change in the relationship between costs and revenues or where the uncertainty caused by an investigation could make historical financial information unpredictable of future operating results or financial condition. The SEC also suggested that the antifraud provisions could create liability for misstatements and omissions regarding such inquiries made outside of SEC filings.[706]

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[704] See Reactions to the SEC Release on Disclosure Obligations Arising from the Defense Procurement Inquiry, Insights, Oct. 1988, at 2.

[705] These line-items include SEC disclosure rules relating to the description of a company's business (Regulation S-K Item 101), of pending legal proceedings (Regulation S-K Item 103), of legal proceedings involving directors, nominees, executive officers, promoters and control persons (Regulation S-K Item 401), and of possible loss contingencies (Article 5-02 of Regulation S-X and FASB #5). With regard to Item 401 of Regulation S-K, the Commission has published proposed amendments to expand the types of legal proceedings required to be disclosed in Commission filings and to increase to ten years (expanding the current five-year provision) the reporting period for such legal proceedings disclosure. Disclosure Concerning Legal Proceedings Involving Management, Promoters, Control Persons and Others, Securities Act Rel. Nos. 33-7106, 34-34923, IC-20670 (Nov. 1, 1994). See United States of America v. Yeaman, Fed. Sec. L. Rep. (CCH) ¶ 90,668 (3d Cir. 1999) (Defendant Yeaman was found guilty of failure to disclose in SEC and NASD filings that he previously had been found to have violated securities laws, even though he was not a named party, but simply the "subject of" the proceeding).

In addition, an issuer is subject to the accounting, record keeping and internal control provisions of the Foreign Corrupt Practices Act (§ 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act). See SEC v. Sundstrand Corporation, No. 90-C20149 (N.D. Ill., May 21, 1990), Lit. Rel. No. 12489 (May 25, 1990), where the Northern District of Illinois entered a final order enforcing the SEC's consent order whereby Sundstrand is permanently enjoined from violating § 13(b)(2)(A) and (B). Pursuant to this order, Sundstrand agreed to appoint a committee to investigate the company's alleged concealment of millions of dollars in overcharges to the Department of Defense, as well as millions of dollars taken as federal income tax write-offs, which were all taken through improper accounting practices. Finally, the court ordered Sundstrand to file with the SEC a report on Form 8-K, to publicly disclose the committee's findings and recommendations.

[706] This was demonstrated by Copley Pharmaceutical, Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 98,695 (D. Mass. 1995) (allegations of bribery rendered a Section 10(b) claim against a pharmaceutical company's officers as to the company's statement that it believed it was in material compliance with FDA Standards sufficiently particular under Fed. R. Civ. P. 9(b)). The antifraud provisions, however, impose no affirmative duty to disclose material events unless a company is trading in its own securities or needs to correct prior statements that were inaccurate when made. See Wander & Pallesen, supra.

According to the 1988 Release, the SEC adopted the Basic materiality analysis for the MD&A by requiring that issuers consider disclosing the possible consequences of a government inquiry "if in light of the associated probabilities and magnitudes, the effects may be material."[707] As noted above, however, the SEC's 1989 MD&A Release specifically rejects this standard and suggests a standard which requires a minimum threshold probability of "more likely than not" before management must disclose information in the MD&A.

Companies subject to a government inquiry may suffer contract cancellations, suspension of contract payments, termination of further government business, or alteration of procedures for obtaining government contracts. Even if not subject to an inquiry, investigations may materially impact companies from additional expenditures incurred or policies changed in connection with defense contract procurement. Given the nature of defense contracting and the dependence of many companies on these contracts, the magnitude of these consequences can be so great that issuers may have difficulty claiming that government inquiries are not material. Therefore, if management cannot determine that these consequences are not reasonably likely to occur, the issuer will have to disclose the investigation in its MD&A.

B. Immateriality Cases

1. Gaines v. Haughton

The Ninth Circuit's decision in Gaines v. Haughton [708] is a landmark for the proposition that management misconduct is immaterial as a matter of law. In Gaines, the court ruled that Lockheed was not required to disclose in a proxy statement payments of "massive" bribes by directors to foreign officials because, absent evidence of kick-backs or other self-dealing, such misconduct was immaterial as a matter of law. The court distinguished acts involving self-dealing which it found presumptively material for §14(a) purposes, and merely offensive corporate behavior or mismanagement, which it ruled immaterial for federal securities law purposes.

The Ninth Circuit reasoned that the nondisclosure of the bribes did not cause any identifiable pecuniary loss to the company, other than the waste of the amounts of the bribes themselves. The court stated that mismanagement and waste of corporate assets are more appropriately redressed through state law breach of fiduciary duty claims. The court refused to boot-strap such state corporate law claims into a federal securities law

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[707] Exch. Act Rel. No. 25951, at 62,126.

[708] 645 F.2d 761 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982).

claim[709] and held that absent self-dealing, illegal foreign payments were immaterial as a matter of law.[710]

2. Weill v. Dominion Resources, Inc.

In Weill v. Dominion Resources [711] a federal district court in Virginia held that certain alleged nondisclosures amounted to no more than mere corporate mismanagement, and were immaterial omissions under federal securities law. The court further expounded upon the policy reasons for holding management misconduct immaterial as a matter of law. In discussing materiality, the court quoted from the U.S. Supreme Court case of TSC Industries v. Northway [712] stating:

> [I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information - a result that is hardly conducive to informed decision making.[713]

3. Charter Medical Corp. v. Cardin

In Charter Medical Corp. v. Cardin,[714] the Fourth Circuit determined that management misconduct was immaterial and need not be disclosed. In this case, Charter alleged that the controlling shareholders and executive officers of Psych Systems, Inc. defrauded Charter by failing to disclose prior to the acquisition of Psych Systems that the president of Psych had been involved in a fraudulent scheme to inflate sales reported in the annual financial statements. Psych's auditors discovered the scheme and corrected the financial statements prior to their public release. Thereafter, Psych acted to isolate the president from the financial affairs of the company. Psych never advised Charter of

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709 Id. at n.33 (citing Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977)) (no implied cause of action exists under Rule 10b-5 for claims of breach of fiduciary duty typically regulated by state law).

710 See U.S. v. Matthews, 787 F.2d 38 (2d Cir. 1986) (absent self-dealing, mismanagement is not material for federal securities law purposes); See also Warner Communications, Inc. v. Murdoch, 581 F. Supp. 1482 (D. Del. 1984) (securities laws do not require parties to publicly admit the culpability of their actions); Amalgamated Clothing and Textile Workers Union, AFL-CIO v. J. P. Stevens & Co., 475 F. Supp. 328 (S.D.N.Y. 1979) (the proxy statement rules do not require management to accuse itself of antisocial or illegal policies), vacated as moot, 638 F.2d 7 (2d Cir. 1980).

711 Fed. Sec. L. Rep. (CCH) ¶ 98,714 (E.D.Va. 1994).

712 436 U.S. 438 (1976).

713 Weill, Fed. Sec. L. Rep. (CCH) ¶ 98,714, at 92, 339 (citing TSC Industries, 426 U.S. at 448).

714 850 F.2d 688 (4th Cir. 1988), cert. denied, 488 U.S. 982 (1988). For a discussion of the facts of the case see The SEC Today Vol. 88-210 (Nov. 1, 1988), and The SEC Today Vol. 88-222 (Nov. 18, 1988).

the president's attempted indiscretion. However, Charter was aware of Psych's poor financial condition. Hence, the alleged omissions pertained only to the president's character.

Charter argued that the president's history of questionable behavior was material in a 1933 Act Section 12(2) context because Charter regarded the president as a key employee and wished to retain him following the proposed merger. In an unpublished opinion the district court granted the defendant's motion for summary judgment and the Fourth Circuit affirmed. Charter maintained that the Fourth Circuit's decision conflicted with other circuit court decisions involving the disclosure of management misconduct. In its writ for certiorari, Charter requested that the Supreme Court clarify materiality standards for management misconduct as it did for merger negotiations in Basic.

Contrary to the plaintiff's allegations, the Fourth Circuit's decision is consistent with prior case law in this area. The information allegedly omitted by Psych did not impact the company's economic condition. The information pertained solely to the quality of the president's character. Consequently, this fact situation would not have been helpful to the Supreme Court in settling the current controversy about the disclosure of management misconduct that has a potentially direct quantitative impact upon an issuer. The Supreme Court denied certiorari.

4. Citron v. Daniell

The Connecticut district court ruled that a company's proxy statement disclosures that the government was investigating its practice of bribing government officials to win defense contracts was sufficient to warn investors that these proceedings could affect its stock price.[715] The court dismissed as "absurd" the plaintiffs' allegations that the company (United Technologies, Inc.), which designed and built jet engines, should have disclosed the bribes in its annual reports. The court stated that it "would be unreasonable to require board members to tell the world they are thieves, unless, of course, they have been charged and/or convicted."[716]

5. Greenstone v. Cambex Corporation

In Greenstone v. Cambex Corporation,[717] a federal district court in Massachusetts held that the defendant, Cambex, did not have a duty to disclose material information about its illegal business practices. Cambex, which engaged in the development, lease, and sale of computer enhancement products, apparently had violated terms of a lease agreement with IBM by removing components of machines owned by IBM Credit Corporation and selling or leasing them to Cambex's customers. The plaintiff asserted

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[715] See Citron v. Daniell, 796 F. Supp. 649 (D. Conn. 1992).

[716] Id. at 654.

[717] Fed. Sec. L. Rep. (CCH) ¶ 96,904 (D. Mass. 1991).

that Cambex's press releases and SEC filings were false and misleading, because they did not disclose that Cambex's illegal practices were the source of revenues described in the press releases and filings. The court agreed that information about Cambex's improper activities was material, but, citing Roeder, held that Cambex had no affirmative duty to disclose this information merely because it was material.

6. U.S. v. Crop Growers

The recent case U.S. v. Crop Growers Corp. similarly follows the reasoning of Citron and Greenstone in finding no duty to disclose untried criminal activities in SEC filings.[718] In Crop Growers, company executives were indicted on numerous counts of illegal federal election activities, and the conspiracy and concealment of such alleged crimes. The 18 count indictment charged the executives with 10 separate counts of failing to disclose the illegal activities in SEC filings. The court dismissed the 10 counts, focusing on the lack of a duty to disclose untried activities and due process. "A fortiori, where a statute or regulation imposes no duty whatever to disclose information, due process concerns require that criminal liability not be based on omission of such information."[719]

7. Gallagher v. Abbott Laboratories

In Gallagher v. Abbott Laboratories, the Seventh Circuit affirmed the district court's adoption of the new materiality standard and ruled that the failure of a pharmaceutical company ("Abbott") to disclose specific details of an ongoing FDA investigation and the receipt of an FDA warning letter was not material.[720] The court reasoned that Abbott's omission is only material when the disclosure of the FDA's investigation would be viewed by the reasonable investor as significantly altering the total mix of information available about Abbott.[721] In this case, the court determined that the history of monitoring , negotiations and inspections between Abbott and the FDA rendered the nondisclosure of yet another FDA investigation inconsequential.[722] Furthermore, the court noted that their determination of non-materiality was affirmed by the lack of market reaction to the eventual disclosure of another FDA investigation.[723]

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[718] U.S. v. Crop Growers, 945 F. Supp. 335 (D.D.C. 1997).

[719] Id. at 345.

[720] Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001), aff'g. Anderson v. Abbott Labs., 140 F. Supp. 2d. 894 (N.D. Ill. 2001). See also supra note 16. In contrast, in a derivative shareholders litigation based virtually on the same allegations and facts, the Seventh Circuit partially reversed the district court's dismissal of the complaint for failure to plead demand futility and held that: (1) the plantiffs' allegations raised reasonable doubt as to whether directors' actions were the product of a valid exercise of business judgment; and (2) the plantiffs' allegations were sufficient to overcome the directors' exemption from liability contained in the company's articles of incorporation. Abbott Labs Derivative S'holder Litig., 2003 WL 1572015 (7th Cir. 2003).

