New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM

An ALM Publication
VOLUME 243—NO. 119
WEDNESDAY, JUNE 23, 2010

SECOND CIRCUIT REVIEW

Expert Analysis

PSLRA Provisions on Safe Harbor For Forward-Looking Statements

By **Martin Flumenbaum**

And **Brad S. Karp**

This month we discuss *Slayton v. American Express Co.*,[1] in which the U.S. Court of Appeals for the Second Circuit addressed for the first time the application of the safe harbor provision of the Private Securities Litigation Reform Act (PSLRA) to forward-looking statements. In a decision written by Judge Robert A. Katzmann, and joined by Judge Guido Calabresi,[2] the court held that the safe harbor provision, which is written in the disjunctive, applies to forward-looking statements that are "identified and accompanied by meaningful cautionary language or [are] immaterial or the plaintiff fails to prove that [the statements were] made with actual knowledge that [they were] false or misleading."[3]

With respect to this last category, the court also held that the Supreme Court's decision in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*[4] applies to plaintiffs' pleading of "actual knowledge," and thus requires plaintiffs to plead facts establishing an inference that defendants had actual knowledge of falsity that is at least as compelling as any opposing inference. The Second Circuit further confirmed that the PSLRA's safe harbor provisions may apply to statements made in the Management Discussion and Analysis (MD&A) section of SEC filings.

Procedural History

Plaintiffs' relevant allegations focus on representations by American Express concerning a portfolio of high-yield debt securities, including junk bonds and collateralized debt obligations (CDOs). On May 15, 2001, American Express filed its first quarter results on Form 10-Q, and reported losses of $182 million in its high-yield debt portfolio for the first quarter. In the MD&A section of the May 15 SEC filing, American Express explained that "[t]he high yield losses reflect the continued deterioration of the high-yield portfolio and losses associated with selling certain bonds."[5] American Express then elaborated, projecting that "[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter" (the "May 15 statement").[6]

> The 'Slayton' decision clarifies that the safe harbor applies to forward-looking statements accompanied by meaningful cautionary language.

The 10-Q also contained cautionary language. Several pages following the May 15 statement, the company stated that the Form 10-Q "contain[ed] forward-looking statements, which are subject to risks and uncertainties" and warned that "[f]actors that could cause actual results to differ materially from these forward-looking statements include…potential deterioration in the high-yield sector, which could result in further losses in [the relevant] investment portfolio."[7]

Subsequently, on July 18, 2001, American Express issued a press release announcing that it would take an additional $826 million loss due to further write-downs in the high-yield debt portfolio. One year later, plaintiffs filed this action against American Express Company, a related subsidiary, and various officers and directors of American Express, asserting claims on behalf of a putative class of investors under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Plaintiffs alleged that at the time the 10-Q was issued, the defendants knew that the May 15 statement was misleading. In particular, plaintiffs alleged that executives at American Express began discussing the possibility that the portfolio would have additional losses related to its high-yield debt in early May, before the statement was made.

The defendants filed a motion to dismiss, arguing, among other things, that the May 15 statement projecting a deceleration of losses in the high-yield portfolio is protected by the PSLRA's safe harbor for forward-looking statements. The district court (Pauley, J.) granted the motion, finding that the information known to the defendants at the time of the May 15 statement "could support an inference of scienter" but that "the more compelling inference is that Defendants were not acting with an intent to deceive."[8] Thus, the district court held that plaintiffs had not met their burden to allege that the challenged forward-looking statement was made with "actual knowledge" that it was false or misleading at the time it was made.

The Second Circuit Decision

The Second Circuit affirmed the district court's decision, providing the first interpretation by the Second Circuit of the provisions of the PSLRA that create a safe harbor for forward-looking statements.

The Second Circuit first held that the safe harbor provision is "written in the disjunctive." Defendants thus have three separate lines of defense: the safe harbor applies if (i) the statement is accompanied by meaningful cautionary language; (ii) the statement is

MARTIN FLUMENBAUM *and* BRAD S. KARP *are partners at Paul, Weiss, Rifkind, Wharton & Garrison LLP. They specialize in complex commercial litigation and white collar criminal defense.* JOANNA L.W. TRACHTENBERG, *a litigation associate at the firm, assisted in the preparation of this column.*

immaterial; or (iii) the plaintiff has failed to plead or prove that the statement was made with actual knowledge that it was false or misleading. If the defendant can convince the court that any of these three provisions is satisfied, then the safe harbor applies and the fraud claim cannot be sustained.

The court then held that the safe harbor provision applies to statements made in the Management's Discussion and Analysis (MD&A) section of an SEC filing. Relying on the PSLRA's exemption from protection for forward-looking statements that are "included in a financial statement prepared in accordance with generally accepted accounting principles," plaintiffs had argued that American Express' statements about anticipated losses are exempted from protection. The court concluded, however, that because the MD&A portion of a filing is separately regulated by the SEC, and is presented apart from the financial statement portions, it is eligible for safe harbor protection. The court also rejected plaintiffs' suggestion that a forward-looking statement either must be included in a discrete section or specifically labeled as forward-looking. Instead, a court must look at "the facts and circumstances of the language used in a particular report…[to] determine whether a statement is adequately identified as forward-looking."[9]

The court next wrestled with the "thorny issue" of deciding whether a defendant can claim protection from the safe harbor when the cautionary language failed to warn of a known risk. In the complaint, plaintiffs alleged that defendants knew, but failed to disclose, the "major and specific risk that rising defaults on the bonds underlying [the] investment-grade CDOs would cause deterioration in [the] portfolio at the time of the May 15 statement."[10] Instead, plaintiffs alleged, defendants provided only the more general warning that the portfolio could experience further losses if the high-yield sector continued to deteriorate. This general warning, plaintiffs argued, was inadequate.

