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I. INTRODUCTION

Congress included safe harbor provisions for forward-looking statements in the 1995 Private Securities Litigation Reform Act ("PSLRA" or "Reform Act")[1] to "enhance market efficiency by encouraging companies to disclose forward-looking information."[2] The second of these safe harbors provides that a defendant "shall not be liable with respect to any forward-looking statement, whether written or oral, if . . . the forward-looking statement is . . . immaterial."[3] Prior to the enactment of the PSLRA, lower courts applied a variety of materiality standards to forward-looking statements. Many courts applied the standard endorsed by the Supreme Court in *Basic Inc. v. Levinson*[4] (a case involving non-predictive statements), under which a statement's materiality turns on whether "'there is a substantial like-

1. Private Securities Reform Act of 1995, 15 U.S.C. §§ 77k, 77*l*, 77z-1, 77z-2, 78a, 78j-*1*, 78t, 78u, 78u-4, 78u-5 (Supp. I 1995). The safe harbor provisions are codified at 15 U.S.C. § 78u-5 (Section 27A of the Exchange Act of 1934 ("Exchange Act") and Section 21E of the Securities Act of 1933 ("Securities Act")). The Reform Act defines "forward-looking statement" as:

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items; (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer; (C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission; (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C); (E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or (F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

15 U.S.C. § 78u-5(i)(1) (Supp. I 1995).

2. H.R. CONF. REP. NO. 104-369, at 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 741.

3. 15 U.S.C. § 78u-5(c)(1) (Supp. I 1995).

4. 485 U.S. 224 (1988).

lihood that a reasonable shareholder would consider it important.'"[5] Other courts found the direct application of the *Basic* test inappropriate in the forward-looking statement context and, therefore, applied various proxy "bright-line" materiality tests instead.

Because the PSLRA does not express an explicit preference for the standard endorsed in *Basic* or for any of the bright-line materiality tests, post-PSLRA courts must decide which standard is most consistent with the overall legislative scheme of the Act to determine whether the second safe harbor immunizes a given forward-looking statement from liability. This Note argues that the use of bright-line materiality tests rather than the standard endorsed in *Basic* was unjustified before the enactment of the PSLRA and remains unjustified after the Act's passage. This Note, therefore, concludes that post-PSLRA courts should not use these bright-line tests to give content to the second PSLRA safe harbor.

Part II of this Note briefly describes the Securities Exchange Commission's ("SEC" or "Commission") regulatory approach to forward-looking statements prior to the PSLRA and then summarizes the PSLRA safe harbor provisions. Part III discusses the disagreement in *Helwig v. Vencor Inc.*,[6] the principal case of this Note, between the Sixth Circuit en banc majority and dissent over the applicability of the PSLRA's "immateriality" safe harbor to optimistic earnings forecasts made by the defendant that proved inaccurate. The majority cited the materiality standard endorsed in *Basic*, but then, in a puzzling turn, found that the Sixth Circuit's bright-line "substantial certainty" test, if appropriately qualified, was consistent with that standard. Applying this qualified substantial certainty test to the defendants' earnings forecasts, the majority found that the forecasts could not "be deemed 'immaterial' within the meaning of the PLSRA."[7] The dissent argued that *Basic* does not require courts to assess the materiality of forward-looking information by applying the materiality standard endorsed by the Supreme Court in that case. The dissent, therefore, applied the substantial certainty test without

5. *Id.* at 231 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

6. 2001 Fed. App. 0179P (6th Cir.), 251 F.3d 540. In order to avoid confusion, this decision will be referred to hereinafter in the footnotes as *Helwig II.* The court's earlier decision, *Helwig v. Vencor*, 2000 Fed. App. 0145P (6th Cir.), 210 F.3d 612, will be referred to as *Helwig I.* Unless otherwise noted, all textual references to *Helwig* shall refer to *Helwig II.*

7. *Helwig II*, 2001 Fed. App. 0179P, ¶ 34, 251 F.3d at 556.

any qualification and found the forecasts immaterial as a matter of law.

Part IV of this Note identifies several important aspects of the Supreme Court's treatment of the issue of materiality and then, with the help of that background, analyzes the *Helwig* dissent's use of the substantial certainty test. Part V describes some of the other bright-line materiality tests that pre-PSLRA circuit and district courts have applied to find projections and other forward-looking information immaterial as a matter of law. The Fourth Circuit has often achieved this result by applying a "guarantee" test, under which a projection is material only if its presentation suggests to investors that the results it projects are guaranteed. The Fourth Circuit's justification for applying this test, rather than the materiality test endorsed in *Basic*, is based on the assumption that accuracy-based protection[8] is not available with respect to forward-looking statements because such statements almost always prove wrong in hindsight.[9] This justification is unconvincing, Part V argues, because the fact that a projection did not materialize does not mean that a court cannot still find it was "true when made" by assessing the accuracy of the projection's implied representations. Part VI provides a brief conclusion.

II. BACKGROUND

The threshold requirement for establishing liability under all of the federal securities fraud rules is a showing that the defendant made a materially false or misleading statement.[10] In other words, a court's assessment of the falsity and materiality of the defendant's

8. In a case involving an allegedly fraudulent statement of historical fact, a defendant can prevail simply by demonstrating that the historical events or performance that the statement reported did in fact occur.

9. In the Fourth Circuit's view, the added protection of the guarantee materiality test compensates for this loss of accuracy-based protection.

10. A statement about an issuer that is technically true may nevertheless cause an outside observer to come to an incorrect conclusion if the speaker fails to make certain additional disclosures germane to the statement. The language used in Rule 10b-5 (the antifraud rule relied on by the plaintiffs in the principal case of this Note) to ensure that such technically true but misleading statements are deemed false is very similar to that used in sections 11 and 12(a)-2: "It shall be unlawful . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b), 10b-5(b) (2001); *cf.* 15 U.S.C. § 77k(a), and 15 U.S.C. § 77*l*(2) (Supp. I 1995). *See generally* Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87 (1999).

statements determines the actionability per se of the statements. If a court determines that the defendant's statements were both false and material, it will then apply the other elements of the antifraud rule relied upon by the plaintiff to determine whether the circumstances under which the actionable statements were made entitle the plaintiff to recovery.[11]

For the first several decades following the passage of the Securities Act and the Exchange Act, the SEC prohibited the inclusion of financial projections and other forward-looking information in documents filed with the Commission.[12] Consequently, only a small number of private securities fraud cases during this period were based on allegedly fraudulent forward-looking statements. The SEC formally reversed its policy on forward-looking statements in 1978 and shortly thereafter adopted a general safe harbor rule to encourage their disclosure in filed documents.[13] Since that time, however,

11. The plaintiffs in *Helwig* sought to recover under Rule 10b-5, promulgated by the SEC under section 10(b) of the Exchange Act. To prevail on a Rule 10b-5 securities fraud claim, a plaintiff must prove that, in connection with purchase or sale of a security, (1) the defendant made false statement or omission (2) of material fact (3) with scienter (4) upon which the plaintiff justifiably relied (5) that caused the plaintiff's damages. 17 C.F.R. § 240.10b-5 (2001); Twiss v. Kury, 25 F.3d 1551, 1558 (11th Cir. 1994). While the first two elements of the rule, falsity and materiality, concern the nature of the disclosure itself (its actionability per se), the third, fourth, and fifth elements concern, respectively, the state of mind of the party that made the disclosure, the response of the plaintiff to the disclosure and the impact of that response on the plaintiff. The primary distinction between Rule 10b-5 and the antifraud rules of the Securities Act, most importantly sections 11 and 12(a)(2), is that a showing of scienter is not a prerequisite to recovery under the latter. *See* 15 U.S.C. §§ 77k, 77*l*(2) (Supp. I 1995). Under section 11, for instance, an issuer is strictly liable for material misstatements or omissions in a registration statement and other participants in the offering may be jointly liable to the extent they failed undertake a reasonable investigation of the truthfulness of the misstatements. 15 U.S.C. § 77k (Supp. I 1995).