[721] See id.

[722] See id.

The court concluded that if reasonable investors believed the FDA investigation and warning letter altered the total mix of information available about Abbott, there would have been a greater market reaction.[724]

C. Materiality Cases and the Duty to Disclose

1. Roeder v. Alpha Industries, Inc.

Other courts have rejected the rigid analysis set forth in Gaines that management misconduct and government investigations are immaterial as a matter of law. The First Circuit in Roeder v. Alpha Industries, Inc.[725] ruled that information regarding the payment of bribes by Alpha Industries to obtain government subcontracts may have been material to investors notwithstanding the absence of allegations of self-dealing. The court rejected the public policy considerations which had compelled the Gaines court to hold incidences of corporate bribery immaterial as a matter of law. Instead, the First Circuit advocated a case-by-case analysis requiring the balancing of all facts and circumstances, an analysis consistent with that adopted by the Supreme Court in Basic in the mergers context.

The court emphasized that it could not dismiss the misconduct as mere "matters of taste" because "illegal payments that are so small as to be relatively insignificant to the corporation's bottom line can still have vast economic implications."[726] The First Circuit noted that Alpha Industries would suffer devastating financial harm if, due to the misconduct, the company was barred from obtaining future government business, which represented 60%-65% of its sales. Apparently, the magnitude of the potential harm was so great that the court determined that the bribes may have been material even before an indictment.

Despite the foregoing, the First Circuit dismissed Roeder's complaint for failing to establish that Alpha Industries had a duty to disclose the bribes, even if material. Roeder's complaint did not allege any inaccurate, incomplete or misleading disclosures, required or voluntary, made by Alpha Industries. There were no corporate insiders trading on confidential information. Roeder evidently claimed that Alpha Industries had

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723 See id.

724 See id.

725 814 F.2d 22 (1st Cir. 1987).

726 Roeder, 814 F.2d at 26; See also Decker v. Massey - Ferguson, Ltd., 681 F.2d 111 (2d Cir. 1982) (motion for dismissal denied because evidence at trial was required to establish the effect of improper payments on the overall business); SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978) (motion for summary dismissal denied because immaterial payoffs to liquor distributors could economically impact the company's business).

an affirmative duty to disclose all material information.[727] The First Circuit correctly held that no such general duty to disclose exists. Given the court's expansive materiality analysis, however, it would appear that if Roeder alleged that Alpha Industries' MD&A failed to adequately disclose the alleged misconduct and the potential of an adverse impact on the company's financial condition and operating results, his complaint may have survived a motion to dismiss.[728]

2. Craftmatic Securities Litigation

In Craftmatic Securities Litigation,[729] the Third Circuit undertook a rather curious analysis to distinguish between "qualitative" and "quantitative" materiality with respect to management misconduct. The plaintiffs in Craftmatic purchased Craftmatic stock for $8.50 per share in an initial public offering made by the company in early 1986. At the time, Craftmatic sold and marketed various furniture products through direct sales and through independent distributors, to which the company supplied advertising, marketing, and promotional services. Craftmatic's prospectus for this offering included: (1) disclosure of the company's plans to use the proceeds of the offering to expand into new products; (2) statements that the company believed that it was in compliance with both consumer protection laws and a recent Consent Order and Assurance of Voluntary Compliance entered into with the Federal Trade Commission; (3) predictions that the requirements of the Consent Order relating to the company's change in sales practices would not have a material adverse effect on its business; and (4) statements that its past success as a leader in direct sales of "custom-fitted" reclining chairs was due primarily to the effectiveness of its advertising, promotion, and marketing programs.

In 1987, Craftmatic experienced a large operating loss, a decrease in sales and advertising commissions, and the failure of two new product lines. The company also entered into consent orders with the states of Washington, Oregon and Pennsylvania regarding its customer sales practices in those states. The disclosure of these adverse business developments caused Craftmatic stock price to fall to close to $1 per share. Plaintiffs alleged violations of several provisions of the securities laws, asserting that Craftmatic's prospectus was materially misleading. Plaintiffs claimed that Craftmatic should have disclosed in the prospectus its deceptive and unfair sales practices, its resulting violations of consumer protection laws and the Consent Order, the expenses and risks of the new product lines, and a myriad of information regarding management's incompetence and lack of internal controls.

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[727] Roeder relied on the fraud on the market theory in support of his argument that issuers have an affirmative duty to disclose all material information to the public. The First Circuit correctly disposed of this proposition by positing that the fraud on the market theory addresses reliance and not an issuer's duty to disclose.

[728] In light of the 1988 and 1989 SEC Interpretive Releases, the SEC apparently would have required that Alpha disclose in its MD&A the investigation into the bribery and its potential effect on the financial condition of the company unless management could show that an indictment or contract loss was not likely to occur.

[729] 890 F.2d 628 (3d Cir. 1989).

After discussing Sante Fe Industries v. Green [730] at length, the Third Circuit affirmed the district court's dismissal of those claims pertaining solely to management's failure to sufficiently characterize themselves and their programs as inept. The court stated:

Where the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities acts.[731]

The court determined that Craftmatic need not have disclosed that its product research was meaningless, its cost and accounting controls were ineffective, and its management was unfocused. The court also dismissed the plaintiffs' claims that Craftmatic should have disclosed that the deceptive and illegal practices would result in charges being brought against the company and the risks associated with Craftmatic's expansion into new product lines. The Third Circuit held that this information was "sufficiently speculative and unreliable to be immaterial as a matter of law."[732]

The court did find, however, that Craftmatic should have disclosed certain other information which the court believed was beyond the general incompetence of management and was therefore material. Specifically, Craftmatic failed to disclose that:

(1) the success of the advertising, promotion, and marketing programs depended on deceptive, illegal practices;

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730 430 U.S. 462 (1977) (absent misrepresentation or deception the failure to disclose a breach of fiduciary duty is not actionable under Rule 10b-5).

731 Craftmatic, 890 F.2d at 640; See also Chaus Securities Litig., Fed. Sec. L. Rep. (CCH) ¶ 95,646 (S.D.N.Y. 1990) (failure to disclose "garden variety mismanagement" is not actionable under the federal securities laws); Fleet/Norstar Securities Litig., Fed. Sec. L. Rep. (CCH) ¶96,146 (D.C.R.I. 1991) (allegations that bank failed to disclose inappropriate loan loss reserves and unmanageable lending practices constitute claims of internal corporate mismanagement not actionable under the federal securities laws). In contrast, a district court in the Southern District of Florida determined that a bank's failure to disclose imprudent lending practices violated Rule 10b-5. The defendants in First American Bank and Trust v. Frogel, 726 F. Supp. 1292 (S.D. Fla. 1989), caused First American to engage in risky loan practices and to expand in markets outside the traditional realm of commercial banking. The district court conceded that failure to disclose a breach of fiduciary duty does not constitute a violation of the federal securities laws. Nonetheless, the court held that failure to disclose the "quantitative" consequences of the high risk loans and questionable business practices involved in this case did violate Rule 10b-5.

A 1992 Third Circuit case staked out a position somewhere between Fleet/Norstar and First American. In Shapiro v. UJB Financial Corp., Fed. Sec. L. Rep. (CCH) ¶ 96,651 (3d Cir. 1992), the court stated that "mere failure to provide adequate reserves (or to perform competently other management tasks) does not implicate the concerns of the federal securities laws and is normally not actionable." Id. at 93,067. However, the court continued: "if a defendant characterizes loan loss reserves as `adequate' or `solid' even though it knows they are inadequate or unstable, it exposes itself to possible liability for securities fraud." Id.

732 Craftmatic, 890 F.2d at 644, see also Ballan v. Wilfred American Educ. Corp., 720 F. Supp. 241 (E.D.N.Y. 1989) (holding that defendants were not obligated to predict as the "likely" outcome of investigations that indictments would follow, with financial disaster in their train).

(2) the marketing program violated various consumer protection laws and consent orders between Craftmatic and federal and state governments;

(3) the marketing program resulted in an abnormally high level of consumer complaints; and

(4) despite its entry into consent orders resulting from the company's advertising and marketing activities, Craftmatic misrepresented its chairs as "custom-fitted."[733]

The court held that Craftmatic had a duty to disclose this information in its prospectus. The court found that without such disclosure, statements in the prospectus relating to the success of the marketing program and Craftmatic's assertion that the company was in compliance with consumer protection laws were misleading. The Third Circuit refused to dismiss these claims, holding that a reasonable jury could find the omissions material and misleading under §11(a), §12(2) and Rule 10b-5 of the federal securities laws.

The Third Circuit never addressed whether the company's omissions involved information that would cause a "quantitative" impact on the financial disclosures in the prospectus. The fact that the past success of the promotional program was based on illegal practices did not mean the program could not be equally effective without such practices. Also, the court should have inquired whether the violation of the consumer protection laws and the consent orders would result in fines, lost business or disgorgement of past profits. Under the Third Circuit's analysis, almost any statement in Craftmatic's prospectus relating to its business could have been considered misleading. On remand, the district court should inquire whether the omissions were actually "quantitative" information or purely "qualitative" information.

3. Par Pharmaceutical, Inc. Securities Litigation

Par Pharmaceutical, Inc. Securities Litigation [734] illustrates the application of an issuer's duty not to mislead in the context of a government investigation of bribery. In Par, the Southern District of New York held that the existence of an undisclosed bribery scheme to obtain early FDA approval of new generic drugs could render Par Pharmaceutical's statements regarding FDA approval of their products misleading. From 1986 to 1988 Par Pharmaceutical and its 60% owned subsidiary, Quad Pharmaceutical, allegedly paid several bribes to FDA officials to secure early required approval for its products and to delay approval of competitors' products. During this time, Par Pharmaceutical saturated the company's SEC filings, reports to shareholders and press releases with information regarding the FDA approvals and record sales and earnings.

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[733] Craftmatic, 890 F.2d at 640.

[734] 733 F. Supp. 668 (S.D.N.Y. 1990).

Par not only disclosed the number of approvals received in a given year, but also compared those numbers to competitors' approval rates and to approvals received by both companies in previous years. Further, Par attributed its healthy financial performance to this steady flow of FDA approvals and used its approval rate as evidence for future success.

In June 1988, Congress began an investigation into the FDA generic drug approval process. Par's records were subpoenaed in connection with the investigation in July 1988. Par's Quarterly Report, issued in August 1988, acknowledged the investigation. In an October press release, Par disclosed that Par and Quad were targets of the investigation but the company did not believe this would have an impact on the business. In April 1989, officers of the two companies agreed to plead guilty to bribery charges and, in July 1989, Par and Quad agreed to plead guilty to bribery, facing fines of up to $500,000 each.

The market value of Par's stock, which had traded as high as $27.25 during the class period, fell to $8 in April 1989. Plaintiffs alleged that Par's public touting of its competitive advantage in obtaining quick FDA approvals and Par's earning performance were false and misleading and therefore violated Rule 10b-5. Plaintiffs claimed that the company should have disclosed that the approval rate advantage was due to the illegal bribes, not any expertise or business acumen, and that the discovery or termination of the bribery scheme would profoundly harm Par's sales and earnings. The defendants moved to dismiss the complaint.

a. Predictions and Speculations

The district court dismissed the plaintiffs' allegations that Par should have disclosed the consequences associated with the cessation or discovery of the bribery scheme. The court held that failure to disclose such "predictions" cannot support Rule 10b-5 liability because the company did not have an obligation to speculate on the many potential ramifications of this scenario, ranging from minor setbacks to complete ruin. This could, however, be the exact type of information required to be disclosed in an issuer's MD&A by the SEC 1988 Release and SEC 1989 MD&A Release. Given the Third Circuit's similar analysis in Craftmatic, these cases may signify that this is an area where the courts will not impose Rule 10b-5 liability even if the SEC would require a line-item disclosure in the MD&A. Once again, this claim may have survived a motion to dismiss had plaintiffs alleged an inadequate MD&A.

b. Logical Nexus

Curiously, the district court determined that the defendant's statements could be considered misleading as to Par's ability to obtain FDA approval. The court stated that a jury could find that Par's glorification of its FDA approval rate could have conveyed to a reasonable investor "the false impression that Par had a particular expertise in

obtaining FDA approvals constituting a legitimate competitive advantage over other companies and that this advantageous expertise was responsible for its success in obtaining FDA approvals."[735]

The district court also rejected the defendants' argument that there was no "logical nexus" between the bribery scheme and Par's earnings, sales or FDA product approval. The court held that, contrary to the defendants' assertion that any connection was pure speculation, one of the questions for the jury was whether Par's earnings, sales, and product approvals did in fact result from the bribery of the FDA officials.[736] Given the FDA approval pattern for Par's products, a jury could probably link the bribery to FDA approvals and resulting increased earnings.[737] Consequently, Par's omissions would meet the standard of "quantitative" materiality, because the loss of the FDA approvals resulted in significantly decreased sales and earnings.