Noting that Congress had "directed [the court] not to inquire into a defendant's state of mind," the court sought to determine the meaning of the provision extending protection to forward-looking statements that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." Looking at the legislative history, and specifically at the Conference Report, the court observed that this requirement was not meant to provide "an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer" and stressed that "[c]ourts should not examine the state of mind of the person making the statement."

The court, however, found "Congress' directions difficult to apply" because the statute required the court to assess the factors that "realistically" could cause results to differ "at the time the statement was made." The court suggested that "Congress may wish to give further direction on how to resolve this tension, and in particular, the reference point by which we should judge whether an issuer has identified the factors that realistically could cause results to differ from projections."[11]

The court concluded that it was not required to resolve this tension, in any event, on the facts before it. It concluded that the cautionary language provided by American Express was "vague" and "verges on [] mere boilerplate," and therefore was insufficient to render protection. The court reasoned that, as applied to the present case, defendants' statement that there may be continued deterioration in the high-yield sector effectively amounted to a warning that "if our portfolio deteriorates, then there will be losses in our portfolio." The court also noted that the cautionary language relied upon by defendants had been used in numerous earlier filings, which had been issued before American Express received new information. This reuse of the language "belie[d] any contention that the cautionary language was 'tailored to the specific future projections.'"[12]

Finally, the court turned to the question of whether the facts alleged by plaintiffs were sufficient to demonstrate that the defendants made the May 15 statement with actual knowledge that it was false or misleading. Citing the U.S. Court of Appeals for the Third Circuit's decision in *Institutional Investors Group v. Avaya Inc.*,[13] the court noted that "the scienter requirement for forward-looking statements is stricter than for statements of current fact. Whereas the liability for the latter requires a showing of either knowing falsity or recklessness, liability for the former attaches only upon proof of knowing falsity."[14] In other words, a plaintiff cannot plead "actual knowledge" of falsity by a mere pleading of recklessness.

Instead, the court must determine whether a reasonable person would "deem an inference that the defendants (1) did not genuinely believe the statement, (2) actually knew they had no reasonable basis for making the statement, or (3) were aware of undisclosed facts tending to seriously undermine the accuracy of the statement, 'cogent and at least as compelling as any opposing inference.'"[15]

The court then conducted a weighing of the inferences. On the one hand, it found that there were two facts supporting the inference of scienter: first, that management had been advised of the likely risk that there would be further deterioration in the high-yield portfolio, and second, that defendants did not know the magnitude of this deterioration, and thus had no reasonable basis to estimate that it would be "substantially less" than the first quarter loss of $182 million. On the other hand, the court found that the "opposing nonfraudulent inference" was no less compelling. Plaintiffs had failed to plead any facts that would tend to show that defendants subjectively believed that potential losses would exceed $182 million, and were not permitted to "plead fraud by hindsight." The court also gave weight to the lack of any alleged fraudulent motive for management to deceive shareholders. The court held that, absent such a motive, "under our holistic review, [plaintiffs'] circumstantial evidence of actual knowledge must be correspondingly greater."

Finding this to be a "close case," the court held that, examining the allegations collectively, the inference of actual knowledge of falsity was not at least as compelling as any opposing inference. The May 15 statement therefore was protected under the statutory safe harbor.

Conclusion

The Second Circuit's decision in *Slayton* provides important guidance both for lawyers who draft public filings and those litigating the applicability of the safe harbor to allegedly misleading forward-looking statements. Significantly, the decision clarifies that the safe harbor applies to forward-looking statements accompanied by meaningful cautionary language irrespective of whether the defendant is also alleged to have had actual knowledge that the statement was false at the time it was made. *Slayton* highlights, however, the importance of providing specific cautionary language that is tailored to the relevant risks, and emphasizes the importance of amplifying prior risk disclosures in situations where additional risks have become known.

1. Docket No. 08-5422-cv, 2010 WL 1960019 (2d Cir. May 18, 2010).
2. Judge Jon O. Newman was originally a member of the panel, but recused himself after oral argument and did not participate in the decision.
3. Id. at *5.
4. 551 U.S. 308 (2007).
5. *Slayton*, 2010 WL 1960019, at *2.
6. Id.
7. Id. at *3.
8. *In re Am. Express Co. Secs. Litig.*, No. 02 Civ. 5533, 2008 WL 4501928 at *8 (SDNY Sept. 26, 2008).
9. *Slayton*, 2010 WL 1960019 at *8.
10. Id. at *9.
11. Id. at *10.
12. Id. at *11.
13. 564 F.3d 242 (3d Cir. 2009).
14. *Slayton*, 2010 WL 1960019 at *12 (quoting *Avaya Inc.*, 564 F.3d at 274).
15. Id. at *13.