12. *See* Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1117 (1989). The SEC's policy was based on the view that investors would place undue faith in projections included in documents reviewed by the Commission. *Id.* at 1117–19.

13. *See id.* at 1122–23; *see also* 12 C.F.R. § 563d.3b-6 (2001). The Commission concurrently adopted Rule 175 under the Securities Act. The text of Rule 175 is identical to Rule 3b-6 except for the respective references to the "Securities Exchange Act of 1934" and the "Securities Act of 1933." Consistent with courts' interpretations of Rule 10b-5 and the other federal antifraud rules, Rule 3b-6 includes in the definition of "fraudulent statement" any statement "which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, [or] an omission to state a material fact necessary to make a statement not misleading." 12 C.F.R. § 563d.3b-6(d) (2001).

courts have been criticized for inconsistently applying the safe harbor.[14]

In late 1994, noting that, "[c]ontrary to the Commission's original intent, the safe harbor is currently invoked on a very limited basis in a litigation context,"[15] the SEC solicited public comment on whether the safe harbor was "effective in encouraging disclosure of voluntary forward-looking information and protecting investors or, if not, [whether it] should be revised."[16] Shortly thereafter, however, the Commission's rulemaking proceedings were effectively preempted by the introduction of a bill in Congress that contained a wide variety of provisions aimed at reforming federal securities litigation, including a new safe harbor for forward-looking statements.[17] When the legislation was finally enacted at the end of 1995 as the PSLRA, it contained three independent forward-looking statement safe harbors.[18]

The first safe harbor immunizes a forward-looking statement that is identified as such and "is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[19] While there is wide agreement that this safe harbor is based upon the judicially developed "bespeaks caution" doctrine, the decisions that address the question of what constitutes a "meaningful" cautionary statement are inconsistent.[20] The second safe harbor, the meaning of which was debated by the *Helwig* majority and dissent, immunizes a forward-looking statement that is "immaterial."[21] The third safe harbor shields defendants from liability if the plaintiff fails

14. *See* Safe Harbor for Forward-Looking Statements, Securities Act Release No. 33,7101, 57 SEC Docket 1999, 1994 WL 562021, at *9 (Oct. 13, 1994).

15. *Id.* at *1.

16. *Id.*

17. *See generally* H.R. 1058, 104th Cong. (1995).

18. 15 U.S.C. § 78u-5 (Supp. I 1995) (section 27A of the Exchange Act and section 21E of the Securities Act). Although section 27A speaks in terms of a single safe harbor, because of the disjunctive nature of subsection (c)(1) a defendant can obtain the protection of the section by meeting any of the three independent tests. *See infra* text accompanying notes 19–22.

19. *Id.* § 78u-5(c)(1)(A)(i) (Supp. I 1995).

20. *See* Ann Morales Olazabal, *Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What's Safe and What's Not?*, 105 DICK. L. REV. 1, Fall 2000, at 14.

21. 15 U.S.C. § 78u-5(c)(1)(A)(ii) (Supp. I 1995).

to prove that the speaker who made the forward-looking statement had "actual knowledge" that the statement was false or misleading.[22]

III. *HELWIG V. VENCOR*

This Part discusses the disagreement between the *Helwig* majority and dissent over the applicability of the PSLRA "immateriality" safe harbor. It first provides a summary of the facts and procedural history of the case and then discusses the contrasting responses of the majority and dissent to the Sixth Circuit "substantial certainty" materiality doctrine.[23]

22. *Id.* § 78u-5(c)(1)(B) (Supp. I 1995). Along with the safe harbor provisions, the PSLRA's heightened pleading standards were among the most controversial provisions of the Reform Act. *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 977 (1996). The falsity pleading standard, set forth under section 21D(b)(1) of the Exchange Act, requires that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C § 78u-4(b)(1)(B) (Supp. I 1995). The scienter pleading standard, set forth under section 21D(b)(2) of the Exchange Act, requires that where a "required state of mind" is an element of the plaintiff's cause of action, the complaint "shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C § 78u-4(b)(2) (Supp. I 1995). At the pleading stage of a litigation based on allegedly fraudulent forward-looking statements, the safe harbor provisions interact with these pleading standards. For instance, the actual knowledge requirement of the third safe harbor supplies the "required state of mind" to which the PSLRA scienter pleading standard applies. Likewise, where a plaintiff asserts that cautionary statements accompanying a projection were not meaningful because, for instance, an internal company report describes factors that were *not* contained in the cautionary statements accompanying the projection, but which were much more likely to affect actual results than those factors that were contained in such statements, the complaint may be dismissed under the falsity pleading standard unless it identifies such things as "the sources of [the plaintiff's] information with respect to the reports, how [the plaintiff] learned of the reports, who drafted them, or which officers received them." *In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 985 (9th Cir. 1999). For commentary on the Reform Act's pleading standards, see Marilyn F. Johnson et al., *In re* Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773 (2000); Ann Morales Olazabal, *The Search for "Middle Ground": Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN., Spring 2001, at 153; Elliott J. Weiss & Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 That the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q., Summer 1998, at 457; Elliot J. Weiss, *Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS., Spring/Summer 2001, at 5.

23. *See* Hiler, *supra* note 12, at 1180–81.