D. Suggested Analysis of Management Misconduct and Government Inquiries

After the Gaines decision it appeared that disclosure issues relating to management integrity were settled. In view of the 1988 SEC Interpretive Release and the Roeder decision, management misconduct and government investigations can no longer be dismissed out-of-hand as immaterial as a matter of law. Instead, issuers must carefully examine these matters to determine whether they could adversely affect the issuer's bottom-line financial performance. If material, issuers must then decide whether they have a duty to disclose management misconduct or government investigations due to a line-item requirement or in order to make other disclosures accurate and complete. Insiders must also disclose any confidential information they have relating to such activities before trading in the company's stock.

The above decisions and the case-by-case analysis adopted therein are consistent with the Supreme Court's decision in Basic, rejecting the constructive immateriality doctrine for preliminary merger negotiations. Several of these cases, however, may contradict the proposition set forth in Santa Fe Industries, Inc., v. Green,[738] that claims of mismanagement involve state law actions which should not be boot-strapped to federal

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735 Id. at 678.

736 See Greenfield v. Professional Care, Inc., 677 F. Supp. 110 (E.D.N.Y. 1987) (holding that failure to disclose a scheme to defraud the New York medicaid system and the state investigation thereof rendered the company's financial disclosures misleading, because reported earnings were illegally obtained).

737 The court noted that prior to the inception of the alleged bribery scheme, Par's success in obtaining FDA approval had been limited. During the alleged bribery period, Par's and Quad's rapid approval rate increased dramatically along with earnings and sales. When the alleged bribes stopped, the pace of approvals subsided, accompanied with a drop in earnings and sales.

738 430 U.S. 462 (1977).

securities laws claims by alleging nondisclosure of the mismanagement.[739] In a rather disingenuous fashion, the Craftmatic court attempted to avoid Santa Fe by requiring the disclosure of the financial consequences of illegal acts rather than of the acts themselves, side-stepping the issue of what constitutes "quantitative" versus "qualitative" information.

Unfortunately, issuers still have few guidelines for gauging materiality and making disclosure decisions regarding management misconduct (whether alleged or actual) and government investigations.[740] From a practical standpoint these incidents should be treated no differently than any other corporate development. Conduct involving self-dealing or other breaches of trust generally should be presumed material. For other questionable activity, facts relating to management wrongdoing should be examined from an economic and financial standpoint to determine whether they meet the criteria of quantitative materiality.[741]

When the duty to disclose government investigations arises outside of the MD&A, issuers should employ the Texas Gulf Sulphur probability/magnitude analysis to determine whether illegal conduct or a government investigation thereof would be considered material. The issuer should focus on whether fines, disgorgement of profits, the loss of a substantial amount of business, or any other quantitative impact on liquidity, capital resources, or results of operations could result from a conviction or consent decree. In deciding whether the information is material, the amount at risk should be tempered by the likelihood of the government's success in obtaining an indictment or conviction.

When determining what to disclose regarding government inquiries in the MD&A, an issuer should first determine whether the inquiry more likely than not will

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739 This contradiction was explicitly noted in Weill v. Dominion Resources, Inc., Fed. Sec. L. Rep. (CCH) ¶ 98,714 (E.D. Va. 1994).

740 The 1988 Interpretive SEC Release clarifies disclosure obligations of government investigations as they fall within the current rubric of the securities laws, but does not offer any real resolution of the qualitative/quantitative debate. Although case law tends to hint that disclosure of management misconduct and government investigations cannot be completely dismissed, current federal securities laws do not actually compel the disclosure of government investigations. In fact, in 1994, when the SEC proposed amendments to the Securities laws, it did not even indicate that management misconduct should be disclosed. The issue of disclosure of government investigations was never addressed. See Harvey L. Pitt, Karl A. Groskaufmanis and Vasiliki B. Tsaganos, "Director Duties to Uncover and Respond to Management Misconduct," Insights, June 1997, at 8; See also SEC Release No. 33-7106 (Nov. 1, 1994). Note also that the Reform Act now requires an issuer's accountant to report to the issuer any illegal act it detects during the course of its audit and to resign and/or notify the Commission if the issuer ignores the accountant's report. Section 10A of the Exchange Act and Rule 10A-1. See, also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9.

741 See ABC Arbitrage Plaintiffs Group v. Tchuruk, Fed. Sec. L. Rep. (CCH) ¶ 91,915 (5th Cir. 2002) (affirming a district court opinion to dismiss a fraud claim on materiality grounds because the alleged misstatements involved amounts of money that were immaterial to the company's earnings).

result in sanctions, penalties, or other adverse financial consequences.[742] If such a result is not likely, the inquiry need not be disclosed. If management cannot make such a determination, management should attempt to quantify the impact of such sanctions, penalties, or consequences on the companies' financial condition and operations, as if they were certain to occur. If management believes that a reasonable investor would consider the impact of such potential consequences significant in light of all the circumstances, the MD&A should describe the government investigation.

Finally, issuers should examine both required and voluntary statements which could be rendered misleading by omissions of information relating to management misconduct or potential government inquiries. In light of the Par and Craftmatic decisions, courts will likely treat corporate improprieties and government discovery thereof much the same as any other negative business development. In this regard, issuers should review this type of information in the manner suggested earlier for the disclosure of general business developments and risks.

X. DISCLOSURE OF STOCK ACCUMULATION PROGRAMS AND "GREENMAIL" NEGOTIATIONS IN SCHEDULE 13D

As mergers, acquisitions, and hostile offers return to the landscape, a review of the 13D cases in these areas is appropriate. Several cases, including Phillips Petroleum Securities Litigation, suggest that third parties who file a Schedule 13D or otherwise make public statements regarding a takeover target have a duty to "promptly" amend their filings to disclose "greenmail" discussions at inception. The plaintiffs in these cases allege that bidders have disclosure obligations under Rule 13(d) which parallel the line-item disclosure obligations imposed upon targets by Rule 14d-9. These decisions also reveal that a target's management may be liable for aiding and abetting the outsider's fraud if the target fails to disclose the negotiations of its own accord.

These decisions are worth remembering in light of the increased activity in hostile offers. The SEC's victory in SEC v. First City Financial Corp., Ltd.,[743] confirms that the SEC will not tolerate any failure to comply with the Schedule 13D filing requirements in a hostile takeover context. The SEC's enforcement actions against Macmillan, Inc. and Sequa Corporation also illustrate that the SEC will scrupulously review line-item disclosure regarding defensive

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[742] In determining materiality, Bromberg and Lowenfels suggest that issuers distinguish between an informal versus a formal investigation. Alan R. Bromberg & Lewis D. Lowenfels, Disclosure of Government Investigations, Insights, June 1994, at 17, 19. A formal investigation by the SEC, grand jury, or other agency is more likely to be material. Id. However, its materiality also depends on whether the company is a "target" of the investigation or only a "subject." Id. An action is more likely to be taken against a target, and thus, materiality is more probable. Id.

[743] 890 F.2d 1215 (D.C. Cir. 1989).

measures and will vigorously enforce the requirement that investors promptly amend their Schedule 13D filings to disclose material changes in investment intentions.[744]

Since 1991, "beneficial ownership" under §16 of the Exchange Act has been determined by reference to the same definition under Section 13(d), namely, a person or group that has or shares voting or disposition powers. Using this definition, a 1998 decision imposed §16(b) recapture liability upon a financial advisor who became a member of a "group" by entering into an agreement with certain statutory "insiders" to maximize the value the statutory insiders would receive under a bankruptcy plan of reorganization. The advisors bought and sold stock of the issuer within a six month period believing they were not insiders and, indeed, filed a Schedule 13D disclosing all the relevant information. The court, however, found that the advisors became members of a statutory insider "group" because the agreement granted them a right of first refusal over stock held by the insiders and also provided the advisors with a share of the profits from appreciation in the insiders' stock.

A. Disclosure of "Greenmail" Negotiations

1. Phillips Petroleum Securities Litigation

a. The Third Circuit Opinion: Reckless Statements

The Third Circuit in Phillips Petroleum Securities Litigation [745] concluded that T. Boone Pickens' Mesa Partnership may have defrauded shareholders of Phillips Petroleum by agreeing to a buy-out proposal after Mesa had specifically stated in public and in a Schedule 13D that it would not sell its shares back to Phillips "except on an equal basis with all other stockholders". Judge Sirica vacated the lower court's summary judgment order, declaring that a jury could reasonably find that Mesa's "equal basis" statements were reckless when made. The court also held that there existed a genuine issue of material fact as to whether Mesa had any intention from the outset to honor such statements.

On October 22, 1984 Mesa announced a 5.7% stake in Phillips and launched a hostile tender offer for the remaining shares. Pickens then appeared on the nationally televised MacNeil/Lehrer News Hour denying his reputation as a "greenmailer" and affirming statements in the Schedule 13D that Mesa would sell out to Phillips only if all shareholders received the same offer.

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[744] The SEC's concern regarding line-item disclosure is further evidenced by the March 6, 1989 Release proposing amendments to Schedules 13D, 14D-1, 14B and 13E-3 to require disclosure regarding "substantial equity participants" in filing persons involved in control transactions. See Exch. Act Rel. No. 26599 (Mar. 6, 1989). Although the SEC sought comments on this proposal, no further action was taken.

[745] 881 F.2d 1236 (3d Cir. 1989).

Phillips countered by pursuing a vigorous legal defense and by engaging in settlement discussions with Mesa beginning December 21, 1984. The evidence showed that on several occasions during the negotiations Mesa rejected settlement proposals favorable to Mesa on the ground that all shareholders would not be treated equally. When Phillips offered a plan of recapitalization cashing out Mesa and providing a preferred exchange offer for all other shareholders, Mesa demanded a valuation opinion by independent advisors that the proposed exchange offer gave shareholders value equal to the cash price to be paid Mesa for its shares. On December 23, 1984, Phillips and Mesa agreed to a recapitalization plan which required that Mesa sell its shares to Phillips for cash prior to completion of the plan.

The district court rejected the plaintiffs' claim that Mesa defrauded Phillips shareholders by agreeing to the recapitalization plan and the Mesa buy-out after having made the "equal basis" statements. Specifically, the district court ruled that plaintiffs could not establish scienter because nothing in the record indicated that the equal basis statements made by Mesa were untrue when made. The district court held that "so long as the statements regarding equal value basis were an accurate reflection of the present intent of [Mesa] when made, the statements are not actionable under Section 10(b)."[746] The court also rejected the plaintiffs' promissory estoppel claim that they reasonably relied on the continuing applicability of Mesa's earlier statements of intent that were never publicly updated.

