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Securities Law: When Does a Securities Disclosure Truly "Bespeak" Caution?

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SECURITIES LAW: WHEN DOES A SECURITIES DISCLOSURE TRULY "BESPEAK" CAUTION?—*In re Donald J. Trump Casino Securities Litigation—Taj Mahal Litigation*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994)

I. INTRODUCTION

Recently, an increasing number of courts have employed the "bespeaks caution" doctrine[1] in cases involving violations of the securities laws.[2] The doctrine is significant because it provides issuers[3] protection from liability when they make public disclosures[4] that include soft in-

1. The "bespeaks caution" doctrine provides that predictive statements, or "soft" information, are not actionable when accompanied by cautionary language which is specifically tailored to disclose the risks involved. *See* Dennis J. Block & Jonathon M. Hoff, *Court Defines Scope of Bespeaks Caution Doctrine*, N.Y. L.J., Nov. 18, 1993, at 5. In order to bespeak caution, a disclosure containing risk statements must be accompanied by detailed cautionary language which specifically and repeatedly addresses the underlying factual assumptions of the investment. *See* Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 949 F.2d 243, 245 (8th Cir. 1991). Documents such as prospectuses, therefore, bespeak caution when they unquestionably warn potential investors in a meaningful way about uncertain economic conditions. *See* Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991).

2. Five courts of appeals recently adopted the bespeaks caution doctrine. *See Romani*, 929 F.2d at 879; I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 763 (2d Cir. 1991); Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1040 (6th Cir. 1991); *Moorhead*, 949 F.2d at 245-46; *In re* Convergent Technologies Sec. Litig., 948 F.2d 507, 516 (9th Cir. 1991). See *infra* notes 68-95 and accompanying text for further discussion of these cases.

Other courts of appeals have not expressly adopted the bespeaks caution doctrine, but have discussed issues involving materiality and reliance elements of securities claims in the context of soft information. *See, e.g.*, Raab v. General Physics Corp., 4 F.3d 286, 291 (4th Cir. 1993) (dismissing securities claims because statements of earnings predictions in annual report were not material); Pommer v. Medtest Corp., 961 F.2d 620, 624-25 (7th Cir. 1992) (holding that misstatements to investors that corporation held patent at time of stock sale were material); Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 644 (3d Cir. 1989) (dismissing securities claims of omissions in a prospectus relating to projections of future business course and future profitability because challenged omissions were not material); Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 207-08 (5th Cir.) (determining adequacy of disclosures of projections based on materiality test), *cert. denied*, 488 U.S. 926 (1988).

3. The Securities Act of 1933 [hereinafter 1933 Act] states that "[t]he term 'issuer' means every person who issues or proposes to issue any security." 15 U.S.C. § 77b(4) (1988). The 1933 Act defines the term "security" as "any note, stock, . . . bond, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security.'" *Id.* § 77b(1). For the purposes of this article, an issuer includes anyone who files a periodic report pursuant to the Securities Exchange Act of 1934 [hereinafter 1934 Act].

4. "The disclosure requirements for new security offerings are intended to afford potential investors an adequate basis upon which to decide whether or not to make an investment and to prevent misrepresentation, deceit, and other fraudulent practices in the sale of securities." General Guide: The Securities Act of 1933, 1 Fed. Sec. L. Rep. (CCH) ¶ 111, at 1015 (June 9, 1993). A security is generally treated the same under the 1934 Act as it would be under the 1933 Act, although they both provide different exceptions from the definition of a security and different

formation. Soft information "refers to statements of subjective analysis or extrapolation, such as opinions, motives, and intentions, or forward-looking statements, such as predictions, estimates, and forecasts."[5] When predictive statements do not come true, disappointed investors often sue the issuer, alleging that the disclosure document was misleading.[6] To avoid such unnecessary litigation, courts have employed the bespeaks caution doctrine to truncate securities litigation on motions to dismiss or motions for summary judgment.[7]