A. Facts and Procedural History

In 1997, Vencor, Inc. was one of the largest full-service providers of long-term health care in the United States.[24] In February of that year, the company publicly announced several earnings forecasts, including estimated fourth-quarter earnings of $0.59 to $0.64 per share.[25] The same month, President Clinton proposed legislation aimed at balancing the federal budget.[26] The proposed legislation contained several provisions for adjusting the manner and extent of Medicare and Medicaid payouts to health care providers such as Vencor.[27] Vencor directed the preparation of several cost analyses of the budget reform proposals and, in July, circulated an internal memorandum regarding the potential impact of the legislation on the company's finances.[28]

At the end of July, Congress passed the Balanced Budget Act,[29] which contained two of the four health care reform provisions that were included in President Clinton's February proposal.[30] The President signed the legislation shortly thereafter. In late September, Vencor reaffirmed its February earnings forecasts for the fourth quarter without disclosing the results of its internal analyses of the budget reform proposals. In addition, in each of its three periodic reports filed with the SEC from February to September, Vencor stated that it could not "predict the content of any healthcare or budget reform legislation"[31] and that it was thus "unable to assess the effect of any such legislation on its business."[32] On October 22, however, Vencor announced that its fourth quarter earnings would fall far short of its forecasts because of the impact of the Balanced Budget Act on its operations.[33] In response to the announcement, its stock price fell nearly thirty percent.[34]

24. *See Helwig II*, 2001 Fed. App. 0179P, ¶ 1 (6th Cir.), 251 F.3d at 545.
25. *Id.* ¶ 4, 251 F.3d at 545.
26. *Id.* ¶ 2, 251 F.3d at 545.
27. *Id.* ¶ 3, 251 F.3d at 545.
28. *Helwig I*, 2000 Fed. App. 0145P, ¶ 4 (6th Cir.), 210 F.3d at 616 n.7.
29. Balanced Budget Act of 1997, Pub. L. No. 105-33, 111 Stat. 251 (1997).
30. *Helwig II*, 2001 Fed. App. 0179P, ¶ 3, 251 F.3d at 546.
31. *Id.* ¶ 4, 251 F.3d at 546.
32. *Id.*
33. *Id.* ¶ 5, 251 F.3d at 546.
34. *Id.* Vencor's stock price fell from $42-5/8 per share to $30 per share after the announcement. *Id.*

The plaintiffs, seeking recovery on behalf of a class of investors that bought shares of Vencor between February and October, brought suit in December alleging, among other things, that the earnings forecasts were materially misleading in violation of section 10(b) and Rule 10b-5.[35] Considering Vencor's motion to dismiss, the district court found that the plaintiffs had stated a claim under the PSLRA, but then, without notice to either party, converted Vencor's motion to dismiss into a motion for summary judgment, which it then granted.[36] On appeal, a majority of a three-member panel of the Sixth Circuit agreed with the plaintiffs that the motion conversion was improper, but nevertheless affirmed the district court's dismissal after finding that the plaintiffs' complaint did not the meet the PSLRA pleading standards.[37] The plaintiffs responded by filing a petition for a rehearing en banc, which the court granted.[38]

Finding that the district court's motion conversion was a "serious error"[39] and that the plaintiffs' complaint stated a claim, the en banc court reversed the district court's dismissal.[40] Judge Merritt, writing for the seven-member en banc majority, framed his opinion in terms of whether, under the allegations in the plaintiffs' complaint, Vencor could claim any of the PSLRA safe harbors for its earnings forecasts and other forward-looking statements.[41] After determining that none of the safe harbors were available for any of Vencor's forward-looking statements, the majority found it relatively easy to conclude that the plaintiffs had met the pleading standards of

35. *Helwig I*, 2000 Fed. App. 0145P, ¶ 11, 210 F.3d 612, 618. The defendants included, in addition to the company, six of the company's directors. *Id.* ¶ 3, 210 F.3d at 615.

36. *Helwig II*, 2001 Fed. App. 0179P, ¶¶ 25–26, 251 F.3d at 552–53.

37. *Helwig I*, 2000 Fed. App. 0145P, ¶ 16, 210 F.3d at 619. A plaintiff's Rule 10b-5 claim may be dismissed under the PSLRA if the court finds that allegations in the complaint fail to provide sufficient corroborating details to meet the particularity requirements of the PLSRA pleading standards. In this case, the two-member panel majority did not question the sufficiency of detail in the plaintiffs' complaint, but rather found that the alleged facts did not "establish either (1) the falsity or the misleading characteristics of the defendants' statements or, (2) a strong inference that the defendants had the state of mind required by the statute." *Id.* ¶ 17, 210 F.3d at 620. In other words, while sufficiently particularized, the plaintiffs' allegations, in the majority's view, failed to satisfy the substantive requirements of the PSLRA pleading standards. *See* 15 U.S.C. § 78u-4(b) (Supp. I 1995).

38. Helwig v. Vencor, Inc., 222 F.3d 268 (6th Cir. 2000).

39. *Helwig II*, 2001 Fed. App. 0179P, ¶ 25, 251 F.3d at 552.

40. *Id.* ¶ 1, 251 F.3d at 544.

41. *Id.* ¶¶ 30–31, 251 F.3d at 554–55.

the PSLRA.[42] In dissent, Judge Kennedy, joined by five other judges, argued that the earnings projections and other forward-looking statements were immaterial as a matter of law and were, therefore, protected under the second PSLRA safe harbor.[43]

Under the materiality test endorsed by the Supreme Court in *Basic Inc. v. Levinson*, a false or misleading statement is actionable under Rule 10b-5 if "'there is a substantial likelihood that a reasonable shareholder would consider it important.'"[44] The thirty-percent drop in Vencor's stock price in response to the company's announcement that actual earnings would fall short of its forecasts strongly suggests that reasonable investors considered the forecasts important. The following section examines how, notwithstanding the seemingly obvious significance of the forecasts to investors, the *Helwig* majority and dissent were able to reach different conclusions as to the forecasts' materiality.[45]

B. The Conflicting Approaches of the Helwig *Majority and Dissent in Determining the Availability of the PSLRA Immateriality Safe Harbor*

The *Helwig* majority ultimately concluded that, although *Basic* involved nonpredictive statements, it was appropriate to apply the materiality standard endorsed in that case to Vencor's earnings forecasts.[46] It began its analysis, however, by acknowledging the Sixth Circuit doctrine that "sales figures, forecasts and the like only rise to the level of materiality when they can be calculated with substantial

42. *Id.* ¶ 53, 251 F.3d at 562.

43. *Id.* ¶¶ 69–80, 251 F.3d at 567–70 (Kennedy, J., dissenting). Judge Kennedy also argued, as she did in the panel majority opinion, that the allegations in the complaint failed to meet the "strong inference" requirement of the scienter pleading standard. *Id.* ¶¶ 84–86, 251 F.3d at 571 (Kennedy, J., dissenting). See *supra* note 22 for a discussion of the PSLRA pleading standards.

44. 485 U.S. 224, 231 (1988) (quoting TSC Indus., Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976)).

45. This Note does not discuss the disagreement between the majority and the dissent over the availability of the immateriality safe harbor for the statements that Vencor made regarding the Balanced Budget Act in its annual and quarterly reports prior to the signing of the Act. The majority found that these statements were forward looking for purposes of the PSLRA and that they were material. The dissent, applying the "substantial certainty" materiality test discussed below, found that these statements were immaterial. This Note also does not directly address the disagreement between the majority and the dissent over whether the complaint met the heightened pleading standards of the PSLRA.

