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Second Circuit Affirms Dismissal Of Securities Fraud Complaint, But Rejects Reform Act Safe Harbor Defense

In *Slayton v. American Express Co.*, No. 08-5442, 2010 WL 1960019 (2d Cir. May 18, 2010), the United States Court of Appeals for the Second Circuit affirmed the dismissal of a securities fraud class action against American Express Company ("Amex") on the ground that the complaint did not plead a strong inference of defendants' scienter. While the court affirmed dismissal, it rejected Amex's argument that the alleged misrepresentation was protected by the "safe harbor" for forward-looking statements set forth in the Private Securities Litigation Reform Act of 1995 ("Reform Act"). In doing so, the Court set forth useful guidance for determining when a statement is "forward-looking" and whether cautionary warnings are sufficiently "meaningful" to trigger the protection of the statute's safe harbor.

Plaintiffs were purchasers of Amex stock. They alleged that Amex and several Amex executives violated Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5, when Amex allegedly made a material misrepresentation in a statement in a quarterly report on Form 10-Q filed with the Securities and Exchange Commission ("SEC") in May 2001.

Plaintiffs' allegations were based on a *Wall Street Journal Asia* article. According to the article, the President of Amex, Kenneth Chenault, ordered a "very hard look" at Amex's high-yield debt portfolio after Amex reported losses from this portfolio of $123 million in 2000. In late February 2001, Amex received an email from its subsidiary, American Express Financial Advisors (AEFA), that "set a huge alarm ringing" concerning the rapid deterioration of AEFA's high-yield debt portfolio. On April 2, 2001 Amex announced an additional $182 million in first quarter 2001 high-yield write-downs, adding, however, in a press release, that "[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter." In early May 2001, Chenault was advised that Amex "was facing additional losses on its high-yield debt investments beyond those already booked" and that the deterioration of the high-yield debt portfolio was so bad, "even the investment-grade CDOs held by [Amex] showed potential deterioration." At this point, neither Amex nor AEFA executives could estimate the range of potential losses, and so, for the first time, began conducting an internal investigation into the extent of the high-yield losses.

On May 15, 2001, Amex reported the $182 million in first quarter losses from AEFA's high-yield debt portfolio in its Form 10-Q for the first quarter of 2001. The company blamed the losses on the "continued deterioration of the high-yield portfolio and losses associated with selling certain bonds," but added "[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter." The company also cautioned in its Form 10-Q that the filing "contain[ed] forward-looking statements, which are subject to risks and uncertainties," and added 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 AEFA's investment portfolio."

Amex's work to investigate and estimate the losses from the portfolio continued through July 2001. When Chenault discussed the results with investigators working on the issue, he was "stunned" by their estimate of $400 million in losses. Amex subsequently issued a press release on July 18, 2001, announcing that it would be taking a $826 million loss due to "additional write-downs in the high-yield debt portfolio at [AEFA] and losses associated with rebalancing the portfolio towards lower-risk securities."

In their complaint, plaintiffs alleged that defendants had no reasonable basis upon which to make the projections contained in the May 15, 2001 statement that losses for the remainder of 2001 were expected to be substantially lower than the first quarter losses. Amex argued the statements made in the Form 10-Q qualified as "forward-looking statements" as contemplated in the Reform Act, and as such, were protected by the Reform Act's "safe harbor" provision. The Reform Act provides a defendant is immune from liability for a "forward-looking statement" that later turns out to have been false if the statement is (i) "identified as a forward-looking statement, 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) immaterial; or (iii) the plaintiff fails to prove that the forward-looking statement was made by or with the approval of an executive officer with actual knowledge that the statement was false or misleading. *See* 15 U.S.C. § 78u-5. Under Reform Act, "forward-looking statements" in financial statements "prepared in accordance with generally accepted accounting principles" ("GAAP") are excluded from, and thus not protected by, the safe harbor.

The United States District Court for the Southern District of New York granted Amex's motion to dismiss. Pointing to the fact that "defendants immediately put together a team to analyze all of AEFA's high-yield debt and then announced the results of the analysis in July 2001," the district court held that while the "information [defendants] received in May 2001 could support an inference of scienter," "the more compelling inference [was] that defendants were not acting with an intent to deceive, but rather attempting to quantify the extent of the problem before disclosing it to the market."