In *In re Donald J. Trump Casino Securities Litigation—Taj Mahal Litigation*,[8] the United States Court of Appeals for the Third Circuit joined five other courts of appeals by endorsing the bespeaks caution doctrine.[9] The Third Circuit affirmed the district court's dismissal of the investors' securities claims alleging material misrepresentations and omissions.[10] The court reasoned that the prospectus contained explicit cautionary statements which specifically addressed each

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exempted securities. General Guide: The Securities Exchange Act of 1934, 1 Fed. Sec. L. Rep. (CCH) ¶ 170 at 1051 (July 14, 1993). The 1933 Act "is designed to provide disclosure of pertinent information regarding the offer and sale of securities." General Guide: The Securities Act of 1933, 1 Fed. Sec. L. Rep. (CCH) ¶ 109, at 1015 (June 9, 1993). Generally, issuers disclose information in a registration statement and prospectus. *Id.* Section 6 of the 1933 Act requires that an issuer file a registration statement with the Securities and Exchange Commission. *Id.* ¶ 113, at 1015. The registration statement includes "any amendments, reports, documents, or memoranda filed as part of the statement or incorporated by reference." *Id.* A prospectus is defined in § 2(10) of the 1933 Act and includes "specific types of communications that offer the sale of a security." *Id.* The 1934 Act establishes a broad range of continuing disclosure and regulatory requirements. General Guide: The Securities Exchange Act of 1934, 1 Fed. Sec. L. Rep. (CCH) ¶ 170, at 1051 (July 14, 1993). The 1934 Act regulates the activities of various entities and persons involved in the securities industry. *Id.*

5. *Craftmatic*, 890 F.2d at 642. Rule 175, 17 C.F.R. § 230.175, provides a similar definition of soft information. *See infra* note 38. It should be noted that technical differences exist between various types of soft information. For example, a forecast is an actual prediction, while a projection is a somewhat more artificial extrapolation based on an assumption.

6. Since a projection, forecast, or other soft information is necessarily contingent on future events, even if this information is based on established trends and exhaustive analysis, it is inherently less reliable than statements of historical fact. Block & Hoff, *supra* note 1. "Accordingly, disclosure of such information carries a significant litigation risk if future events prove the prediction or opinion to be incorrect." *Id.* For a discussion of "fraud by hindsight", see *infra* notes 214-20 and accompanying text.

7. The early termination of securities claims also allows the issuer to avoid the burdens of class certification, extensive discovery, and the resulting pressure to settle. Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 BUS. LAW. 481, 482 (1994). For a discussion of cases employing the bespeaks caution doctrine to grant a defendant's motion to dismiss or motion for summary judgment, see *infra* notes 68-95 and accompanying text.

8. 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

9. *Id.* See *supra* note 1 for a list of the other courts of appeals recognizing the doctrine.

10. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 793 F. Supp. 543, 568 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

of the plaintiffs' claims.[11] The *Taj Mahal* opinion clearly sets forth the scope of the bespeaks caution doctrine.[12]

This Note addresses the application of the bespeaks caution doctrine to securities claims involving the disclosure of soft information. Section II of this Note outlines the development of the Securities and Exchange Commission's[13] stance on the disclosure of soft information, describes the particular securities regulations relevant to *Taj Mahal*, and reviews case law interpreting the bespeaks caution doctrine.[14] Section III describes the facts surrounding *Taj Mahal* and explains the Third Circuit's holding in the case.[15] Section IV examines the Third Circuit's holding in light of Supreme Court precedent and the rulings of other federal circuit courts of appeals.[16] Section IV also compares the *Taj Mahal* decision with current SEC policy and discusses public policy issues raised by the decision.[17]

Section V concludes that *Taj Mahal* is consistent with both Supreme Court precedent and the prevailing interpretation of the bespeaks caution doctrine by other courts of appeals. Section V also concludes that *Taj Mahal* is consistent with SEC policy and public policy. The Third Circuit's holding in *Taj Mahal* is currently the most instructive decision for issuers who make required public disclosures of soft information pursuant to the federal securities laws.