46. *Helwig II*, 2001 Fed. App. 0179P, ¶ 34, 251 F.3d at 556.

certainty."[47] Rather than reject this substantial certainty test outright (as inconsistent with the materiality standard endorsed in *Basic*), the majority instead opted to qualify the test by adopting the view that "matters that are not material because they are not so probable or relevant . . . may be material if information about them is stated falsely or misleadingly in [other] communications."[48] Applying this qualified "substantial certainty" test to the facts of the case, the majority found that while Vencor's earnings forecasts may not have been material in isolation (because of their uncertainty) they became material, under the standard endorsed in *Basic*, when Vencor falsely stated "information about them"; that is, that it could not assess the impact of the Balanced Budget Act upon future earnings. In other words, Vencor's knowledge that the Balanced Budget Act would adversely affect its earnings, combined with its public insistence that it could not determine whether the Act would have any such effect, in the majority's view, made its earnings forecasts material.[49]

In response, Judge Kennedy claimed, "[T]he majority's reading of our case law is not supported by the opinions they rely on, but instead, it establishes a new principle which contradicts prior cases in this Circuit."[50] Among other flaws in the majority's approach, Judge Kennedy pointed out that the majority "nimbly turns the question from whether estimates were capable of being calculated with substantial certainty to whether there was a substantial certainty that the

47. *Id.* ¶ 32, 251 F.3d at 555 (quoting James v. Gerber Prod. Co., 587 F.2d 324, 327 (6th Cir. 1978)).

48. *Id.* (quoting Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 57 VA. L. REV. 723, 750 (1989)).

49. *Id.* ¶ 34, 251 F.3d at 556. Although the dissent did not criticize the majority's opinion on this basis, the majority's reliance on the falsity of the statements regarding the Balanced Budget Act in its application of the materiality standard endorsed in *Basic* seems problematic. This approach is indistinguishable from an earlier approach used by the Sixth Circuit to assess the materiality of merger discussions that the Supreme Court rejected in that very case. *Basic* came up from the Sixth Circuit, which had concluded that even if the merger discussions at issue were not material initially, they became material when Basic denied they were occurring: "'[O]nce a statement is made denying the existence of any [merger] discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue.'" *Basic*, 485 U.S. at 229 (quoting Basic Inc. v. Levinson, 786 F.2d 741, 749 (6th Cir. 1986)). Justice Blackmun, writing for the majority, rejected this approach, noting that it "fails to recognize that, in order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were *misleading* as to a *material* fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant." *Id.* at 238.

50. *Helwig II*, 2001 Fed. App. 0179P, ¶ 71, 251 F.3d at 567 (Kennedy, J., dissenting).

[Balanced Budget] Act, if enacted, would have any adverse effect on Vencor's business."[51] In Judge Kennedy's view, this reorientation of the substantial certainty test was "disingenuous" because, under a faithful reading of Sixth Circuit precedent, a court is required to find company projections that are incapable of being calculated with substantial certainty immaterial as a matter of law regardless of whether the company disclosed additional information germane to those projections.[52] Applying this test to Vencor's earnings forecasts, Judge Kennedy found the forecasts clearly immaterial because the plaintiffs had made no allegations suggesting the forecasts could be calculated with substantial certainty.[53]

IV. The Supreme Court's Treatment of the Materiality Requirement Under the Federal Securities Laws

This Part reviews important aspects of the Supreme Court's holdings in *TSC Industries, Inc. v. Northway, Inc.*[54] and *Basic Inc. v. Levinson*[55] with respect to the issue of materiality. It then explains how the *Helwig* dissent was able to distinguish the holdings of these cases to justify its use of the substantial certainty test to find Vencor's earnings forecasts immaterial as a matter of law.

A. The Pre-PSLRA Materiality Teachings of the Supreme Court

1. TSC Industries, Inc. v. Northway, Inc.

In *TSC Industries*, National Industries, Inc. ("National") acquired thirty-four percent of TSC Industries' ("TSC") outstanding stock from TSC insiders.[56] Shortly thereafter, the boards of the two companies, soliciting the stockholders' approval of a transaction whereby TSC would become a wholly owned subsidiary of National,

51. *Id.* ¶ 65, 251 F.3d at 568 (Kennedy, J., dissenting).

52. *Id.*

53. *Id.* (Kennedy, J., dissenting). Judge Kennedy added that Congress' consideration of the Balanced Budget Act, on which the majority based its conclusion that the earnings estimates were material, if anything, made the estimates less material because it could only have made them less capable of being calculated with substantial certainty. *Id.* (Kennedy, J., dissenting).

54. 426 U.S. 438 (1976).

55. 485 U.S. 224 (1988).

56. *TSC Industries*, 426 U.S. at 440.

distributed joint proxy statements to the stockholders of their respective companies.[57] The plaintiff, a major TSC shareholder, brought an action against both companies alleging that the joint proxy statement was materially misleading in violation of section 14(a) and Rule 14a-9 because it failed to disclose the extent of National's control over TSC at the time the transaction was approved by the TSC board.[58]

The Court of Appeals held the omission was material as a matter of law because "'a reasonable shareholder *might* consider [the omission] important.'"[59] Finding this standard "unnecessarily low,"[60] the Supreme Court stated: "The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[61] The Supreme Court emphasized that its formulation of this standard was guided by "[a] recognition . . . of the Rule's broad remedial purpose."[62] This emphasis on the purpose of Rule 14a-9 suggests that the Court intended the standard to be applicable only in the Rule 14a-9 context. [63] Nevertheless, nearly every court that has been required to make a materiality determination under *any* of the federal antifraud provisions in a post-*TSC Industries* case has commenced its inquiry by repeating the *TSC Industries* standard.[64]

57. *Id.* at 441.

58. *Id.* at 442–43.

59. *Id.* at 445 (quoting TSC Indus., Inc. v. Northway, Inc., 512 F.2d 324, 330 (7th Cir. 1975)).

60. *Id.* at 448.

61. *Id.* at 449. The Court then clarified what constitutes "important" in this context:

> It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id.

62. *TSC Industries*, 426 U.S. at 448.

63. The formulation of the standard itself, focusing as it does on whether "a reasonable shareholder would consider [the information] important in deciding how to *vote*," also supports this conclusion regarding the Court's intent. *Id.* at 449 (emphasis added).

64. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 41 (3d ed. 2001).

Although the *TSC Industries* Court reversed the lower court's holding that the alleged omissions were material as a matter of law, it did not apply the materiality standard it announced to find the alleged omissions *immaterial* as a matter of law. Instead, observing that it is normally improper to decide the issue of materiality as a matter of law, the Court remanded for further proceedings:

> In considering whether summary judgment on the issue [of materiality] is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact. Only if the established omissions are "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment.[65]

Although this language does not suggest that the Court viewed this part of its holding as being applicable only in the Rule 14a-9 context, in the years that followed the Court's decision, lower courts often found ways to declare statements that allegedly violated Rule 10b-5 immaterial as a matter of law.[66] The Third Circuit, for instance, developed an agreement-in-principle test that empowered judges to find preliminary merger discussions immaterial as a matter of law without making any direct inquiry into their significance to an investor.[67] The subsequent adoption by several other circuit courts of the agreement-in-principle test led the Supreme Court, eight years after its decision in *TSC Industries*, to grant certiorari in *Basic Inc. v. Levinson*.[68]

2. Basic Inc. v. Levinson

In *Basic*, the plaintiffs asserted that Basic Inc. violated Rule 10b-

65. *TSC Industries*, 426 U.S. at 450 (quoting Johns Hopkins U. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970)).

66. The lower courts' failure to follow the guidance of the Court on this issue is surprising given their expansive use of the *TSC Industries* materiality formulation, which, as noted above, was apparently not intended to be applied outside the Rule 14a-9 context.