The Third Circuit agreed with the district court that Mesa's statement of intent with respect to "equal basis" need have been true only when made and that a subsequent change of intent would not, by itself, give rise to a cause of action under Rule 10b-5. Judge Sirica also found that the record established that Mesa had promptly announced and disseminated its change of intent as required by Section 13(d). However, the Third Circuit vacated the district court's order of summary judgment based upon its conclusion that Mesa's equal basis statements may have been "reckless" and an "extreme departure from ordinary care," satisfying plaintiffs' burden of establishing scienter. The court noted:

> Even though they needed only be true when made, such unequivocal statements [providing no contingency for changing circumstances] presented an obvious danger of misleading the public — because they can be read as a

[746] Phillips Petroleum Securities Litig., 697 F. Supp. 1344, 1352 (D. Del. 1988).

> statement by [Mesa] that, no matter what happened, it would not change its intentions.[747]

The Third Circuit also determined that the record contained circumstantial evidence supporting the plaintiffs' allegations that Mesa had no intention from the outset to honor the equal treatment statements. Since a jury could reasonably conclude that the proposed recapitalization was an insufficient basis to cause Mesa to change its intent, the district court's entry of summary judgment for failure to address evidence of scienter was incorrect and vacated.

b. The District Court on Remand: Materiality and Causation

On remand, Mesa again moved for summary judgment, claiming that the "equal basis" statements were not material and that the alleged misrepresentations did not proximately cause plaintiffs' injury. Mesa quoted the Third Circuit's statement that "reliance upon a mere expression of future intention cannot be 'reasonable,' because such expressions do not constitute a sufficiently definite promise."[748] Mesa also urged that because the "equal basis" statements were inherently subject to change and constituted an insignificant portion of Mesa's tender offer announcement, they were immaterial as a matter of law.[749] According to Mesa, the stock price movement was due to shareholders' concerns about the anticipated tender offer and not the "equal basis" statements.

The district court, however, found several factors that could support a jury determination that the statements were material. The court noted that (1) Mesa's general intentions were subject to Schedule 13D disclosure requirements, (2) the one-page press release announcing the tender offer included reference to the "equal basis" statements, (3) Pickens discussed and explained the "equal basis" statements in the MacNeil/Lehrer interview, and (4) due to Pickens' reputation as a greenmailer, the "equal basis" statements lent credibility to the tender offer. Consequently, the evidence was sufficient to create a question of fact as to the materiality of the statements in relation to Mesa's attempted takeover.

The district court also rejected Mesa's defense that the plaintiffs had failed to establish proximate cause. Because Mesa's alleged material misrepresentations were disseminated in a well developed and open

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747 Phillips Petroleum Securities Litig., 881 F.2d at 1246.

748 Phillips Petroleum Securities Litig., 738 F. Supp. 825, 831-32 (D. Del. 1990).

749 Id. at 832.

securities market, the plaintiffs were entitled to a rebuttable presumption of reliance, encompassing both transaction and loss causation. Mesa had failed to rebut this "fraud on the market" presumption by showing (i) that the market did not respond to the misrepresentation, (ii) that the price difference was not a result of the fraud, (iii) that the plaintiff knew the representation was false, or (iv) that plaintiff would have made the purchase regardless of the undisclosed information.

2. Lou v. Belzberg

A federal court in New York has held that, as a matter of law, a Schedule 13D could not be considered misleading for failing to disclose a "greenmail" motive for the purchase of the shares arising out of the First City Financial/Ashland incident.[750] Contrary to the other cases discussed herein, Lou v. Belzberg [751] suggests that if the Schedule 13D discloses that the stockholder may dispose of shares of stock, the possibility of selling those shares back to the issuer at a profit is an obvious conclusion that need not be explicitly stated.

On March 25, 1986, after informing Ashland that it had acquired a 9% stake in the company, First City sent a letter to Ashland's Chairman stating that First City was "prepared" to acquire all of the outstanding stock of Ashland for $60 per share. That same day, Ashland's announcement of First City's holdings increased Ashland's stock price per share by $3.25 to $52. Ashland immediately rejected First City's offer and initiated defensive measures, including intensive efforts to obtain passage of a state anti-takeover statute.

First City filed a Schedule 13D on March 26 stating that (1) it had acquired 9.2% of Ashland's common stock, (2) it had requested a meeting with Ashland to discuss a possible acquisition, and (3) it intended to propose at the meeting a price of $60 per share to acquire all of Ashland's common stock, pending Ashland board of director approval. The March 25 letter to Ashland was attached as an exhibit to the Schedule 13D. First City also stated that depending on Ashland's receptivity to its offer and other available market opportunities "it may increase or decrease or continue to hold or to dispose of its position in the Issuer and may seek to obtain representation on the Issuer's board of directors."[752]

On March 27, First City filed under the Hart-Scott-Rodino Act seeking antitrust clearance to acquire more than 50% of Ashland's stock. By March 31, Ashland had proposed, as of a "restructuring" plan, to purchase First City's shares for $51 per share, $.50 per share less than the current market price. First City agreed, entering into a ten-

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[750] See SEC v. First City Financial Corp., 890 F.2d 1215 (D.C. Cir. 1989), discussed infra Section X.B.I.

[751] 728 F. Supp. 1010 (S.D.N.Y. 1990).

[752] Id. at 1013.

year standstill agreement not to purchase any voting shares of Ashland. The next day Ashland's stock fell slightly to $49.75 per share. The transaction was concluded by April 2, when First City amended its Schedule 13D.

Plaintiffs sued under Rule 10b-5, alleging that First City's Schedule 13D was materially false and misleading because First City never intended to acquire all of the Ashland stock, but rather intended to "greenmail" Ashland into buying back its stock at a premium. Plaintiffs also alleged that First City implied in its Schedule 13D that it could obtain financing for the acquisition, when in fact it knew it could not. Defendants moved for summary judgment.

The court granted summary judgment with respect to plaintiffs' claims of a "greenmail" motive, finding that First City had complied with the requirements of Schedule 13D and as a matter of law made no material misrepresentation or omissions with respect to its holdings in Ashland. The court noted that First City adequately disclosed accurate information regarding its 9.2% position in Ashland, its proposal to acquire all of the Ashland's stock for $60 per share, and that it might increase, decrease, or dispose entirely of its holdings in Ashland. The court stated that it was self-evident that First City might sell its shares at a profit. Schedule 13D did not require First City to disclose this potential outcome in such pejorative terms as "greenmail." This conclusion may be at odds with other cases, which seem to require more specific disclosure of intent in Schedule 13D filings.

Curiously, the court concluded that First City may have misled investors about its preparedness to finance the acquisition of all of Ashland's stock. Despite clear and unequivocal disclaimers in the Schedule 13D stating that First City had not secured financing for the transaction, the court held that there existed triable issues of fact regarding First City's intent to misrepresent its ability to consummate the proposed acquisition. It is unclear what more First City could have disclosed to convey that its financing was conditional. Regardless, the court dismissed plaintiffs' claim with leave to amend because the complaint had not been pled with sufficient particularity.

3. Kamerman v. Steinberg

The federal court in New York reaffirmed its decision in Belzberg about the disclosure of "greenmail" intentions in a Schedule 13D by granting the defendants motion for summary judgment in Kamerman v. Steinberg,[753] a case arising out of Saul Steinberg's attempted takeover of the Walt Disney Corporation and the subsequent sale of his Disney holdings back to the company at a substantial premium. Citing Belzberg, the Kamerman court held that Steinberg's Schedule 13D filings sufficiently disclosed the possibility of a sale to the company because Steinberg had reserved the right to sell all or

[753] 744 F. Supp. 59 (S.D.N.Y. 1990). For a full discussion of the facts of this case, see, Kamerman v. Steinberg, 681 F. Supp. 206 (S.D.N.Y. 1988).

some of his shares in the 13D.[754] The plaintiffs failed to adequately support their allegations that defendants' intention at the time of the filing of the Schedule 13Ds was to "greenmail" Disney.

The events began on March 28, 1984 when defendants filed a Schedule 13D disclosing that they had acquired 6.3% of Disney's common stock, stating that their purpose was for "investment" but that they also reserve the right to dispose of all or a portion of such Securities on terms and at prices determined by them . . . [and that they] reserve the right at any time to cease being passive investors if in their judgment such action becomes necessary or desirable to protect or enhance the value of their investment.[755]

Defendants filed three amendments to this Schedule 13D, each showing an increase in their holdings of Disney stock but no change in their stated purpose of such holdings. On April 25, a fourth amendment was filed indicating that defendants were seeking permission under the Hart-Scott-Rodino Act to acquire up to 5,467,000 additional shares of Disney common stock. One week later, defendants purchased 1,000,000 additional shares of Disney stock, increasing their holdings from 9.3% to 12.2% of the company's common stock.

Meanwhile, Disney began to take action. On May 17, 1984, the company announced the purchase of Arvida Corporation, a Florida real estate company, for 2.6 to 3.8 million shares of Disney stock. Defendants responded by amending their Schedule 13D on May 25, indicating that they would no longer remain passive investors, but would consider courses of action to take control of Disney. Disney, in turn, announced its agreement to acquire Gibson Greetings, Inc.

On June 8, defendants initiated a tender offer for 49% of Disney's stock at $67.50 per share, or $72.50 per share if Disney endorsed the tender offer and canceled the Gibson Greetings acquisition. By June 11, Disney had agreed to repurchase defendants' stock for $70.83 per share plus reimbursement of $28 million in expenses. Defendants filed their final Schedule 13D on June 13, 1984. After six years of litigation and a settlement with the class of plaintiffs who purchased Disney stock after May 24, 1984,[756] the defendants moved for summary judgment of the Kamerman class action for plaintiffs who had purchased their Disney stock between March 28 and May 24, 1984.

In granting the defendants' motion for summary judgment, the court distinguished the situations in Belzberg and Kamerman from that in Seagoing.[757] In Seagoing, the court found that the defendants' motives were not passive at the time the Schedule 13D was

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754 Kamerman, 744 F. Supp. at 60.

755 Kamerman, 681 F. Supp. at 209.

756 See Brown v. Steinberg, Fed. Sec. L. Rep. (CCH) ¶ 95,493 (S.D.N.Y. 1990).

757 See infra notes and accompanying text discussing Seagoing.

filed. To the contrary, the court found in Kamerman that plaintiffs failed to demonstrate that Steinberg's motives were not that of a passive investor when he filed the 13Ds in question.

The court stated that most of Steinberg's actions, both during and after the class period, supported the contention that Steinberg was merely "keeping his options open" and pursuing the most profitable avenues. These actions, including the block purchase of the 1,000,000 shares, could have indicated an intent to take control of Disney as much as an intent to force the company to repurchase the shares at a premium. The court concluded that it was unreasonable to use hindsight to infer from an end result that Steinberg's intention from the beginning was to reach that end result.

4. Seagoing Uniform Corporation v. Texaco

In Seagoing Uniform Corporation v. Texaco,[758] the district court refused to dismiss a claim by a Texaco shareholder alleging that the Bass brothers of Texas violated Section 13(d) by failing to disclose in a Schedule 13D their true speculative intentions in acquiring Texaco stock. On January 18, 1984, just days after Texaco announced its acquisition of Getty Oil, the Bass investor group filed a Schedule 13D disclosing their ownership of Texaco stock and stating that their purchase was "simply for investment purposes." The plaintiff alleged that the Bass group actually intended to "greenmail" Texaco.

The plaintiff submitted that the Bass group had met with Texaco's chairman and chief executive officer to discuss a buy-back deal as early as May 1982, when they owned slightly less than 5% of Texaco stock. The Bass group allegedly acquired additional Texaco shares, and triggered the Schedule 13D filing requirement, solely to drive up the price of Texaco stock and pressure Texaco management to repurchase their stock. The plaintiff also asserted that the Bass defendants continued negotiations with Texaco senior officers regarding the sale of their stock after the Schedule 13D filing and several amendments thereto.

The plaintiff maintained that the Bass group's false and misleading Schedule 13D induced plaintiff to purchase Texaco stock at an artificially inflated price. The plaintiff also alleged that Texaco aided and abetted the Bass group's fraud by issuing a press release implying that the Basses were merely passive investors, even though Texaco had knowledge to the contrary.