II. Background

The federal securities laws require that securities issuers disclose all material information to investors.[18] The SEC's position on an issuer's disclosure of soft information changed over the years from being prohibitive to requiring certain disclosures.[19] The bespeaks caution doctrine allows issuers to escape liability for disclosures of soft information which fail to be indicative of future events so long as the disclosure document contains specific and repeated cautionary statements.[20]

11. *Taj Mahal*, 7 F.3d at 377.
12. *See id.* at 371-73.
13. Created by Congress in the 1934 Act, the Securities and Exchange Commission [hereinafter SEC] is "the federal agency that administers the federal securities laws . . . [as] an independent bipartisan, quasi-judicial agency of the United States Government." General Guide: Federal Regulation of Securities, 1 Fed. Sec. L. Rep. (CCH) ¶ 107, at 1013 (June 9, 1993).
14. *See infra* notes 18-100 and accompanying text.
15. *See infra* notes 101-73 and accompanying text.
16. *See infra* notes 174-203 and accompanying text.
17. *See infra* notes 204-40 and accompanying text.
18. *See infra* notes 21-31 and accompanying text.
19. *See infra* notes 32-51 and accompanying text.
20. *See infra* notes 52-100 and accompanying text.

A. Duty to Disclose

The federal securities laws set forth an issuer's duty to disclose information in both the express disclosure mandates of the statutes and the rules promulgated thereunder,[21] and in the antifraud provisions of the statutes and rules.[22] Congress enacted the 1933 Act and 1934 Act to provide for full and fair disclosure to investors.[23] The SEC is the

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21. For example, the SEC requires filings of reports to ensure proper disclosure under: (1) the 1933 Act, 15 U.S.C. §§ 77a-77aa (1988), in registration statements for public offerings or distributions or in circulars to be furnished in the case of "exempt" offerings under Regulation D, 17 C.F.R. §§ 230.501-506 (1993), or rule 144, 17 C.F.R. § 230.144 (1993); and (2) various provisions of the 1934 Act, 15 U.S.C. §§ 78a-78*ll* (1988), including the registration and continuous disclosure requirements of §§ 12 and 13(a) and the rules thereunder; the proxy rules promulgated under § 14(a); the "going-private" rules promulgated under § 13(e); the tender offer and takeover rules promulgated under §§ 13(d), 13(e), and 14(d); and the insider trading rules under § 16. *See* 15 U.S.C. §§ 78*l*-78n, 78p, 78t-1 (1988 & Supp. V 1993).

22. *See, e.g.*, 1933 Act, § 12(2) (stating that an issuer who offers or sells a security "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading" shall be liable to the investor unless the issuer can sustain the burden of proof that it did not know or could not have known in the exercise of reasonable care the untruth or omission), and § 17(a)(2) (stating that the offer or sale of any security "by means of any untrue statement of a material fact or any omission 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" is unlawful), 15 U.S.C. §§ 77*l*(2), 77q(a) (1988); 1934 Act, § 10(b) (stating that it is unlawful to use "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe" in connection with the purchase of any security), and § 14(e) (stating that it is unlawful to "make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading" in connection with any tender offer), 15 U.S.C. §§ 78j(b), 78n(e) (1988 & Supp. V 1993).

23. Congress intended that the 1933 Act "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof." Securities Act of 1933, 1 Fed. Sec. L. Rep. (CCH), pmbl. at 1551 (May 27, 1933). *See, e.g.*, Pinter v. Dahl, 486 U.S. 622, 638 (1988) (noting that Congress designed disclosure provisions of the 1933 Act to protect unsophisticated investors); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1577 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (describing congressional intent to protect unsophisticated investors from fraudulent practices); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 564 (E.D.N.Y. 1971) (stating that purpose of 1933 Act is to protect the average, small investor). The 1934 Act stated the need for securities regulation as follows:

> [T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . to insure the maintenance of fair and honest markets in such transactions . . . .