67. *See* Staffin v. Greenberg, 672 F.2d 1196, 1207 (3d Cir. 1982).

68. 485 U.S. 224, 230 (1998).

5 when the company falsely denied that it was involved in merger negotiations.[69] The negotiations extended over three months and culminated in Basic's public endorsement of the acquiror's tender offer for all of the company's shares.[70] The denials included three separate public statements, the last of which was made in a report to Basic's shareholders issued about one month before the company endorsed the tender offer.[71]

Although neither party disputed the "application of the [*TSC Industries*] § 14(a) definition of materiality to § 10(b) and Rule 10b-5,"[72] Justice Blackmun, writing for the majority, found it worthwhile to state: "We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context."[73] He then acknowledged, however, that, in cases involving information about contingent or speculative events, the "reasonable investor" inquiry required by a direct application of the *TSC Industries* materiality standard may lead to unpredictable results because "it is difficult to ascertain whether the 'reasonable investor' would have considered [such] information significant at the time."[74]

To resolve the difficulty inherent in judging the importance of speculative events, Basic urged the Court to apply the Third Circuit's

69. *Id.* at 226–28.

70. *Id.* at 227–28.

71. *Id.*

72. *Id.* at 232 n.8.

73. *Basic*, 485 U.S. at 232.

74. *Id.* By holding that the *TSC Industries* standard should nevertheless be directly applied to statements containing contingent or speculative information such as a statement regarding the status of preliminary merger negotiations, the Court, in addition to extending the application of the *TSC Industries* standard to the Rule 10b-5 context, also extended the application of the standard to a new type of information. In *TSC Industries*, the statements the plaintiffs alleged were misleading concerned the extent of TSC's *present* control over National. Information concerning current or historical facts is often called hard information and is distinguishable from the speculative or soft information at issue in *Basic*. The significance of merger negotiations to a reasonable investor, as the Court points out, is a function of the probability that the negotiations will culminate in an agreement and the magnitude of the deal's impact on the company if they do. *Id.* at 238. Thus, while Basic's statements concerned a current state of affairs (the existence/status of merger negotiations), the significance of the statements was only ascertainable by reference to future events. These were not, however, forward-looking statements. This is not to say, of course, that statements regarding merger negotiations cannot be forward looking. Had Basic, for instance, rather than denying that the company was presently involved merger negotiations, instead stated that the company believed a merger would be consummated on favorable terms, its statement would have been forward looking.

agreement-in-principle test.[75] Under that test, preliminary merger negotiations do not become material until the parties reach agreement on the price and structure of the deal.[76] Although it acknowledged that the agreement-in-principle test would provide management with "a usable, bright-line rule"[77] for determining when a statement is material, the Court rejected the test because such a justification does not even "purport[] to explain why drawing the line at agreement-in-principle reflects the significance of the information upon the investor's decision."[78] In other words, the Court found the agreement-in-principle test's inquiry into the status of the merger discussions to decide the materiality question inappropriate because nothing about that inquiry suggests that its results are likely to correlate with the results of the "reasonable investor" inquiry required by a direct application of the *TSC Industries* standard.

The Court also observed that any other approach to assessing materiality that eliminates, as the agreement-in-principle test does, the need for "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him"[79] will suffer from the same defect: "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive."[80] It seems that in practice such approaches to materiality will tend to be underinclusive far more often than overinclusive.[81] In other words, they will empower judges to find misrepresentations *immaterial* as a mat-

75. *Id.* at 232–33.

76. *Id.* at 233.

77. *Id.*

78. *Id.* at 234. Instead of the "agreement-in-principle" test, the court adopted the highly fact-dependent probability/magnitude test, which, rather than shifting the focus of inquiry to the significance a reasonable investor would attach to the negotiations, simply assists the fact-finder in evaluating the level of such significance. *Id.* at 238; *see supra* note 74.

79. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

80. *Basic*, 485 U.S. at 236 (1988).

81. There are likely to be very few cases, for instance, in which a court would find denials of merger negotiations material under the agreement-in-principle test, but immaterial under a direct application of the *TSC Industries* standard. It is true that even though investors in a large company would not likely consider acquisitions of much smaller companies significant at any stage, such acquisitions would nevertheless be deemed material under the agreement-in-principle test once their terms were settled. It seems that such small acquisitions, however, would very rarely, if ever, create incentives for managers to cover up the negotiations.

ter of law more often than they will empower them to find misrepresentations *material* as a matter of law.

B. The Precedential Value of TSC Industries *and* Basic *for Cases Involving Forward-Looking Statements*

The *Basic* holding with respect to materiality can be restated in two parts: (1) The definition of materiality developed in *TSC Industries* for the purpose of Rule 14a-9 is also the proper materiality definition for the Rule 10b-5 context; and (2) it is incorrect, in assessing the materiality of a defendant's statements, to use tests that redirect the focus of inquiry away from the significance a reasonable investor would attach to the statements in order to find those statements immaterial as a matter of law. The second part of the holding thus concerns the proper mode of application of the materiality standard established by the first part of the holding.

The Supreme Court in *Basic* did not qualify the first part of its holding. Consequently, a lower court cannot escape use of the *TSC Industries* definition of materiality if the case before it involves a Rule 10b-5 claim. Arguably, however, the Supreme Court did qualify the second part of its holding. In a footnote at the beginning of the Court's discussion of the second part of its holding, the Court observed, "We do not address here any other kinds of contingent or speculative information, such as earnings forecasts or projections."[82] A lower court might, therefore, consider the second part of the *Basic* holding to be mandatory only in cases that involve either hard information (as in *TSC Industries*) or non-predictive soft information (as in *Basic*).[83]

The *Helwig* dissent read *Basic* in precisely this manner. Although Judge Kennedy acknowledged, consistent with the first part of the *Basic* holding, that "whether information is material depends on whether it is determined that a reasonable investor would find the information important,"[84] she resisted the second part of the *Basic* holding because the role her substantial certainty test plays in answering that question is indistinguishable from the role the agree-

82. *Basic*, 485 U.S. at 232 n.9.

83. In other words, a lower court could conclude that while *Basic* abrogated circuit court materiality tests that empower judges to find non-predictive statements immaterial as a matter of law, it left intact circuit court materiality tests that do the same with respect to forward-looking statements.