The district court rejected the Bass group's defense that because the parties had not reached an agreement in principle, the negotiations were not material and need not have been disclosed. The court determined that the negotiations may have been material under the flexible standard adopted by the Supreme Court in Basic. The court also noted that, regardless of whether the discussions were material and whether a duty to disclose

[758] 705 F. Supp. 918 (S.D.N.Y. 1989).

ever arose, the Bass investors had "a duty to speak the full truth" when it undertook to say anything. The court ruled that a jury could find that the Bass group's failure to disclose the negotiations in the Schedule 13D, and Texaco's failure to disclose them in its press release, constituted a failure to reveal the full truth actionable under Rule 10b-5.[759]

5. Fry v. Trump

In Fry v. Trump,[760] the district court refused to dismiss a claim that Donald Trump defrauded shareholders of Bally Manufacturing Company by filing a false and misleading Schedule 13D which failed to disclose that Trump allegedly intended to "greenmail" the Company. On November 24, 1986, Trump's Schedule 13D disclosed that he had acquired 9.9% of Bally "for the purpose of making a significant investment in the company." Trump also allegedly made various false public statements denying that he was a "greenmailer" and claimed he was looking out for the interests of all Bally shareholders.

In response to Trump's Schedule 13D filing, Bally management feverishly erected defensive measures and, as a stalling tactic, arranged meetings with Trump to discuss a friendly takeover. Bally subsequently signed a contract to purchase the Golden Nugget, and Trump sued to enjoin the transaction as an illegal entrenchment device. Throughout these maneuvers, Trump and Bally allegedly continued negotiations to resolve their dispute. On February 23, 1987 the parties announced that Bally would buy out Trump at a premium, and that Trump had agreed to drop his legal claims and had executed a ten-year standstill agreement.

Bally shareholders sued both the Bally directors and Trump, alleging that the repurchase transaction constituted a breach of fiduciary duty, waste of corporate assets and illegal payment of "greenmail." The district court found that the plaintiffs stated a valid claim against the Bally directors and also against Trump for aiding and abetting the directors' breach of fiduciary duty.

The court also refused to dismiss the plaintiffs' claim that Trump violated Rule 10b-5 by making misleading public statements that he was not a "greenmailer" while he was actually engaged in repurchase negotiations. Finally, the court ruled that the Bally directors may have aided and abetted Trump's Rule 10b-5 violation by agreeing to repurchase his shares without first disclosing the negotiations.

The court declined to determine whether Trump had an initial duty to disclose the Bally negotiations, without more. The court questioned whether the rationale of the Supreme Court's decision in Basic, that preliminary merger negotiations need not be

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[759] No private cause of action for damages exists under Section 13(d). However, the court ruled that the plaintiff could rely on Section 10(b) because it had alleged that both the Bass group and Texaco had acted with scienter and that it had reasonably relied upon the alleged misrepresentations.

[760] 681 F. Supp. 252 (D.N.J. 1988).

disclosed, applies to repurchase negotiations. The court did determine that even if Trump had no initial duty to reveal the negotiations, he was not entitled to intentionally mislead shareholders by making false statements with respect thereto.

The district court also ruled that even if Trump's initial Schedule 13D and public denials of "greenmail" were accurate when made, he had a duty to update such statements once they "became materially misleading in light of subsequent events," that is, once he entered into repurchase negotiations.[761] The court did not elaborate whether this duty to update arose under Section 13d or was a broader obligation under Rule 10b-5. Section 13d may have imposed upon Trump an obligation to amend his Schedule 13D to disclose the repurchase negotiations. However, the court's suggestion that Rule 10b-5 imposes a general duty to update is ill-founded.

B. Disclosure of Stock Accumulation Programs

1. SEC v. First City Financial Corporation, Ltd.

The decision by the Court of Appeals for the District of Columbia in SEC v. First City Financial Corporation, Ltd.[762] represents a major victory for the SEC in its efforts to enforce the Section 13(d) filing requirements. The SEC charged that First City, a Canadian company controlled by the Belzberg family and its president, Marc Belzberg, deliberately violated Section 13(d) by failing to disclose an informal "put-call" agreement with Bear Stearns which pushed First City's beneficial ownership of shares of Ashland Oil Company above 5%. The court rejected the defense of First City and Belzberg that Bear Sterns had acquired the Ashland shares for its own account and without direction of First City.

In February 1986, First City began accumulating shares of Ashland stock after a New York stockbroker had advised Marc Belzberg that Ashland was a sensational opportunity, well-suited for the "Sam Belzberg Effect." By February 28, First City had accumulated 1.4 million shares, or just over 4.9% of all Ashland stock, largely through secret nominee accounts. On March 4, Belzberg telephoned Alan Greenberg of Bear Stearns and discussed Ashland. This phone discussion was the centerpiece of the litigation. The SEC claimed, and Alan Greenberg testified, that Belzberg instructed Bear Stearns to buy Ashland shares for First City's account. Belzberg, on the other hand, maintained that he only suggested Bear Stearns buy for its own account.

Immediately after the fateful phone conversation Bear Stearns purchased 20,500 Ashland shares. If purchased for First City, those shares would have pushed First City's ownership of Ashland stock over 5% and triggered the 10 day filing period of Section 13(d). Between March 4 and 14, Bear Stearns purchased an additional 330,700 Ashland shares.

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761 Id. at 258 (citing Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984)).

762 890 F.2d 1215 (D.C. Cir. 1989).

On March 17, Belzberg called Greenberg and arranged a written put/call agreement for 330,700 Ashland shares accumulated by Bear Stearns. When delivered to Belzberg several days later, the "strike price" which Bear Stearns was charging First City was $43.96 per share, almost $500,000 below the market price of $45.37 per share. After First City's SEC compliance officer advised Belzberg that the below-market strike price created an inference that First City was the beneficial owner of the shares before March 17, Belzberg called Greenberg and arranged for a strike price of $40.00 per share, still almost $450,000 below the market price.

Between March 17 and 25, Bear Stearns bought another 890,100 Ashland shares for First City by using several put and call agreements. After these purchases, Belzberg proposed a "friendly" takeover of the company which Ashland rejected. On March 25, Ashland issued a press release disclosing that First City held between 8% and 9% of Ashland's stock. The next day First City filed a Schedule 13D indicating ownership of 9% of Ashland stock and disclosing its intent to launch a tender offer for all remaining shares at $60 per share. On March 31, Ashland bought out First City at $51 per share, resulting in a profit of $15.4 million for First City.

The case turned on the question whether the put/call agreement between First City and Bear Stearns was entered into on March 4, (the date of the Belzberg-Greenberg phone call) as the SEC claimed, or on March 17 (the date the formal document was delivered) as First City argued. If the agreement was entered into on March 4, First City should have filed a Schedule 13D by March 14, almost two weeks before its initial filing on March 26. The court concluded that the circumstantial evidence showed an informal agreement on March 4.

The court found compelling and inexplicable the $500,000 discount strike price. The court also noted that First City launched a full-scale takeover less than two weeks after the March 4 call and that First City had utilized similar put/call arrangements with Bear Stearns only months earlier in another takeover attempt. The court rejected Belzberg's explanation of the discount strike price that Bear Stearns was acting like "Santa Claus" by offering a "bit of a break" to gain more First City business. The court also affirmed the district court's order that First City disgorge $2.7 million of its profit on the Ashland stock.

2. SEC v. Evans

In SEC v. Evans [763] the SEC charged that three former executives of Macmillan, Inc. violated Section 13(d) by failing to disclose in a Schedule 13D that purchases of Macmillan shares by the company's ESOP were executed, in part, to further a recapitalization plan intended to deter the threat of a hostile takeover. The three individuals consented to an order enjoining future violations without admitting or denying the SEC charges.

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[763] Fed. Sec. L. Rep. (CCH) ¶ 94,802 (D.D.C. 1989).

On May 27, 1987, the three executives allegedly began to develop a plan of recapitalization of Macmillan, anticipating a takeover bid for the company. As a of this plan, the executives allegedly caused the Macmillan ESOP to purchase 1.2 million shares, over 5% of Macmillan stock. The ESOP filed a timely Schedule 13D which stated that the purpose of the ESOP stock purchases was to further the purpose of the Macmillan ESOP to allow employee ownership of the company. The SEC maintained that the failure to disclose the proposed recapitalization and that "a purpose" of the ESOP acquisition was to further the recapitalization violated Section 13(d). As a warning to companies establishing ESOPs as takeover defenses, the SEC stated:

> The Commission wishes to emphasize that where disclosure is made or is required concerning the purchase of securities in an Employee Stock Ownership Plan, the person making the disclosure must carefully consider the need to disclose fully the purposes of the transaction and any plans or proposals served by the transaction, including, where applicable, any anti-takeover or other defensive purposes, plans or proposals. In this regard, consideration must be given to the appropriate disclosure under Section 13(d) of the Exchange Act where a reporting person has any plans or proposals which relate to or would result in any "actions which may impede the acquisition of control of the issuer by an person."[764]

3. In the Matter of Sequa Corporation

The SEC's action In the Matter of Sequa Corporation[765] illustrates the SEC's enforcement policy regarding the Schedule 13D filing requirements in a hostile takeover context. On October 15, 1987 Sequa Corporation filed a Schedule 13D disclosing that it had obtained a 12.3% toe hold in Atlantic Research Corporation. The filing included standard "investment purposes" language and reserved Sequa's option to increase or decrease its holdings and to seek control of Atlantic based upon various factors and conditions, including economic, money and stock market conditions. After the "Black Monday" stock market break on October 19, 1987, two entities offered to sell to Sequa blocks of Atlantic Research stock. On October 22, 1987, Sequa executed agreements to

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764 Id. at ¶ 94,305. See Missouri Portland Cement Co. v. H.K. Porter Co., 535 F.2d 388, 394 (8th Cir. 1976) (holding that an acquirer who tendered an offer to increase its holdings to 49.2% if the outstanding stock, despite a statement that the shares "may give Porter effective working control of Missouri," clearly had a control purpose that should have been disclosed); but see, Azurite Corp. Ltd. v. Amster & Co., Fed. Sec. L. Rep. (CCH) ¶ 98,666 (2d Cir. 1995). In Azurite, the Second Circuit stated that plans to wage a proxy contest for control of a company need not be disclosed under Item 4 of Schedule 13D unless they are sufficiently "fixed." The scope of the category of fixed plans is limited: the court explained that there is no requirement to make predictions of future behavior or to disclose tentative plans, so that a course of action need not be disclosed unless it is "decided upon."

765 Administrative Proceeding File No. 3-7196, SEC Docket Vol. 43, No. 13, at 1433 (May 19, 1989).

acquire approximately 6.1% of Atlantic Research shares, bringing its aggregate holdings to almost 18.3%.

By October 28, 1987, Sequa had determined to acquire at least a 20% interest in Atlantic Research to enable it to use the equity method of accounting for the investment. On November 2, 1987, however, Atlantic Research officials rejected Sequa's request that the company amend its "poison pill" to enable Sequa to acquire 20%-21% of the company without triggering the rights plan. Later that evening, Sequa announced a tender offer for all shares of Atlantic Research common stock. The next morning Sequa filed a first amendment to its Schedule 13D to reflect its October 22, 1987 purchases of Atlantic Research shares.

The SEC determined that Sequa's twelve day delay in amending the Schedule 13D to disclose the October 22 purchases was not "prompt" and violated Section 13(d). The SEC confirmed that whether an amendment is prompt is to be determined "based on all of the facts and circumstances surrounding both prior disclosures by the filing person and the material changes which trigger the obligation to amend."[766]

The SEC concluded that Sequa should have amended its Schedule 13D once the company had determined to increase its holdings of Atlantic Research to 20%. Curiously, the SEC also indicated that Sequa had a duty to amend its Schedule 13D even earlier, after the October 19 market collapse, to reflect that Sequa no longer considered viable certain of the alternatives set forth in Item 4 of the filing. This suggests that investors which utilize broad "buy or sell" boiler plate language in their 13Ds must amend their filings if, due to significant market developments, they lose their flexibility to buy or sell shares or take other action described in the traditional "laundry list."