Securities Exchange Act of 1934, § 2, 2 Fed. Sec. L. Rep. (CCH) ¶ 20,111, at 15,051 (June 6, 1934) (amended 1975). *See* Securities Exchange Bill of 1934, H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934) ("[T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value."); *see also* Santa Fe Indus. v. Green, 430 U.S. 462, 477-78 (1977) (describing the purpose of the 1934 Act as one implementing a "philosophy of full disclosure").

primary administrator of the federal securities statutes, and Congress delegated to it the responsibility of assuring that investors have access to material information.[24]

1. The Concept of Materiality

In *TSC Industries v. Northway, Inc.*,[25] the Supreme Court stated that a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to act and the fact would significantly alter the "total mix" of information available to a reasonable investor.[26] In *Basic Inc. v. Levinson*,[27] the Court expressly made this standard applicable to actions arising under section 10 of the 1934 Act and Rule 10b-5 promulgated thereunder, which prohibit fraudulent misstatements and omissions in connection with the purchase or sale of any security.[28] In *Virginia Bankshares, Inc. v. Sandberg*,[29] the Court noted that "there is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, can

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24. For example, in § 13(a) of the 1934 Act, Congress authorized the SEC to prescribe such rules and regulations necessary for the protection of investors and to ensure fair dealing in the securities markets. *See* 15 U.S.C. § 78m(a) (1988). Section 13(a) gives authority to the SEC to promulgate rules requiring corporations to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K. *See* 17 C.F.R. §§ 240.13a-1, -11, -13 (1993).

25. 426 U.S. 438 (1976).

26. *Id.* at 449.

27. 485 U.S. 224 (1988).

28. *Id.* at 232. Section 10(b) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988). Section 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or 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, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1993).

29. 501 U.S. 1083 (1991).

take on [material] importance."[30] Thus, the Court held that soft information can be material.[31]

2. The SEC's Traditional Stance on Disclosure

Traditionally, the SEC prohibited the use of soft information in disclosure documents.[32] This prohibition protected unsophisticated investors who might rely too heavily on predictive statements in making their investment decisions.[33] In 1973, the SEC integrated soft information into the disclosure system by repealing the traditional prohibition of soft information in SEC filings.[34] An issuer's disclosure of soft information, however, remained voluntary.[35]

3. The Safe Harbor Rules

In 1979, the SEC adopted rules to provide "safe harbor" protection for certain types of soft information filed with the SEC.[36] Under Rules 175 and 3b-6,[37] certain soft information[38] is not fraudulent unless the plaintiff proves that the information "was made or reaffirmed

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30. *Id.* at 1090-91. Indeed, the Court stated that a "share owner faced with a proxy request will think it important to know the directors' beliefs about the course they recommend, and their specific reasons for urging the stockholders to embrace it." *Id.* at 1091.

31. For example, the Supreme Court in *Virginia Bankshares* labelled as material the directors' belief that the offer price was high and the proposed merger was fair. *Id.* at 1098.

32. *See* Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,666 (Feb. 2, 1973) [hereinafter 1973 Disclosure Announcement] (acknowledging that "[i]t has been the Commission's long standing policy generally not to permit projections to be included in prospectuses and reports filed with the Commission."). Prior to 1973, the SEC prohibited the disclosure of soft information in a prospectus. *See* Guidelines for the Release of Information by Issuers Whose Securities Are in Registration, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578 (Aug. 16, 1971) (prospectus disclosures should be "limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value").

33. *See* Summary of Report on Disclosure to Investors (Wheat Report)—A Reappraisal of Administrative Policies Under the '33 and '34 Acts, [1963-1972 Special Studies Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,603, at 65,242 (May 9, 1969) ("Because of their conjectural and rapidly changing character, projections . . . in filed documents might become traps for the unsophisticated who would be prone to attach more significance to such projections than they deserve.").

34. *See* 1973 Disclosure Announcement, *supra* note 32, ¶ 79,211, at 82,667.

35. *See* 1973 Disclosure Announcement, *supra* note 32, ¶ 79,211, at 82,667.

36. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938 (June 25, 1979) (codified at 17 C.F.R. §§ 230.175, 240.3b-6 (1993)). "[The SEC] stated its belief that reasonably based and adequately presented projections should not subject issuers to liability under the federal securities laws solely because the projected results did not materialize. In this regard, the [SEC] noted that even the most carefully prepared and thoroughly documented projections may prove [to be] inaccurate." *Id.* at 81,939.

37. 17 C.F.R. §§ 230.175, 240.3b-6 (1993).

38. Under Rules 175 and 3b-6, soft information means:

without a reasonable basis or was disclosed other than in good faith."[39] By removing the threat of liability for making such disclosures when their predictions fail to be indicative of future events, safe harbor rules encourage issuers to voluntarily disclose soft information.[40] To procure a wider range of disclosures under their protection, the safe harbor rules include a broad definition of soft information.[41]

Defendants, however, have not relied on the safe harbor rules as a defense in securities cases as might be expected.[42] Commentators have suggested that Rule 175 is less valuable to defendants than originally intended because the "reasonable and good faith" standard[43] is, by nature, fact-based and not easily employed to terminate claims of securities violations on motions to dismiss or motions for summary judgment.[44] In addition, although the SEC repeatedly emphasized that disclosure of soft information in filed disclosure statements is voluntary under the safe harbor rules, the courts disagree as to whether and under what circumstances the disclosure of soft information may be required.[45]

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(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K . . . or Item 9 of Form 20-F; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c) (1), (2), or (3) of this section.

17 C.F.R. §§ 230.175(c)(1-4), 240.3b-6(c)(1-4) (1993).

39. *Id.* §§ 230.175(a), 240.3b-6(a).

40. *See* Proposed Safe Harbor Rule for Projections, Securities Act Release No. 5993, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,757, at 81,042 (Nov. 7, 1978).

41. See *supra* note 38 for the range of soft information disclosures protected by the safe harbor rules. Although the definition of soft information is broad, protection under the safe harbor rules is still limited by the requirement that issuers disclose such information in documents filed with the SEC or the annual report to shareholders. *See* 17 C.F.R. §§ 230.175(b)(1), 240.3b-6(b)(1).

42. *See* Dennis J. Block & Jonathon M. Hoff, *Disclosing Soft Information: Limiting Litigation Risk*, N.Y. L.J., Jan. 30, 1992, at 5. "Rather, courts and defendants invoke the pleading requirements under the Federal Rules of Civil Procedure or common law doctrines which, in any event, are substantially similar to the SEC's safe harbor rules." Dennis J. Block & Jonathan M. Hoff, *Forward-Looking Statements: Reducing Litigation Risks*, N.Y. L.J., Aug. 25, 1994, at 5.

43. *See supra* note 39 and accompanying text.

44. Block & Hoff, *supra* note 1.

45. *See, e.g.*, Wieglos v. Commonwealth Edison Co., 892 F.2d 509, 516 (7th Cir. 1989) (stating that "issuers need not reveal all projections"); Starkman v. Marathon Oil Co., 772 F.2d 231, 241-42 (6th Cir. 1985) (finding that there is no duty to disclose financial projections unless they are "substantially certain"), *cert. denied*, 475 U.S. 1015 (1986); Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 206 (5th Cir. 1988) (making no attempt "to determine when, or even if, predictive information must be disclosed"), *cert. denied*, 488 U.S. 926 (1989); *see also* John M. Olivieri, *Liability for Forward-Looking Statements: The Securities and Exchange Commission's Ambiguous Stance*, 1993 COLUM. BUS. L. REV. 221.

4. Item 303 of Regulation S-K

After eliminating its historical opposition to disclosure of soft information, the SEC merely encouraged disclosure of soft information until the promulgation of Item 303 of Regulation S-K.[46] Item 303 requires disclosure of certain soft information in the Management's Discussion and Analysis section[47] of periodic reports, proxy statements, and prospectuses.[48] In determining whether Item 303 imposes a duty of disclosure, courts make two assessments:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[49]

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46. 17 C.F.R. § 229.303 (1993). Adopted in 1977, Regulation S-K sets forth disclosure requirements for the content of the nonfinancial or textual portions of various disclosure documents contemplated by the 1933 Act and 1934 Act as found in the applicable forms, interpretive releases, and disclosure guides. *See* 17 C.F.R. § 229.10(a) (1993).