84. *Helwig II*, 2001 Fed. App. 0179P, ¶ 80 n.1, 251 F.3d at 570 n.1 (Kennedy, J., dissenting).

swering that question is indistinguishable from the role the agreement-in-principle test plays in assessing the materiality of preliminary merger negotiations.[85] Just as the agreement-in-principle test redirects the focus of inquiry to the status of the merger discussions (away from the significance a reasonable investor would attach to the discussions), Judge Kennedy's test redirects that focus to whether the projections "were capable of being calculated with substantial certainty."[86] Moreover, like the agreement-in-principle test, the substantial certainty test does not explain why the certainty of the forecasts "*reflects* [their] significance . . . upon the investor's decision[s]."[87] Thus, like the agreement-in-principle test, the substantial certainty test is "necessarily . . . underinclusive."[88] The difference between the two tests, of course, is in the type of statements to which each may be applied. Judge Kennedy did not explain why this difference should matter for the purpose of Rule 10b-5, but simply affirmed that under Sixth Circuit precedent it does: "This Circuit has continued to use the standard I rely on today well after the Supreme Court's decision in *Basic*."[89]

V. Is There Any Justification for Applying a Non-*TSC Industries* Materiality Test to Forward-Looking Statements?

The substantial certainty test, it turns out, is only one of several materiality tests that lower courts, in post-*Basic* decisions, have used to find forward-looking statements immaterial as a matter of law

85. Consequently, Judge Kennedy contends that Sixth Circuit precedent requires the court to "make [the materiality] determination in the context of projections by ascertaining whether the projections are able to be calculated with substantial certainty," rather than by directly applying the *TSC Industries* test. *Id.* (Kennedy, J., dissenting).

86. *Id.* ¶ 75, 251 F.3d at 568 (Kennedy, J., dissenting).

87. *Basic*, 485 U.S. at 234 (emphasis added). An investor will, of course, consider the relative certainty of a forecast in assessing its significance. An inquiry into the relative certainty of a projection is, therefore, consistent with the second part of the *Basic* holding, assuming that information regarding such certainty was available to investors. Judge Kennedy's materiality approach, however, mandates much more than simply taking the relative certainty of a projection into account. Under her approach, projections are immaterial as a matter of law not only if they are so uncertain that a reasonable investor, knowing of that uncertainty, would consider them insignificant, but also if, while not subject to such extreme uncertainty, they simply cannot be calculated with substantial certainty.

88. *Id.* at 236.

89. *Helwig II*, 2001 Fed. App. 0179P, ¶ 80 n.1, 251 F.3d at 570 n.1 (Kennedy, J., dissenting).

without directly inquiring into the significance a reasonable investor would attach to the statements. Several circuits have applied a "guarantee" test to achieve this result.[90] Likewise, in what Professor Donald C. Langevoort terms "strong uses" of the popular "bespeaks caution" doctrine, several lower courts have found issuer statements containing specific forecasts of future performance that are accompanied by generic warnings immaterial as a matter of law.[91]

90. *See, e.g.*, Lasker v. N.Y. State Elec. & Gas Corp., 85 F.3d 55 (2d Cir. 1996); Searls v. Glasser, 64 F.3d 1061 (7th Cir. 1995); Hillison Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204 (4th Cir. 1994); Raab v. Gen. Physics Corp., 4 F.3d 286 (4th Cir. 1993); Krim v. BancTexas Group, Inc., 989 F.2d 1435 (5th Cir. 1993). The guarantee test, like the agreement-in-principle test and the substantial certainty test, is a proxy for direct application of the *TSC Industries* test. Like those tests, the guarantee test relieves the judge of the obligation of assessing what inferences a reasonable investor would draw from the disclosures or omissions and of the significance to him of those inferences. While the agreement-in-principle test shifts the focus of inquiry to the status of the negotiations and the substantial certainty test to the level of certainty with which the projection is capable of being calculated, the guarantee test shifts the focus of inquiry to the wording of the prediction. *See infra* Part V.A. Thus, like the agreement-in-principle test and the substantial certainty test, the guarantee test designates one criterion as determinative and therefore is also necessarily underinclusive.

91. Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 BUS. LAW, Feb. 1994, at 481, 486. Professor Langevoort notes:

> the most striking feature of these [strong] uses is the mechanical nature of their exercise. Instead of looking closely and contextually at the disclosure in light of the cautions, . . . the cautionary language is given talismanic significance. Even a forecast that conveys carefully considered optimism gains protection. No doubt the relative simplicity of this approach is what entitles the courts to apply it is [*sic*] as a matter of law.

Id. (citations omitted). Professor Langevoort contrasts such strong uses of the bespeaks caution doctrine with its more restrained use in *Kaufman v. Trump's Castle Funding*, 7 F.3d 357 (3d Cir. 1993), in which the court carefully considered the extent to which accompanying cautionary statements were tailored to an allegedly fraudulent statement of optimism before finding the statement immaterial as a matter of law. Langevoort, *supra*, at 486. The *Kaufman* court provided the following description of the "bespeaks caution" doctrine:

> [W]hen 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.

Kaufman, 7 F.3d at 371. Some commentators argue that Congress intended to codify this description of the doctrine by its adoption of the first PSLRA forward-looking statement safe harbor, which immunizes from liability any projection that is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the [projection]." 15 U.S.C. § 78u-5(c)(1)(A)(i) (Supp. I 1995); *see supra* notes 19, 20, and accompanying text. In the author's view, the *Kaufman* court's description should not control courts' interpretation of this safe harbor for two reasons. First, the description does not contemplate that a projection will only be found immaterial as a matter of

Although Justice Kennedy did not explain why the second part of the *Basic* holding should not apply to forward-looking statements, it is clear that to the extent a justification for that view exists, it must be based on a distinction between these types of statements and the types of statements at issue in *TSC Industries* and *Basic* (statements containing hard facts or non-predictive soft information).[92] The Fourth Circuit has offered such a justification. This Part examines that justification, which was advanced by the court in *Raab v. General Physics Corp.*[93] in support of the guarantee test, and ultimately finds it unconvincing because of its failure to acknowledge the accuracy-based protection of the implied representation doctrine.

A. The Fourth Circuit's Justification for Its Use of the Guarantee Materiality Standard

In *Raab*, the plaintiffs argued that the defendant's annual report contained a variety of materially misleading statements, including several forecasts that failed to materialize. Among those forecasts were predictions that "[r]egulatory changes . . . ha[d] created a marketplace for the [defendant's] DOE Services Group with an expected annual growth rate of 10% to 30% over the next several years[,]" and "the DOE Services Group [was] poised to carry the growth and success of 1991 well into the future."[94] After citing authority for the use of the "guarantee" test, the court found the predictions immaterial as a matter of law because they "hardly constitute[d] a guarantee."[95] The court then explained how, in its view, the distinction between

law if, as *TSC Industries* and *Basic* require, it is so obviously unimportant in the context of the cautionary statements that reasonable minds could not differ as to its materiality. *See supra* Part IV.A–B. Second, specific projections such as earnings forecasts are generally important to investors whether or not accompanied by relevant risk factors. It does not make sense, therefore, to say that accompanying risk factors make such projections immaterial. Such accompanying risk factors may, however, be relevant to the question of whether the projection was "true when made." *See infra* Part V.B.

92. In other words, the justification cannot be wholly based on types of factors that the Supreme Court found did not justify the use of the agreement-in-principle test. For instance, the argument that a given materiality test for forward-looking statements would provide management with a "usable, bright-line rule" for determining when its predictions are material will not do. *See Basic*, 485 U.S. at 233.

93. 4 F.3d 286 (4th Cir. 1993).

94. *Id.* at 288.