4. IBS Financial Corp. v. Seidman & Associates, L.L.C.

A district court in New Jersey clarified exactly who must comply with the reporting requirements of 13D concerning beneficial ownership. When partnerships or other entities file statements complying with the disclosure requirements for 13D, they must include in those statements certain disclosures about each person in control of the partnership or entity. In IBS Financial Corp. v. Seidman & Associates, L.L.C.,[767] the court held that although certain entities may have had majority equity interests in an LLC, they were not deemed to have "control" for the purposes of 13D reporting requirements. The court held that where an individual manager has exclusive authority over the finances and general operations of an LLC, that manager controls the LLC even if he does not hold a majority equity interest in the LLC. Therefore, disclosures need

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766 SEC Docket Vol. 43, No. 13, at 1435 (citing Cooper Laboratories, Inc., Exch. Act Rel. No. 22,171, Fed. Sec. L. Rep. (CCH) ¶ 83,788 (June 26, 1985)).

767 Fed. Sec. L. Rep. (CCH) ¶ 99,455 (D.N.J. 1997).

only be made by the individual manager in control and not the entities holding the majority equity interest.[768]

C. Summary of Schedule 13D Cases

None of the private actions discussed above, other than the two cases arising out of the Belzberg/Ashland incident, is a final decision on the merits. However, the fact that the plaintiffs' claims in these cases survived motions to dismiss or motions for summary judgment reflects greater scrutiny of the conduct and public statements of those engaged in hostile takeovers. The SEC proceedings against the Belzbergs in First City and against Macmillan in Evans serve notice that the SEC intends to enforce both the timely filing obligations and the line-item disclosure requirements of Schedule 13D.

These decisions and the SEC's enforcement action against Sequa Corporation are instructive for investors who contemplate an aggressive posture with their investments to avoid the overly-broad "investment purposes" language/statements previously used in response to Item 4 (that investor may buy or sell stock as conditions warrant).[769] Despite the district courts' holdings in Belzberg and Kamerman, other cases suggest that general statements of this nature may require amendment as a transaction progresses.[770] To avoid misleading investors and to eliminate obligations to amend filings (when, for example, one of the many options contained in an Item 4 response becomes unavailable) investors should carefully tailor their disclosure to specific factual circumstances. Moreover, Item 4 disclosure should be constantly reviewed for continued accuracy.

XI. DISCLOSURE OBLIGATIONS CONCERNING ENVIRONMENTAL LIABILITY

In the 1990's, the SEC has more closely scrutinized companies that fail to adequately disclose actual and contingent environmental liabilities and attendant compliance costs.[771] It has

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768 Id. at ¶ 96,998.

769 For a recent analysis of Item 4 disclosure, see Albert J. Li, The Meaning of Item Four of Schedule 13D of the Securities Exchange Act of 1934: A New Framework and Analysis, The Business Lawyer, May 1997, at 851.

770 See Hallwood Realty Partners v. Gotham Partners, Fed. Sec. L. Rep. (CCH) ¶ 90,967 (S.D.N.Y. 2000) (holding that the plaintiff company, an alleged target for a takeover, sufficiently pleaded the existence of a Section 13(d) violation because the plaintiff specifically set forth (1) who the alleged Section 13(d) group members were, (2) their holdings in the plaintiff and (3) strong circumstantial evidence of conscious misbehavior in not disclosing their intention to takeover the plaintiff company), aff'd by, Fed. Sec. L. Rep. (CCH) ¶ 98,562 (2d Cir. 2002)

771 For example, SEC Commissioner Richard Y. Roberts has stated that the SEC intends to increase its focus on the adequacy of environmental disclosures when reviewing filings. See e.g., The SEC Today Vol. 93-70 (April 14, 1993). Commissioner Roberts has also revealed that, in addition to the SEC's issuance of Staff Accounting Bulletin No. 92, the SEC intends to pursue a formal memorandum of understanding with the EPA regarding disclosure of environmental contingencies. See 25 Sec. Reg. & L. Rep. (BNA) 659 (May 7, 1993). The EPA currently provides the SEC with a list of parties designated "potentially responsible parties". See The SEC Today Vol. 90-96 (May 17, 1990). Commissioner Roberts has delivered many speeches on this subject.

thus become increasingly important for companies to understand the SEC's position with regard to disclosure obligations concerning environmental liability.

In the disclosure of environmental liabilities, three requirements under Regulation S-K have direct applicability: (i) Item 101, relating to the description of the reporting company's business; (ii) Item 103, relating to disclosure of legal proceedings; and (iii) Item 303, relating to Management's Discussion and Analysis of Financial Condition and Results of Operations (this requires, for example, disclosure of potential "Superfund" obligations).

In 1993, the Staff of the Commission issued Staff Accounting Bulletin No. 92 ("SAB 92"), which provides guidance to accounting and disclosure obligations relating particularly to contingent environmental liability. In 1996, the Association of Certified Public Accountants (AICPA) issued its Statement of Position (SOP 96-1) which provides even more guidance with respect to accounting for environmental liabilities.

A. Levine v. NL Industries, Inc.

In Levine v. NL Industries, Inc.[772] the district court examined an issuer's duty to disclose non-compliance with environmental laws in its Annual Report. The court rejected the plaintiff's allegations that NL Industries was required to disclose in its Form 10-K certain violations of emissions standards at the Fernald Uranium Processing Facility owned by the Department of Energy and operated by an NL Industries subsidiary.

The Fernald Facility accounted for no more than 0.2% of NL's annual gross income and the operating contract required the Department of Energy to indemnify NL in the event of loss or liability related to compliance with environmental laws. The plaintiff had purchased his NL stock in 1982 for $22-1/8 per share. Immediately prior to NL's 1984 announcements regarding the violations of emission standards at the Fernald Facility, NL's stock was trading at around $10 per share. By 1986, when the State of Ohio filed an action for clean-up costs and penalties, NL's stock price remained between $13 and $14 per share.

The court determined that the Form 10-K line-items requiring disclosure of environmental matters[773] and pending legal matters[774] did not obligate disclosure by NL of the particular violations at the Fernald Facility. Because the Department of Energy was ultimately responsible for environmental liabilities under the operating contract, the costs of compliance with environmental laws could not have impacted NL's capital

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772 717 F. Supp. 252 (S.D.N.Y. 1989), aff'd, 926 F.2d 199 (2d Cir. 1991).

773 17 C.F.R. § 229.101(c)(1)(xii) requires disclosure "as to material effects that compliance with Federal, State and local provisions . . . relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."

774 17 C.F.R. § 229.103 requires disclosure of "any material pending legal proceedings" including information about "any such proceeding known to be contemplated by governmental authorities."

expenditures, earnings, or competitive position. Furthermore, NL was not aware of any legal proceedings contemplated with respect to the environmental violations, and thus the information could not be disclosed as a pending legal proceeding. The court dismissed Levine's claim, stating that he had failed to show that NL had a duty to disclose the omitted information.

On appeal, the Second Circuit affirmed the lower court's dismissal, focusing on the immateriality of the allegedly omitted information.[775] The Second Circuit found that NL's shareholders could not plausibly suffer financially from NL's alleged failure to disclose the violations at the Fernald Facility due to the Department of Energy indemnity, and, therefore, information relating to such violations was immaterial.[776] The Second Circuit cautioned, however, that the Form 10-K line-item requiring disclosure of environmental matters would require the disclosure of the cost of failing to comply with environmental regulations, as well as the cost of complying with such regulations, and that the district court's opinion in Levine should not be interpreted otherwise. Apparently, NL would have had a duty to disclose the costs related to the Fernald Facility violations in its Form 10-K if such costs had been material, and if NL had not had the Department of Energy indemnity.

B. SAB 92

In 1993, the SEC published SAB 92, which answers a series of specific questions pertaining to accounting and disclosure obligations by public companies of their contingent environmental liabilities, among other matters. Given the growing importance of environmental disclosures, it is crucial that companies understand SAB 92, which has also influenced the narrative disclosure for environmental contingencies and obligations.

The first question addressed by SAB 92 is whether it is appropriate to offset in the balance sheet a claim for recovery that is probable of realization against a probable contingent liability and report the difference as a net amount in the company's balance sheet. The interpretive response: "not ordinarily" appropriate. The staff stated that in order to most fairly present potential consequences of the contingent claim on the company's resources, there should be separate presentation of gross liability from any related claim for recovery in the balance sheet.

The second question concerns a situation where the reporting company is jointly and severally liable as a potentially responsible party ("PRP"), but there is a reasonable basis for apportionment of costs among the other PRPs. The issue is whether the reporting company must recognize a liability with respect to costs apportioned to the other responsible parties. The interpretive response is no; however, if it is probable that the other parties will not fully pay costs apportioned to them, the reporting company

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[775] Levine v. NL Indus., Inc., 926 F.2d 199 (2d Cir. 1991).

[776] This finding is clearly supported by the lack of market reaction to the eventual announcements of the violations and the State of Ohio actions.

should include the registrant's best estimate, before consideration of potential recoveries from other parties, of the additional costs that the registrant expects to pay. Registrants should also discuss the solvency of one or more parties if it is in doubt or the responsibility for the site if it is disputed.

The third question deals with how uncertainties (e.g., estimates regarding the extent of liability and amounts of related costs) affect the recognition and measurement of liability. The response states that the measurement of liability should be based on currently available facts, existing technology, and presently enacted laws and regulations, and should take into consideration the likely effects of inflation and other societal and economic factors. If management can only estimate a range of liability, then the lower limit of the range should be recognized even if the upper limit of the range is uncertain.

For question four, the SEC states that an environmental liability may be discounted to reflect the time value of money if the aggregate amount of the obligation and the time and amount of payments are fixed or reliably determinable for a specific site. Further, the rate used to discount the cash payments should be the rate that will produce an amount at which the environmental liability could be settled in an arms-length transaction with a third party. If the liability is recognized on a discounted basis, the notes to the financial statements should discuss in detail the basis and amount of discounting.

The fifth question outlines the financial statement disclosures that should be furnished with respect to recorded and unrecorded product or environmental liabilities. Examples of disclosures that may be necessary include:

(i) Circumstances affecting the reliability and precision of loss estimates;

(ii) The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency;

(iii) Uncertainties with respect to joint and several liabilities that may affect the magnitude of the contingency;

(iv) Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties;

(v) The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with disclosure of any material limitation of that recovery;

(vi) Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers;

(vii) The time frame over which the accrued or presently unrecognized amounts may be paid out; and

(viii) Material components of the accruals and significant assumptions underlying estimates.

Question six discusses disclosures outside of the financial statements. The response advises that registrants should consider the requirements of Regulation S-K and S-B (governing small business) Items 101, 103, and 303. The response also refers to the 1979 and 1989 interpretive releases.[777] Disclosures made pursuant to these provisions should be sufficiently specific to enable a reader to understand the scope of the contingency. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material.

In question seven, the staff indicates that material liabilities for site restoration, post closure, and monetary commitments, or other exit costs that may occur on the sale, disposal, or abandonment of a property should be disclosed in the notes to the financial statements. Such disclosures should generally include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, and the range and amount of reasonably possible additional losses. In addition, the reporting company should disclose liability for remediation of environmental damage to a previously disposed of asset unless the likelihood of liability is remote.

Finally, the staff recognizes that where a reporting company expects to incur site restoration costs, post-closure and monitoring costs, or other environmental exit costs at the end of the useful life of an asset, these costs can be accrued over the useful life of the asset. The accrual of the liability would be recognized as an expense.