47. The Management's Discussion and Analysis of Financial Condition and Results of Operations [hereinafter "MD&A"] section of prospectuses filed with the SEC, for example, is the narrative disclosure required under Item 303 of Regulation S-K. *See* 17 C.F.R. § 229.303. The purpose of the MD&A section is to provide "material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future." Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosure, Securities Act Release No. 6835, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,192, at 62,841 (May 18, 1989) [hereinafter 1989 Disclosure Announcement]. Promulgated in 1982, Item 303 provides investors and other users with information relevant to the assessment of a company's financial condition and results of operations, "focus[ing] specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." 17 C.F.R. § 229.303 instructions 2-3.

48. In pertinent part, Item 303 of Regulation S-K calls for disclosure as to:

> Liquidity: [management must] [i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the [corporation's] liquidity increasing or decreasing in any material way.
> Capital Resources: [management must] [d]escribe any known trends, favorable or unfavorable, in the [corporation's] capital resources.
> Results of Operations: [management must] [d]escribe any known trends or uncertainties that have had or that the [corporation] reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from contributing operations.

17 C.F.R. § 229.303(a) (1993).

49. 1989 Disclosure Announcement, *supra* note 47, ¶ 73,193, at 62,843. "Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination [was] made." *Id.* at 62,844.

Under certain circumstances, therefore, Item 303 requires issuers to disclose soft information.[50] Due to its mandatory nature, the MD&A section developed into the single most important disclosure provision in SEC filings and other disclosure documents.[51]

B. The Bespeaks Caution Doctrine

In *Polin v. Conductron Corp,*[52] the Eighth Circuit Court of Appeals enunciated the bespeaks caution doctrine for the first time.[53] In *Polin*, a shareholder filed a securities fraud claim based on allegedly false and misleading statements in proxy statements, annual reports, and other documents.[54] The defendant's annual report stated that results were " 'expected' to show improvement" and that there was "a 'possibility' of a break-even soon."[55] The court found that these terms "bespeak caution in outlook and fall far short of the assurances required for a finding of falsity and fraud,"[56] because such soft information recognized the unpredictable influences of complex variables in a fast-changing field.[57] The annual report's specific cautionary statements sufficiently warned investors that the stock investment had an unpredictable future.[58]

In *Luce v. Edelstein*,[59] the Second Circuit Court of Appeals held that certain of plaintiffs'[60] allegations of securities violations[61] could not survive a motion to dismiss.[62] In *Luce*, the partnership's renovation project did not progress as planned and the partnership continued to borrow additional funds.[63] As a result, the partnership failed to fulfill other promises presented in its Offering Memorandum and Partnership

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50. 1989 Disclosure Announcement, *supra* note 47, ¶ 73,193, at 62,843.

51. *See* Suzanne J. Romajas, *The Duty to Disclose Forward-Looking Information: A Look at the Future of MD&A*, 61 FORDHAM L. REV. S245, S254 (1993).

52. 552 F.2d 797 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977).

53. *See* Joseph J. Fleischman & Shirley L. Berger, *'Bespeaks Caution' Doctrine Gains Favor*, NAT'L L.J., Feb. 7, 1994, at 19.

54. *Polin*, 552 F.2d at 803.

55. *Id.* at 806 n.28.

56. *Id.*

57. *Id.*

58. *Id.*

59. 802 F.2d 49 (2d Cir. 1986).

60. The twenty named plaintiffs represented a class of purchasers of limited partnership interests in defendant's "Broadway Associates", which solicited limited partners to provide capital for a venture that would renovate buildings and convert them into condominiums. *Id.* at 51-52.

61. The plaintiffs' claims alleged violations of § 10(b) of the 1934 Act and Rule 10b-5, and of §§ 12(2) and 17(a) of the 1933 Act. *Id.* at 53.