95. *Id.* at 290; *see supra* note 90.

statements of current fact and predictive statements justifies the use of this test:

> Notwithstanding our holding that the allegedly false predictions here are not material, we recognize that expressions of belief or opinion concerning *current* facts may be material. We do not believe, however, that this materiality extends so easily to opinions on uncertain future events. . . . Predictions of future growth stand on a different footing [than statements concerning current facts] because they will almost always prove to be wrong in hindsight. If a company predicts twenty-five percent growth, that is simply the company's best guess as to how the future will play out. As a statistical matter, twenty percent and thirty percent growth are both nearly as likely as twenty-five. If growth proves less than predicted, buyers will sue; if growth proves greater, sellers will sue. Imposing liability would put companies in a whipsaw, with a lawsuit almost a certainty. Such liability would deter companies from discussing their prospects, and the securities markets would be deprived of the information those predictions offer. We believe that this is contrary to the goal of full disclosure underlying the securities laws, and we decline to endorse it.[96]

This justification for declining to apply the second part of the *Basic* holding to predictions deserves consideration because it does more than simply restate the arguments favoring a bright-line test that the Supreme Court rejected in *Basic*. While the *Raab* court did refer to the effect on management it believed a direct application of the *TSC Industries* materiality standard would have (i.e., disclosure deterrence), it argued that this outcome is the result of an important distinction between statements about current facts and forward-looking statements. The latter, it argued, "stand on different footing . . . because they will almost always prove to be wrong in hindsight."[97]

The court's conclusion that this difference justifies its use of a non-*TSC Industries* materiality standard is based on the Rule 10b-5 requirement that a plaintiff prove the defendant's statement was both false and material.[98] This conjunctive test for actionability gives the defendant in any Rule 10b-5 case two separate grounds for prevailing on a motion to dismiss or summary judgment motion. Accord-

96. *Id.*
97. *Id.*
98. *See supra* notes 10, 11, and accompanying text.

ingly, when a company discloses information it knows will be considered significant by investors, it can still ensure that its statements will not be actionable by simply taking the time to verify their accuracy. This means of protection evaporates, however, where the disclosure contains projections, which "will almost always prove to be wrong in hindsight."[99] Consequently, unless the materiality bar is raised, companies will only make projections that they either know investors will find insignificant or are certain will be realized and thus can guarantee. The guarantee test removes this disclosure deterrent by making all projections except those that a company states as guarantees immaterial as a matter of law. In other words, the test's heightened materiality standard compensates for the loss of accuracy-based protection and thereby restores the liability balance to a state that is conducive to "the goal of full disclosure underlying the securities laws."[100]

The *Raab* court's justification of the guarantee test would also justify Judge Kennedy's substantial certainty test. The important question, of course, is whether the underinclusiveness of such materiality tests is a justifiable price[101] to pay for avoiding the liability "whipsaw" that would otherwise deprive "the securities markets . . . of the information [companies'] predictions offer?"[102] If there was simply no other way to address this excessive liability exposure, then the use of such tests may be justifiable. In other words, if a court's only choices were to either raise the materiality bar or find the prediction actionable because it proved to be wrong, then the court may be justified in applying a standard under which most types of conventional forecasts will be deemed immaterial as a matter of law.[103] As it turns out, however, an alternative method for evaluating the falsity of projections, which has been applied by many lower courts since the SEC's reversal of its policy on the disclosure of forward-looking information, substantially dulls *Raab's* "whipsaw."

99. *Raab*, 4 F.3d at 290.

100. *Id.*

101. The definitional incoherence of these materiality tests, which do not even purport to "reflect[] the significance of the information upon [an] investor's decision," is an additional, albeit related, cost of their use. *Basic*, 485 U.S. 224, 234 (1988).

102. *Raab*, 4 F.3d at 290.

103. While there may be certain types of predictions that issuers can calculate with substantial certainty, revenue and earnings forecasts, which investors are perhaps most interested in, can rarely be calculated with substantial certainty. Likewise, issuers rarely use language in making revenue and earnings forecasts that suggest the predicted results are guaranteed.

B. The Implied Representation Doctrine

The Ninth Circuit was the first court to apply explicitly this alternative approach to analyzing the falsity of forward-looking statements. In *Marx v. Computer Sciences Corp.*,[104] a case that was decided three years before the SEC formally reversed its policy with respect to forward-looking information, the vice president of the Computer Sciences Corporation (CSC) stated in a speech to analysts that CSC expected to earn $1.00 per share for the current fiscal year, the end of which was a little over two months away.[105] The plaintiff learned of the vice president's remarks and purchased 2,000 shares of company stock at $30 per share.[106] When CSC ultimately posted annual earnings of $0.41 per share, its stock price dropped to $10 per share.[107]

The court first found that there could be "[no] doubt that the forecast of earnings was a 'material' fact"[108] and then turned to the falsity inquiry:

> The next question is, was the forecast an "untrue" statement. Of course in hindsight it turned out to be wrong. But at least in the case of a prediction as to the future, that in itself does not make the statement untrue when made. However, the forecast may be regarded as [an implied] representation that [on the date it was made], CSC's informed and reasonable belief was that . . . earnings would be approximately $1.00. . . . In addition, because [the disclosure of the forecast] implies a reasonable method of preparation and a valid basis, we believe also that it would be "untrue" absent such preparation or basis.[109]

It is clear that an article by Homer Kripke, criticizing the SEC's policy at that time of prohibiting the inclusion of projections in filings with the Commission, significantly influenced the Ninth Circuit's analysis.[110] In support of its implied representation doctrine, the court quoting Kripke, stated:

104. 507 F.2d 485 (9th Cir. 1974).

105. *Id.* at 488.

106. *Id.*

107. *Id.*

108. *Marx*, 507 F.2d at 489.

109. *Id.* at 489–90.

110. *See id.* at 485, 490 n.7; Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970).

> projections [should not] be subjected to statutory liabilities, either express or under rule 10b-5, in the same fashion as a statement of fact about last year's sales or the ownership of a building. Rather the sole factual elements of a projection should be that it represents management's view, that it was reached in a rational fashion and that it is a sincere view. Only these elements can be subject to a statutory liability, not the eventuation of the prophecy.[111]

It is this concept of implicit factual elements, or implied representations, that the *Raab* justification for not applying the second part of the *Basic* holding to forward-looking statements fails to acknowledge. Under the implied representation doctrine, a company that decides to disclose projections it knows investors will consider significant can ensure that its statements will not be actionable even if it is not substantially certain that its actual performance will neither fall short of nor outdo those projections. While the speaker cannot verify beforehand the accuracy of the forecast, she can verify beforehand the accuracy of whatever implicit factual elements the particular forecast contains and under the implied representation doctrine that is enough to make the forecast "true when made." Because all forward-looking statements contain implicit factual elements of some sort,[112] it is incorrect for a court to assume, as the *Raab* court appears to have done, that it must either raise the materiality bar or find a projection actionable simply because it turned out to be wrong.

C. Heightened Pleading Standards Allow Courts to Meaningfully Apply the Implied Representation Doctrine to Dismiss Abusive Suits

The Rule 3b-6 safe harbor for forward-looking statements codifies one version of the implied representation doctrine by providing that a forward-looking statement "shall be deemed not to be a fraudulent statement . . . , unless its is shown that such statement was made . . . without a reasonable basis or was disclosed in other than good faith."[113] Thus, if raised by a defendant, the Rule requires a court to evaluate the accuracy of the speaker's implied representa-

111. *Marx*, 507 F.2d at 490 n.7 (quoting Kripke, *supra* note 110, at 1199).