C. SOP 96-1

In an effort to clarify the standards for reporting and disclosing environmental liabilities, the Association of Certified Public Accountants (AICPA) issued its Statement of Position (SOP) 96-1, which provides guidance on accounting issues related to the recognition, measurement, display, and disclosure of environmental remediation liabilities.[778] SOP 96-1 became effective for fiscal years beginning after December 15, 1996, and applies to all companies that prepare financial statements in accordance with generally accepted accounting principles. The SOP identifies certain stages of a remediation effort as benchmarks that should be considered when determining that an environmental liability is probable, reasonably estimable, and therefore should be disclosed.[779] These benchmarks include:

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[777] See Securities Act Release No. 6130 (Sept. 27, 1979) and Financial Reporting Release No. 36 (May 18, 1989).

[778] For a comprehensive account of the events leading up to this Statement of Position, see Howard B. Epstein and Aaldert Ten Veen, Position Statement Clarifies Liability Disclosures, The National Law Journal, Mar. 17, 1997, at B18.

[779] The scope of SOP 96-1 is limited to environmental remediation liabilities resulting from an assertion or threat of assertion of litigation, a claim, or an assessment.

- the identification and verification of a company as a potentially responsible party (PRP);
- the receipt of a unilateral administrative order;
- participation as a PRP in the remedial investigation/feasibility study;
- the completion of a feasibility study;
- the issuance of a record of decision; and
- remediation design through operation and maintenance.

Once a company has determined that it is probable that an environmental remediation liability has been incurred, the liability should be estimated by using the available information. The estimation of liability should include the company's allocable share of the liability for a site and the company's share, if any, of the amount related to the site that will not be paid by other PRPs or the government. In addition, SOP 96-1 requires that the entity also include in the estimate the incremental direct costs of the remediation effort[780] and the costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort.

D. Conclusion

As our planet becomes increasingly aware of the importance of environmental issues, so too must companies understand their social responsibilities with respect to the environment. And as the SEC intensifies its scrutiny of reporting companies' disclosure obligations regarding environmental liabilities, among other matters, so too must companies understand their disclosure obligations under securities law. While the effects of SOP 96-1 may still currently be uncertain, by 1998, we should be able to judge its effects by examining the annual financial statements of companies who prepare their statements in accordance with generally accepted accounting principles.

XII. T + 3

Adopted in 1995, Rule 15c6-1[781] establishes that the standard settlement time for most broker-dealer trades is three business days after the trade or "T + 3."[782] When Rule 15c6-1 was

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[780] These incremental direct costs would include: the cost of completing the remedial investigation/ feasibility study; fees of law firms for work related to determining the extent of required remedial actions; fees of engineering and consulting firms for site investigations and developments of remedial action plans; and the costs of post-remediation monitoring required by the remedial action plan.

[781] 17 C.F.R. § 240.

[782] SEC Release No. 33-7168; 34-35705 (May 11, 1995) (the "FD Adopting Release").

first proposed, commentators expressed concern that settlement within "T + 3"[783] would not be feasible because of the amount of time it would take to print and deliver prospectuses.[784] Two proposals to simplify prospectus delivery were submitted to the commission; the "Four Firms" proposal and the Securities Industry Association ("SIA") approach.[785]

A. The Four Firms Proposal

The Four Firms proposal was based on the view that most of the prospectus could be printed before pricing to facilitate delivery within T + 3, if certain modifications were made to existing SEC rules. Six of the key modifications are summarized below.

1. Reordering of Prospectuses

The SEC's Rule revision allows issuers to present information that becomes available or is likely to change at the time of pricing to be included together either in the beginning of the prospectus after the front cover page in a "pricing-related information" section or wrapped around the prospectus inside the front and back cover pages.[786] The "Pricing-Related Information" section would include among other things: the use of proceeds; capitalization; pro forma financial information; dilution; selling shareholder information; and shares eligible for future sale. If the "pricing-related" information is included after the front cover page of the prospectus, the summary and risk factor sections may appear immediately following the "pricing-related" section. In addition, some information[787] which would normally be required to appear on the cover page may be placed elsewhere in the prospectus.

2. Changes in Offering, Size, or Price

An issuer is permitted to register securities by specifying only the title of the class being registered and the proposed maximum offering price. However, the issuer is still required to specify in the prospectus the amount of securities being offered and, if the issuer is not a reporting company, a bona fide estimate of the range of the maximum

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783 Annette Nazareth, Director of the SEC's Division of Market Regulation, has stated that in the post-September 11 era, the T+1 initiative is gaining great support. Nazareth Reviews Short Selling, T+1 and ECN Fees, SEC Today, Thursday May 23, 2002.

784 The SEC noted that prospectus delivery concerns should be alleviated as electronic delivery becomes more prevalent.

785 The Four Firms include CS First Boston Corporation, Goldman Sachs & Co., Lehman Brothers, Inc., and Morgan Stanley & Co.

786 To ensure that investors continue to easily locate the "Risk Factors" section of the prospectus, the SEC also requires that the cover page of the prospectus identify the page number at which that section appears in the prospectus and that the risk factors section be labeled as "Risk Factors."

787 This information would include disclosure regarding the availability of Exchange Act Information, the nature of reports given to security holders, undertakings with respect to information incorporated by reference, and the enforceability of civil liabilities against foreign persons.

offering price. The aggregate dollar amount associated with each class of securities must be disclosed in the registration fee table. If the issuer registers more than the required number of shares in the offering, the excess securities may be carried forward to subsequent registrations of the same class of securities.

Where the size of an offering increases subsequent to pricing, the issuer may use an abbreviated registration statement to register additional securities, provided that the additional shares represent no more than a 20% increase over the shares previously registered. This abbreviated registration statement includes the facing page, a statement incorporating by reference the contents of the prior filing, all required consents and opinions, and the signature page. It may also include any price-related information with respect to the offering that was omitted from the earlier registration statement pursuant to Rule 430A. The abbreviated registration statement must be filed prior to the time sales are made and confirmation is given, and the statement is effective upon filing.[788]

Where the size or the price of an offering declared effective under Rule 430A do not in the aggregate deviate more than 20% from the price set forth in the registration fee table of the effective filing, a post-effective amendment is not required. On the other hand, where there is a change in offering size or deviation from the price range beyond the 20% threshold, a post-effective amendment is required only if such change materially alters the previous disclosure. The release does, however, indicate that "issuers continue to be responsible for evaluating the effect of a volume change or price deviation on the accuracy and completeness of disclosure made to investors."[789]

3. Manual Signatures and Incorporating by Reference Opinions and Consents

The SEC now permits duplicate or facsimile signatures to be used in lieu of manual signatures for any registration filed under the Exchange Act. If facsimile or duplicate signatures are used, the registrant must maintain the manually signed version for five years and provide it to the SEC upon request.

4. Rule 430A Pricing Period

Rule 430A previously provided that a registration could be declared effective without pricing information if the missing information was contained in a supplemental prospectus filed five days after the effective date of the registration statement. The SEC extended the "pricing" period to 15 days, principally to reduce the likelihood that a post-effective amendment would have to be filed. The SEC, however, has proposed to amend

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788 Abbreviated filing is allowed even where pricing occurs after the SEC offices have closed. Electronic filers may file via Edgar and others may file by fax, between 5:30 and 10:30 p.m. Eastern time. Payment may be made after banking hours by instructing a bank to wire the payment amount no later than the close of the next business day after filing and providing certain certifications to the SEC with the filing. See FD Adopting Release, supra note 608.

789 See n. 32 to the FD Adopting Release, supra note 608.

Rule 430A to allow smaller companies, including small business issuers to delay pricing information for up to one year after the effective date of the registration statement.[790] While such a proposal may seem "somewhat innocuous," some believe that the proposal should be reconsidered, because it provides issuers with a way to avoid important safeguards of the Securities Act registration process.[791]

5. Acceleration Request

The SEC now permits requests for acceleration of effectiveness to be transmitted either via facsimile or orally. A letter indicating that the registrant and managing underwriter intend to request oral acceleration must be submitted to the commission prior to the oral acceleration request.[792]

6. T + 4 for Firm Commitment Offerings Priced After the Close of the Market

Firm commitment offerings priced after 4:30 p.m. Eastern time where the securities are sold by an issuer to an underwriter or a broker-dealer participating in an offering are governed by a "T + 4" settlement time frame. The T + 4 period also applies to a secondary offering where the issuer and managing underwriter agree in writing that such a settlement period will apply. In addition, the Commission has provided an "override" provision to T + 3 for the sale of all securities subject to a firm commitment offering upon agreement by the managing underwriter and the issuer. The Commission has stressed, however, that the override provision is "not intended to dilute the presumption in favor of application of the T + 3 settlement cycle in connection with firm commitment offerings." Instead, the override provision is intended to be used only in those circumstances when T + 3 settlement is not feasible.

B. SIA Proposal

As adopted by the Commission, the SIA approach provides for incremental prospectus delivery. For offerings registered on forms other than S-3 or F-3, prospectus delivery is accomplished by delivery of a preliminary prospectus, a term sheet, if necessary, and a confirmation. The term sheet provides all information material to investors that is not disclosed in the preliminary prospectus. The preliminary prospectus and term sheet, taken together, may not materially differ from the disclosure included in

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790 See SEC Rel. No. 33-7393 (Feb. 20, 1997).

791 See Jesse M. Brill, More on The Rule 144 (and Reg S and 430A) Proposals, The Corporate Counsel, March-April 1997, at 1 (discussing the possible negative effects of the Rule 430A proposal).

792 The letter should also indicate that the registrant and the managing underwriter are aware of their obligations under the Securities Act.

the effective registration statement. The term sheet must be filed with the Commission within two business days after the earlier of the pricing date or first use.[793]

For registrants using short-form registration, delivery may be accomplished by delivery of a preliminary prospectus, an abbreviated term sheet, and a confirmation. The abbreviated term sheet must include, unless described in the preliminary prospectus or incorporated by reference, a description of the securities (as required by Item 202 of Regulation S-K) and information regarding material changes (as required by Item 11 of Form S-3). Offering-specific information usually contained in the final prospectus, such as use of proceeds and plan of distribution, need not be physically delivered to investors and instead is only required to appear in the prospectus supplement filed with the Commission.

It is unclear how comfortable underwriters will be in delivering abbreviated prospectuses or term sheets to investors or in deviating significantly from the current ordering of information contained in a prospectus. Our own experience has been that few issuers have availed themselves of abbreviated prospectus delivery.[794]

XIII. FREE RIDING INTERPRETATION

The SEC on December 7, 1994 approved certain rule changes to the NASD "free-riding" interpretation of the NASD Manual of Rules of Fair Practice,[795] and a further amendment effective in August 1998 changed the definition of who could participate in a hot issue. Some of the key changes to the interpretation include the following:

A. Stand-by Arrangements

The prior interpretation restricted sales to "stand-by" purchasers in certain instances by disallowing persons restricted under the prior interpretation from having a beneficial interest in a "stand-by" account. The new interpretation now provides that securities purchased pursuant to a "stand-by" arrangement (i.e., an agreement to purchase securities not purchased during the offering) are not subject to the provisions of the interpretation if: (1) the "stand-by" is disclosed in the prospectus; (2) the "stand-by" arrangement is the subject of a formal written agreement; (3) the managing underwriter represents in writing that it was unable to find any other purchasers for the securities; and

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793 One author has noted that while a term sheet may be effective to quickly update pricing information, "it may be the less attractive alternative where the form of prospectus included in the registration statement at the time of effectiveness has been significantly modified compared to the preliminary prospectus delivered to investors." Nicholas Grabar, Memorandum Regarding Compliance with Prospectus Delivery Requirements in a T + 3 Settlement Environment, May 17, 1995.

794 Financial printers whom we contacted have indicated that they have not had any problems meeting a "T + 3" deadline. Additionally they have indicated that issuers and underwriters alike have not wanted to be "first on the block" to deliver term sheets or abbreviated prospectuses.