62. *Id.* at 56. The court dismissed plaintiffs' claim that the Offering Memorandum contained intentional misrepresentations as to the potential cash and tax benefits of the partnership. *Id.*

63. *Id.* at 52. The defendants caused the partnership to incur liabilities of approximately $10.2 million but only $500,000 appeared to have been spent on the $4.5 million construction

Agreement.[64] Furthermore, the general partners secretly sold their interests in the partnership for a substantial benefit, while the uninformed limited partners faced losses of two million dollars in addition to further dilution of their equity interest.[65] In considering the allegation of misrepresentation of the partnership's potential cash and tax benefits, the *Luce* court relied on *Polin*, stating that:

> [T]he Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were "necessarily speculative in nature" and that "[n]o assurance [could] be given that these projections [would] be realized." Indeed, the Offering Memorandum warned prospective investors that "[a]ctual results may vary from the predictions and these variations may be material." We are not inclined to impose liability on the basis of statements that "bespeak caution."[66]

The Second Circuit focused on the Offering Memorandum's specifically tailored cautionary language and employed the bespeaks caution doctrine to dismiss this particular claim.[67]

In more recent cases, courts have used the bespeaks caution doctrine to grant defendants' motions to dismiss. The Second Circuit, for example, employed the bespeaks caution doctrine in *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*[68] *I. Meyer Pincus* involved an alleged misstatement in a prospectus.[69] The court read the language in question in its complete context, and concluded that the prospectus contained specific warnings.[70] As a result, the court held that "the statements contained within the prospectus clearly 'besp[oke] caution' rather than encourag[ed] optimism" and dismissed the plaintiff's claims.[71]

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project. *Id.* at 53. Moreover, defendants knew that they had been denied the required zoning rights to build the promised condominiums. *Id.*

64. *Id.* The partnership failed to provide the limited partners with regular accounting and reports on the financial condition and construction status of the renovation project. *Id.* Also, the partnership sold additional limited partnership interests without notice to, or consent by, the plaintiffs. *Id.*

65. *Id.*

66. *Id.* at 56 (quoting Polin v. Conductron Corp., 552 F.2d 797, 806 n.28 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977)).

67. *Id.*

68. 936 F.2d 759 (2d Cir. 1991).

69. *Id.* at 760. The single alleged material misrepresentation was the trading value of closed-end fund shares. *Id.* at 761. The prospectus suggested that the shares were as likely to sell at premiums as at discounts, when, in fact, shares of closed-end companies usually sell at discounts and only infrequently at premiums. *Id.*

70. *Id.* at 762. The language in the prospectus cautioned the reader that shares "may very well trade at a discount relative to net asset value." *Id.* Moreover, the sentence immediately following the language in question warned the investor that share prices cannot be predicted. *Id.* at 763.

71. *Id.*

The First Circuit Court of Appeals also employed the bespeaks caution doctrine in *Romani v. Shearson Lehman Hutton*.[72] In *Romani*, the plaintiff's return on his investment in a standardbred horsebreeding business was disappointing in light of the predictions made in the offering materials.[73] The plaintiff contended that certain statements in the offering materials falsely portrayed both the financial potential of the partnership and the qualifications of the managing general partners in order to lure investors.[74] The court required the plaintiff to introduce factual support for his allegation of securities fraud.[75] Specifically, the plaintiff had to prove that adverse circumstances existed at the time of the offering, and that such circumstances "were known and deliberately or recklessly disregarded by [the] defendants."[76] Only the plaintiff's claim that the business was in poor financial condition had sufficient factual support.[77] Although the offering documents were optimistic, the court found that they contained specific warnings concerning the horsebreeding industry's unpredictable economic future.[78] Employing the bespeaks caution doctrine, the court dismissed the plaintiff's claim based on these specifically tailored cautionary statements.[79]

In *Sinay v. Lamson & Sessions Co.*,[80] the Sixth Circuit Court of Appeals employed the bespeaks caution doctrine to dismiss allegations of securities fraud brought under section 10(b) of the 1934 Act and Rule 10b-5.[81] The court held that the defendant's positive statements[82] about the investment were "only an optimistic prediction which 'be-

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72. 929 F.2d 875 (1st Cir. 1991).