112. It seems unquestionable that every forward-looking statement, no matter how vaguely stated, at a minimum contains the implicit factual representation that the speaker does not, at the time, know of any information that makes that forecasted results impossible.

113. 12 C.F.R. § 563d.3b-6(a) (2001). *See supra note* 13 and accompanying text.

tions before concluding that the forward-looking statement was false. Critics of Rule 3b-6, however, have argued it is ineffective because its provisions "are not applied by the courts in a manner that results in quick and inexpensive dismissals of frivolous lawsuits."[114] Such critics assert that "the safe harbor is infrequently raised by defendants, perhaps because it compels judicial examination of reasonableness and good faith, which raise factual issues that often preclude early, prediscovery dismissal."[115]

At first glance, this assertion may seem to provide an alternative justification for the use of non-*TSC Industries* materiality tests. Even if the application of the implied representation doctrine means that legal liability will not necessarily follow where a projection fails to materialize, if a plaintiff can force an issuer to bear the costs of discovery before a court will apply the doctrine, its protection is largely illusory. Hence, the failure of courts generally to find a way to apply the implied representation doctrine to dispose of cases at the pleading stage would be a viable justification for a *legislative* upward adjustment in the materiality standard. That failure in a particular case (assuming the absence of such a legislative directive[116]), however, would not necessarily justify the judge's application of an underinclusive materiality test. If, for instance, the relevant procedural rules require any plaintiff alleging securities fraud to state, with a high degree of particularity, facts that support an inference that the defendant's statement was false and the judge fails to enforce this pleading requirement, this failure would not justify the judge's subsequent use of a "bright-line" materiality standard to correct his prior error.

The pleading standard set forth in Rule 9(b) of the Federal Rules of Civil Procedure arguably requires such a high degree of particularity.[117] Many courts that accepted this reading of the pleading rule in pre-PSLRA cases involving allegedly fraudulent forward-looking

114. Safe Harbor for Forward-Looking Statements, *supra* note 14, at *8.

115. *Id.* at *9.

116. Nothing in the language of the PSLRA safe harbor or in the legislative history suggests that Congress intended to endorse any of the non-*TSC Industries* materiality standards as an appropriate way of applying the immateriality prong of the safe harbor. While Congress did explicitly define a heightened scienter requirement under the third prong of the safe harbor, it did not define "immateriality."

117. FED. R. CIV. P. 9(b). Rule 9(b) reads, "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." *Id.*

statements thus felt obligated to vigorously apply some form of the implied representation doctrine at the pleading stage of the litigation. In many such cases, these courts dismissed complaints that did not plead with sufficient particularity facts that suggested the implicit representations contained in the forward-looking statement were false.[118] In any event, any pre-PSLRA court that could not find in Rule 9(b) the obligation (or at least the flexibility) to require a plaintiff to plead the falsity element of his 10b-5 claim with a high degree of particularity cannot fail to see such an obligation in the pleading provisions of the PSLRA.[119]

VI. CONCLUSION

The bright-line materiality tests often applied by the lower courts in pre-PSLRA cases involving forward-looking statements are neces-

118. *See, e.g.*, San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 813 (2d Cir. 1996) ("Finally, with respect to the company's forward-looking statements, plaintiffs have not alleged circumstances to show that the defendants lacked a reasonable basis for their optimistic, but qualified, predictions as to the company's future performance."); Sinay v. Lamson & Sessions Co., 948 F. 2d 1037, 1040 (6th Cir. 1991) ("[T]he plaintiffs did not offer any objective evidence that the [forward-looking] statements were anything other than honestly held convictions based on the historical information which Lamson possessed."); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 117–18 (2d Cir. 1982) ("It is the 'more' that section 9(b) requires and that is lacking in plaintiff's complaint. We now know that the increased activity forecast for the construction industry did not take place. However, plaintiff has not alleged any particulars as to why Massey's stated reliance on those forecasts was false or misleading."); Blanchard v. Katz, 705 F. Supp. 1011, 1012 (S.D.N.Y. 1989) ("These paragraphs do not suffice to remedy the lack of factual allegations underlying the claims of misrepresentations and material omissions of the first complaint. . . . Plaintiffs in the case at hand have only made conclusory allegations."); Schwartz v. Novo Industri, A/S, 658 F. Supp. 795, 799 (S.D.N.Y 1987) ("To satisfy the particularity requirement of Fed.R.Civ.P. 9(b), a complaint must allege '(1) specific facts; (2) sources that support the alleged specific facts; and (3) a basis from which an inference of fraud may fairly be drawn.' While plaintiff asserts that Novo knew or should have known of the above-mentioned circumstances, plaintiff, other than these bare categorical allegations, offers no sources for the knowledge it seeks to impute to defendant.") (quoting Crystal v. Foy, 562 F. Supp. 422, 425 (S.D.N.Y. 1983)).

119. Some pre-PSLRA courts may have been reluctant to require a high degree of pleading particularity in cases involving forward-looking statements because Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." FED. R. CIV. P. 9(b). The PSLRA pleading standards, however, do not make an exception to the particularity requirements for the state of mind pleading, but rather specifically provide that the where a "required state of mind" is an element of the plaintiff's cause of action, the complaint "shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C § 78u-4(b)(2) (Supp. I 1995); *see supra* note 22.

sarily underinclusive because they "designate[] a single fact . . . as always determinative of [the] inherently fact-specific finding . . . [of] materiality."[120] Although such tests are inconsistent with the materiality standard endorsed by the Supreme Court in *Basic*, some lower courts have justified their use on the assumption that accuracy-based protection from liability for predictive statements is unavailable because such statements "will almost always prove to be wrong in hindsight."[121] By applying the implied representation doctrine, however, a court can provide significant accuracy-based protection for forward-looking statements even if they have proven wrong. Moreover, the Reform Act's heightened pleading requirements clearly empower courts to vigorously apply the implied representation doctrine at the pleading stage of a case involving forward-looking statements. Post-PSLRA courts, therefore, should use the materiality standard endorsed by the Supreme Court in *Basic*, rather than the lower court bright-line materiality tests, to give content the Reform Act's "immateriality" safe harbor.

These bright-line materiality tests may gradually whither and finally die on the vine because of their non-conformity to the holding in *Basic* and the absence of a justification for their use under the legislative scheme of the PSLRA. However, the *Helwig* dissent's dogged attachment to the substantial certainty test (as well as the *Helwig* majority's qualified acceptance of that test) suggests that such tests may have some measure of staying power. Thus, while the abrogation of the bright-line tests may not be sufficiently critical by itself to warrant Supreme Court review of a case where the issue is raised, when the Supreme Court does decide to enter the thicket of PSLRA safe harbor interpretation, it would do well to explicitly extend its holding in *Basic* to the forward-looking statement context.

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120. Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988).

121. Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993); *see supra* text accompanying note 96.