795 SEC Release No. 34-35059 (December 7, 1994) (the "NASD Release").

(4) the securities purchased are restricted from sale or transfer for a period of three months.[796]

B. Definition of Immediate Family

The old interpretation restricted immediate family members or persons associated with broker/dealers, persons having a connection to the offering, and individuals related to banks, insurance companies and other institutional type accounts from participating in "hot issue" distributions. The amendment to the interpretation then was changed to provide that:

> the prohibition shall not apply to sales to a member of the immediate family of a person associated with a member who is not supported directly or indirectly to a material extent by such person if the sale is by a broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.[797]

With the May 18, 1998 approval by the SEC of this interpretation, effective August 17, 1998, the definition of who may participate in a "hot issue" has changed.[798]

- Hot issues may not be sold to any person who owns or has contributed capital to a broker-dealer, including certain members of immediate family, as well as accounts in which such persons have a beneficial interest.

- A holding company that owns a broker-dealer may not purchase hot issues.

This latest NASD Release does not appear to include a non-broker-dealer "sister company" or certain "passive owners" of broker-dealers with less than 10% ownership or capital interest if (a) the hot issue is purchased from another broker-dealer or (b) the broker-dealer's securities are listed on an exchange or traded in NASDAQ.

C. Venture Capital Investors

The NASD concluded that venture capital investors should be allowed to purchase a hot issue to maintain their percentage ownership in an entity, notwithstanding that the venture capital investor may be a restricted person, or that such person may have a beneficial interest in a venture capital account. The new interpretation therefore provides that venture capital investors may purchase hot issues without implicating the interpretation's restrictions if:

(a) there is one year of pre-existing ownership in the entity;

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796 See id.

797 Id.

798 SEC Releases No. 34-40001 (May 18, 1998) (the "latest NASD Release").

(b) there is no increase in the investor's percentage ownership above that held for three months prior to the filing of registration statement in connection with the initial public offering;

(c) there is a lack of special terms in connection with the purchase; and

(d) [the] Venture Capital Investor shall not assign, sell, pledge, hypothecate or otherwise dispose of the securities for a period of three months following the effective date of the registration statement in connection with the offering.[799]

The NASD has recently warned its members of abusing this exception, reminding members that such "flipping" or "spinning" practices violates their obligations under the "Free-Riding and Withholding Interpretation" of the NASD rules.[800] The "flip" and "spin" occur when an investment bank allocates shares of a "hot" IPO to the personal account of potential future customers, providing for a quick profit. Such activities have recently drawn media attention and debate.[801]

D. Definition of Public Offering

The NASD concluded that the definition of "public offering" implicated private placements of securities which do not present the abuses that the interpretation was designed to guard against. The amended interpretation therefore provides that private placements are not within the purview of the interpretation. Specifically, the amended interpretation defines a public offering as "any primary or secondary distribution of securities made pursuant to a registration statement or offering circular ... of any kind whatsoever except any offering made pursuant to an exemption under §4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended, or pursuant to Rule 504 ... or Rule 506."[802]

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799 Id.

800 See Securities Offerings: NASD Sends Members Warning Concerning Allocation of Hot IPOs, Securities Regulation and Law Report, Vol. 29, No. 47, p. 1687 (Dec. 5, 1997).

801 See The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers -- Coincidentally or Otherwise, Work Follows for the Investment Bank, The Wall Street Journal, November 12, 1997 and SEC, NASD Begin Probes of IPO "Spin" Accounts, Wall S. J., Nov. 13, 1997.

802 Id.

E. The NASD's "Hot Issues" Rule and Private Investment Funds

The NASD promulgated Rule IM-2110-1 to regulate the broker-dealers' allocation of hot issues to their customers.[803] These customers may include private investment funds, and as a result, the rule may have a significant impact on these funds. The rule itself only applies to members of the NASD, and it basically states that a broker-dealer may not allocate hot issues to a fund if the fund has any beneficial owners who are "restricted persons" as defined in the rule, unless two conditions are satisfied: 1.) The fund's operating agreement must contain a carve-out that allocates profits and losses from the hot issue to non-restricted investors only; and 2.) the broker-dealer must obtain a written opinion of an attorney attesting to the carve-out from the fund.[804]

F. History of Rule Filings Regarding Hot Equity Offerings

In October of 1999, the NASDR filed with the SEC an initial proposal to create Rule 2790, "Trading in Hot Equity Offerings," to replace the Free-Riding and Withholding Interpretation, IM-2110-1.[805] The purpose of the initial proposal was to prohibit NASD member firms from withholding securities in a bona fide public offering for the firm's benefit.[806] After NASDR reviewed comments received on the proposal, the National Association of Securities Dealers Inc. Board of Governors approved changes to the rule proposal on August 17, 2000.[807] These approved changes not only restrict industry insiders from investing in "hot issues," but they prohibit the industry insiders from investing in any initial public offering "for their own benefit at the expense of public customers."[808] In sum, the proposed changes broadened the rule's coverage to prohibit investment advisers, portfolio managers and hedge fund managers from buying stock in *any* IPO from brokerages.[809]

As a result, a second amendment to the proposed rule was filed with the SEC on October 10, 2000.[810] On November 28, 2000, the SEC published for comment the second amendment to the NASD's proposed Rule 2790 with the intent that such rule replace the Free-Riding and Withholding Interpretation.

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803 See Frederick L. White, The NASD's 'Hot Issues' Rule as it Applies to Private Investment Funds, The Investment Lawyer, Volume 7, No. 3 (March 2000).

804 See id.

805 See http://www.NASDR.com, File No. SR-NASD-99-60.

806 See "NASD Board OKs Revised Proposal on Industry Insiders' Trading in IPOs", Securities Regulation and Law Report, Vol. 32, No. 33, pg. 1139, Aug. 21, 2000.

807 See id.

808 Id.

809 See id.

810 See File No. SR-NASD-99-60 at http://www.NASDR.com.

On October 24, 2003, the SEC approved Rule 2790 (Restrictions on the Purchase and Sale of IPOs of Equity Securities),[811] which replaces the Free-Riding and Withholding Interpretation (IM-2110-1). The new rules are effective March 23, 2004 for all members and associated persons. The purpose of Rule 2790 is to protect the integrity of the public offering process by:

- Ensuring that NASD members make a bona fide public offering of securities at the public offering price;

- Ensuring that NASD members do not withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and

- Ensuring the industry "insiders" do not take advantage of their "insider" position in the industry to purchase hot issues for their own benefit at the expense of the public.

Rule 2790 replaces the concept of "hot issues" (public offerings that trade at a premium whenever secondary market trading begins) with a general prohibition on NASD members selling any "new issue" to any account in which a "restricted person" has a "beneficial interest." A "new issue" is defined as any initial public offering of an equity security, as defined in Section 3(a)(11) of the Exchange Act. As the NASD's Notice to Members[812] suggests, the application of Rule 2790 to all "new issues," rather than just those that are "hot issues," represents one of the most significant changes between Rule 2790 and IM-2110-1. The definition of "beneficial interest" is expanded under Rule 2790 to include not only ownership interest, but also any type of economic interest, including the right to share in gains and losses.[813] The definition of "beneficial interest" does not include the receipt of a management or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity. The NASD does, however, take the position that the accumulation of such payments, if subsequently invested in the collective investment account (as a deferred compensation arrangement or otherwise) would constitute a beneficial interest in the account.

Rule 2790 states that a NASD member or a person associated with a NASD member may not:

- Sell, or cause to be sold, a "new issue" to any account in which a restricted person has a beneficial interest, unless otherwise permitted;

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811 See NASD NYSE Rulemaking, Release No. 34-48701, at http://www.sec.gov/rules/sro/34-48701.htm (Oct. 24, 2003).

812 NASD NTM 03-79 (Dec. 2003), available at http://www.nasdr.com/pdf-text/0379ntm.pdf.

813 NASD Rule 2790(i)(1).

- Purchase a "new issue" in any account in which a NASD member or person associated with a NASD member has a beneficial interest, unless otherwise permitted; and

- Continue to hold "new issues" acquired by the NASD member as an underwriter, selling group member, or otherwise, except as otherwise permitted by the rule.

The rule does not, however, prohibit:

- Sales or purchases from one NASD member of the selling group to another member of the selling group that are incidental to the distribution of a new issue to a non-restricted person at the public offering price; or

- Sales or purchases by a broker-dealer of a new issue at the public offering price as part of an accommodation to a non-restricted person that is a customer of the broker-dealer.

Rule 2790 eliminates IM-2110-1's "conditionally restricted person" category and consequently expands the universe of restricted persons. In addition to any person who has the authority to buy or sell securities for an investment adviser or a "collective investment account," for example, a hedge fund manager, restricted persons include:[814]

- Persons who have authority to buy or sell securities for a bank, savings and loan association, insurance company, investment company, investment adviser, or collective investment account;

- NASD members and other broker-dealers, including foreign broker-dealers, and associated persons of broker-dealers (except for employees and agents of limited business broker-dealers);

- Finders and fiduciaries with respect to the offering being distributed;

- Certain owners of broker-dealers whose ownership interest is required to be listed on the broker-dealer's Form BD; and

- Immediate family members of restricted persons, which includes any person to whom the restricted person provides material support.

Rule 2790 does, however, exempt certain accounts and persons from its application, including:[815]

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[814] NASD Rule 2790(i)(10).

[815] NASD Rule 2790(c).

- Where restricted persons beneficially own 10% or less of the value of a collective investment vehicle's shares or interests;

- A foreign investment company if it is:

  - Listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority, and

  - No person owning more than 5% of its shares is a restricted person.

- Investment companies registered under the Investment Company Act of 1940;

- A common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Exchange Act provided that:

  - Has investments from 1,000 or more accounts, and

  - Does not limit beneficial interests in the fund principally to trust accounts of restricted persons.

- An insurance company general, separate or investment account, provided that:

  - The account is funded by premiums from 1,000 or more policyholders, or, if a general account, the insurance company has 1,000 or more policyholders, and

  - The insurance company does not limit the policyholders whose premiums are used to fund the account principally to restricted persons, or, if a general account, the insurance company does not limit its policyholders to restricted persons.

- A publicly traded entity (other than a broker-dealer or an affiliate of a broker-dealer where such broker-dealer is authorized to engage in the public offering of new issues either as a selling group member or underwriter) that:

  - Is listed on a national securities exchange or traded on the Nasdaq, or

  - Is a foreign issuer whose securities meet the listing criteria for listing on a national securities exchange or trading on the Nasdaq.

- An ERISA benefits plan that is qualified under Section 401(a) of the Internal Revenue Code and not sponsored solely by a broker-dealer;

- A tax-exempt entity under Section 501(c)(3) or a church plan under Section 414(e) of the Internal Revenue Code;

- A state or municipal government benefit plan subject to state and/or municipal regulation.

In addition, subject to a number of conditions, Rule 2790 exempts issuer-directed securities, new issues purchased as anti-dilution protection from the issuer, the purchase and sale of securities pursuant to a stand-by agreement, and under-subscribed offerings.

Under Rule 2790, a NASD member must satisfy certain conditions for sale prior to selling any "new issue" to any account. The member must obtain a written representation from the account holder(s) (or representatives thereof) that the account is eligible to purchase new issues in compliance with Rule 2790.[816] Where the account is held by a "conduit" (such as a bank or investment adviser), the member must obtain a written representation from the conduit that all purchases of new issues are in compliance with Rule 2790.[817] In either case, the member must (i) have obtained the representation within 12 months of sale, and (ii) maintain a copy of all records pertaining to whether an account is eligible to purchase new issues for at least three years following the last sale to that account. Under the interpretation to Rule 2790, verification is required as frequently as before every sale or as long as every 18 months. A NASD member may not, however, rely upon any representation that it believes, or has reason to believe, is inaccurate.

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816 NASD Rule 2790(b).

817 NASD Rule 2790(b)(2).