The Second Circuit affirmed. Addressing defendants' arguments regarding the safe harbor, the Court observed that Amex's statement "comfortably" fit the Reform Act's definition of "forward-looking statement." Further, the statement was not precluded from safe harbor protection because it was not contained within the "financial statement" portion of the Form 10-Q. The Court, in interpreting "financial statement," noted the legislation itself distinguished between "financial statement[s] prepared in accordance with [GAAP]" and "statement[s] of future economic performance . . . contained in a discussion and analysis of financial condition by the management." The Court found SEC Regulations S-X and S-K confirmed this interpretation, as those regulations, read together, distinguished between financial and non-financial statement portions of filings.

The Court went on to hold, however, that the warnings accompanying the forward-looking statement were vague and meaningless, and thus fell short of the requirements for safe harbor protection. Looking to Third Circuit and Fifth Circuit case law, the Court outlined the requirements for meaningful cautionary statements. Warnings "must be extensive and specific"; they should be "substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge"; they should be "company specific" and "based on a realistic description of the risks applicable to the particular circumstances"; they should not be "vague or blanket (boilerplate) disclaimer[s] which merely warn[] the reader that the investment has risks." *See* *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009) [blog article here]; *Southland Securities Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 372 (5th Cir. 2004). The Court held that defendants bear the burden of demonstrating their warnings are protected under the "meaningful cautionary language prong" of the safe harbor.

Here, Amex's warning that a "potential deterioration in the high-yield sector . . . could result in further losses in AEFA's portfolio" fell short of the "substantive" and "specific" language required to invoke the protection of the safe harbor. The Court noted that the warnings remained unchanged despite the defendants' increased understanding of the problem, which bolstered its conclusion that the warning was not "tailored to the specific future projection."

The Court considered the real issue to be that the defendants "knew of the major and specific risk that rising defaults on the bonds underlying AEFA's investment-grade CDOs would cause deterioration in AEFA's portfolio at the time of the May 15 statement, and yet did not warn of it." The court noted that the Reform Act does not clarify whether an issuer whose "cautionary statement omitted a major risk that he knew about at the time he made the statement" could still be protected by the safe harbor provision, and congressional guidance on this matter was unhelpful, because Congress had explicitly precluded inquiry into a defendant's state of mind when determining whether cautionary language accompanying a forward looking statement is "meaningful." Ultimately, the Court avoided this "thorny issue" because it determined that the defendants' cautionary language was vague.

The Court ultimately affirmed the district court's dismissal of the action because plaintiffs failed to meet the Reform Act's "heightened pleading standard" which required they "state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant's intention 'to deceive, manipulate, or defraud.'" The Court relied on *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) [blog article here], which directs courts analyzing pleadings of scienter to consider whether the totality of circumstances give rise to an inference of scienter that is more compelling that any "plausible opposing inference." The Court concluded that facts alleged in the complaint, while close, did not support an inference of scienter more compelling than any opposing nonfraudulent inference. Framing the issue as "whether a reasonable person would, based on the facts alleged . . . , deem an inference that the defendants (1) did not genuinely believe the May 15 statement, (2) actually knew that 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,'" the Court held that a reasonable person would not. Finding that the defendants had "no reasonable basis" for predicting the extent of the deterioration would be "substantially lower than in the first quarter," the Court nonetheless held that the opposing nonfraudulent inference — that "while the defendants knew that their high-yield portfolio was likely deteriorating, and that they did not know the extent of the deterioration, they subjectively believed that the extent of the deterioration would lead to losses that would be substantially less than $182 million" — was at least as compelling.

Slayton provides useful guidance regarding numerous aspects of the Reform Act's safe harbor provisions. The key "take away" point is that the Second Circuit will scrutinize carefully the cautionary language accompanying forward-looking statements before according the statement the full protection of the safe harbor. Companies wishing to invoke that protection must ensure that the cautionary language specifically target clear and well-defined risks and explain in concrete terms why the company is susceptible to those risks.

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