May 19, 2010

Second Circuit Guides Public Companies Through Safe Harbor for Forward-Looking Statements

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On May 18, 2010, the Court of Appeals for the Second Circuit issued an important decision regarding when a public company's forward-looking statements are protected by the safe harbor provision of the Private Securities Litigation Reform Act ("PSLRA"). In *Slayton v. American Express Company et al.*, No. 08-5442-cv (2d Cir. 2010), the Second Circuit issued one of its most comprehensive decisions on the safe harbor, and it provides lessons for public companies that wish to take advantage of its protections.

The PSLRA's safe harbor provides that a defendant "shall not be liable with respect to any forward-looking statement" if it is:

(i) identified and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement";

(ii) is immaterial; *or*

(iii) the plaintiff fails to prove that it was made with actual knowledge that it was false or misleading.

15 U.S.C. § 78u-5(c). *Slayton* reiterated that the cautionary language prong *will not apply* unless that language is specially tailored to the specific risks involved**.** However, *Slayton* also held that the actual knowledge prong *will apply* unless the plaintiff meets its heavy burden of establishing defendant's "actual knowledge" that the statement was misleading.

In *Slayton*, American Express Company ("AmEx") shareholders alleged that AmEx made a misleading statement in its May 15, 2001 10-Q regarding losses that would result from its high-yield debt portfolio. The 10-Q stated that, while the company incurred $182 million in first quarter losses from a high-yield debt portfolio, "[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter [of 2001]." Several pages after this statement, the 10-Q warned that it "contain[ed] forward-looking statements, which are subject to risks and uncertainties." Plaintiffs' claims were largely based on a *Wall Street Journal Asia* ("*WSJ*") article which reported that, prior to the May 15 statement, AmEx had become aware of possible additional losses on its high-yield debt investments beyond those already booked, and had begun investigating the potential losses. In July 2001, following this investigation and contrary to the prediction in the 10-Q, AmEx estimated $400 million in additional losses, and issued a press release announcing additional write-downs in the high-yield debt portfolio. The *Slayton* plaintiffs argued that the statement in the May 10-Q was not protected by the safe harbor because the cautionary language in the 10-Q was not meaningful and because, as shown by the *WSJ* article, AmEx was aware at the time of the 10-Q that losses would likely be higher than in the first quarter of the year.

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On appeal from an order of the District Court dismissing the complaint, the Second Circuit first rejected AmEx's argument that the May 15 statement was accompanied by meaningful cautionary language, holding that the cautionary language "verges on the boilerplate, essentially warning that 'if our portfolio deteriorates, then there will be losses in our portfolio.'" The Second Circuit focused on the fact that the same cautionary language that appeared in the May 15, 2001 10-Q appeared in numerous other AmEx reports, dating from periods both before and after it reported the $182 million loss. The court held that "[t]he consistency of the defendants' language over time despite the new information they received in early May 2001 belies any contention that the cautionary language was tailored to the specific future projection."

The court went on to consider whether the statement nevertheless fell within the "actual knowledge" prong of the safe harbor. Applying the heightened pleading standard set forth in the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the court framed the issue as whether a reasonable person would deem any of the following three inferences cogent and at least as compelling as any opposing inference: (1) that the defendants did not genuinely believe the May 15 statement, (2) that the defendants actually knew that they had no reasonable basis for making the statement, or (3) that the defendants were aware of undisclosed facts tending to seriously undermine the accuracy of the statement. The court held that the inference of scienter was weakened by the fact that AmEx ordered an investigation as soon as potential future losses were suspected and used conservative assumptions in estimating the losses. The court went on to explain that the fact that the losses eventually reported in July greatly exceeded $182 million did not undermine the non-fraudulent inference, because the fact that the losses were, in fact, significantly higher than estimated did not mean that AmEx knew they would be significantly higher. The court also noted that plaintiffs had not pleaded any facts supporting a motive to deceive, and that as a result, their circumstantial evidence of "actual knowledge" had to be correspondingly greater – and was not.

Slayton teaches several important lessons for public companies. First, "meaningful" cautionary language is language tailored to the statement at issue. Language that has been cut, pasted, and unmodified from past statements can be turned against the company as not sufficiently specific. Language warning of general risks, while helpful, may not be sufficient; cautionary language should address the specific factors driving the risk at issue. Second, and the good news for public companies as well as their officers and directors, is that plaintiffs face a heavy burden in proving "actual knowledge" sufficient to overcome the safe harbor protections. Under *Slayton*, where the facts, even if close, can lead to an inference that the company acted without actual knowledge, application of the safe harbor should prevail.

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