Legal Opinion Letter

WLF Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 14 No. 26 December 3, 2004

HIGH COURT SHOULD REVIEW RULING ON SECURITIES FRAUD "SAFE HARBOR"

by

Joseph De Simone, Matthew D. Ingber and Evan A. Creutz

A recent decision of the United States Court of Appeals for the Seventh Circuit, *Asher v. Baxter International Incorporated*, 377 F.3d 727 (7th Cir. 2004), may dramatically alter the landscape of federal securities litigation and the content of corporate disclosures. Judge Frank Easterbrook, writing for a unanimous court, rejected defendants' attempt to rely on the protection of the "safe harbor" provision of the Private Securities Litigation Reform Act ("PSLRA") on a motion to dismiss prior to discovery. He found that it was impossible to determine, based on the pleadings alone, whether defendant Baxter International ("Baxter") had issued "meaningful" cautionary statements to accompany its forward-looking projections. This reasoning appears to conflict with the decisions of several other appellate courts, and may significantly erode the protections afforded to corporations sharing future projections and plans with the investing public.

Before the enactment of the PSLRA, abusive shareholder litigation curtailed the willingness of corporate managers to disclose information to the marketplace. H.R. Conf. Rep. No. 104-369, at 42-43. To combat this "chilling effect" and to "enhance market efficiency by encouraging companies to disclose forward looking information," Congress enacted the PSLRA safe harbor provision, which immunizes companies from liability for 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." 15 U.S.C. § 77z-2(c)(1)(A)(i) (emphasis added). Since the passage of the PSLRA, scores of federal district courts have granted motions to dismiss based upon this provision.

In *Harris v. IVAX Corp.*, 182 F.3d 799 (11th Cir. 1999), the Eleventh Circuit discussed the "meaningfulness" standard in detail, explaining that safe harbor requires the cautionary language "only to mention important factors that could cause actual results to differ materially from those in the forward-looking statement. . . . It does not require a listing of *all* factors." *Id.* at 807. Thus, the *Harris* court dismissed the complaint and explained that safe harbor protection applies if the cautionary language warns of significant risks "*similar* to that actually realized." *Id.* Several circuit courts likewise have held that federal securities claims may be dismissed pursuant to the PSLRA's safe harbor provision on a motion to dismiss prior to discovery. *See, e.g.*, *Baron v. Smith*, 380 F.3d 49 (1st Cir. 2004); *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004); *Employers Teamsters Local v. Clorox Co.*, 353 F.3d 1125 (9th Cir. 2004). The *Asher* decision represents a sharp divergence from this line of cases.

In *Asher*, Baxter, a medical product manufacturer, released quarterly financial results that fell short of projections it had stated repeatedly over the course of the previous nine months. Although Baxter had tempered its projections with cautionary language that disclosed certain risks which the company faced in the coming year, disgruntled shareholders nonetheless filed a federal securities action, alleging that Baxter's

---

Joseph De Simone is a partner, and **Matthew D. Ingber** and **Evan A. Creutz** are associates, in the New York office of the law firm Mayer, Brown, Rowe & Maw LLP.

failure to disclose additional, material problems caused the price of the stock to become artificially inflated. The district court granted defendants' motion to dismiss, holding that Baxter's cautionary language was sufficiently meaningful to trigger safe harbor protection. *See Asher v. Baxter International, Inc.*, 2003 WL 21825498, at *13 (N.D. Ill. July 24, 2003) ("[T]he cautionary disclosures were substantive and sufficiently tailored to the projections contained in the . . . forward looking statements. Indeed, many of the issues which are addressed in the cautionary statements are the same or closely related to the alleged omissions.").

On appeal, the Seventh Circuit reversed. In the decision, Judge Easterbrook compared the allegedly omitted information with the risk factors disclosed by Baxter. Although, like the district court, Judge Easterbrook found that Baxter's warnings were not "boilerplate," and that they "included Baxter-specific information and highlighted some parts of the business that might cause problems," *Asher*, 377 F.3d at 733, he concluded that the claims could not be dismissed prior to discovery:

> Yet Baxter's chosen language may fall short. There is no reason to think – at least, no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery – that the items mentioned in Baxter's cautionary language were those that at the time were the (or any of the) "important" sources of variance. The problem is not that what actually happened went unmentioned; issuers need not anticipate all sources of deviations from expectations. Rather, the problem is that there is no reason (on this record) to conclude that Baxter mentioned those sources of variance that (at the time of the projection) were the principal or important risks. For all we can tell, the major risks Baxter objectively faced when it made its forecasts were exactly those that, according to the complaint, came to pass, yet the cautionary statement mentioned none of them. . . . This raises the possibility – no greater confidence is possible before discovery – that Baxter omitted important variables from the cautionary language and so made projections more certain than its estimates at the time warranted.

Id. at 734.

Unlike the *Asher* district court and the circuit court cases discussed above — where the courts held that the cautionary language passed muster and invoked the safe harbor provision to dismiss the claims prior to discovery — Judge Easterbrook held that where, as here, the risk disclosed is not *identical* to the negative contingency that came to pass, discovery is necessary to determine whether defendants disclosed the principal or important risks known to them at the time of the disclosure. Put another way, the pre-*Asher* safe harbor courts were willing to dismiss claims based on their determination that defendants' cautionary language was specific and tailored to the risks that accompany the projections, and that the cautionary language, on its face, warned of risks the same or similar to those actually realized. The *Asher* court, however, was unwilling to make a similar determination prior to discovery.

Baxter intends to appeal the Seventh Circuit's ruling to the United States Supreme Court, and the issues raised in *Asher* are ripe for such review. First, the *Asher* decision conflicts with the circuit court opinions discussed above and appears to have created a circuit split. Next, the *Asher* court's reasoning also seems to contradict the express language of the PSLRA, which directs courts on a motion to dismiss to "consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement." 15 U.S.C. § 77z-2(e). *See Johnson v. Tellabs, Inc.*, 262 F. Supp. 2d 937, 953 n.15 (N.D. Ill. 2003). Finally, Judge Easterbrook is an influential jurist and the *Asher* decision likely will have far reaching effects on both federal securities litigation and the content of the information that corporations disclose to their investors. The *Asher* decision already has gained traction — at least one district court has rejected a defendant's safe-harbor defense relying on the *Asher* court's reasoning. *See State of New Jersey v. Sprint Corp.*, 2004 WL 1960130 (D. Kan. Sept. 3, 2004). If other courts continue to adopt Judge Easterbrook's analysis, it would signal a major shift in PSLRA jurisprudence. Absent the Supreme Court's clarification of the schism in the case law, corporate management again may have to limit the information it shares with investors because of the risk of protracted and expensive litigation.

ISBN 1056 3059