73. *Id.* at 877. Instead of expected cash distributions in excess of 13%, the plaintiff only received yields of 2 ½% to 3%. *Id.*

74. *Id.*

75. The plaintiff's complaint alleged fraud under § 10(b) of the 1934 Act and Rule 10b-5. *Id.*

76. *Id.* at 878.

77. *Id.*

78. *Id.* at 879. "The . . . report attached to the Prospectus detailed a number of specific problems facing the standardbred industry, including overbreeding, declining attendance at races and an average decline in yearling prices." *Id.* The prospectus stated that " 'it is impossible to predict with any certainty the future economic trend of the Standardbred industry as a whole.' " *Id.* at 879 n.2 (quoting prospectus at 26).

79. *Id.* at 880. The court stated that "[w]ere such a pleading deemed sufficient, the advent of a recession could be expected to trigger a multitude of complaints in which plaintiffs seek to impose liability for their financial disappointments based on entirely fabricated scenarios of fraud." *Id.*

80. 948 F.2d 1037 (6th Cir. 1991).

81. *Id.* at 1040.

82. On October 24, 1988, the defendant stated that its performance during the first three quarters was gratifying, even though normal seasonal decline would continue into the first quarter of 1989. *Id.* at 1039. On December 23, 1988, the defendant reported that it was having a tremendous year. *Id.* Furthermore, the defendant stated that it was pleased with the 1988 financial results. *Id.*

spoke caution.' "[83] In addition, the court found that imposing liability in this situation would impede the free flow of material information to the market by restraining management from disclosing useful information.[84]

Recently, courts of appeals also used the bespeaks caution doctrine to grant defendants' motions for summary judgment. The Eighth Circuit Court of Appeals employed the bespeaks caution doctrine in *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[85] *Moorhead* involved a bond offering accompanied by a feasibility study which predicted a favorable economic future for a proposed retirement center.[86] In granting the defendant's motion for summary judgment, the court found that the feasibility study contained cautionary language and disclosures about underlying economic assumptions which specifically addressed the statements of soft information.[87] Thus, in its decision in *Moorhead*, the Eighth Circuit explicitly recognized the bespeaks caution doctrine.

The Ninth Circuit Court of Appeals employed the bespeaks caution doctrine in *In re Convergent Technologies Securities Litigation*,[88] affirming the district court's decision to grant the defendants' motion for summary judgment.[89] In *Convergent Technologies*, the plaintiff stock purchasers alleged that the defendants[90] misrepresented the growth in demand for Convergent's existing line of computer workstation products and concealed serious problems with the production and profitability of two product lines in the development stage.[91] The court found that the prospectus provided with the stock offering "virtually overflow[ed] with Convergent's repeated emphasis of significant risk

83. *Id.* at 1040. The court found that there was sufficient cautionary language provided with the questioned statements. *Id.* Statements that a drop in interest rates might lower prices thus reducing revenue, and that the slowdown in the construction market would continue its negative effect, were sufficient to alert a reasonable investor that the investment's future was uncertain. *Id.*

84. *Id.* at 1041.

85. 949 F.2d 243 (8th Cir. 1991).

86. *Id.* at 245.

87. *Id.* The feasibility study stated that some assumptions will not materialize and that actual results achieved during the forecast periods may vary from the forecast. *Id.* at 246. In addition, the feasibility study stated that no assurance can be made that the defendant would make sufficient revenue to pay back maturing principal and interest on the previously issued bonds. *Id.*

88. 948 F.2d 507 (9th Cir. 1991).

89. *Id.* at 509.

90. The defendants included certain officers and directors of Convergent, the underwriters of public offerings of Convergent stock, and Unysis Corporation. *Id.* at 508.

91. *Id.* at 509. The plaintiffs also contended that the underwriter defendants' research reports contained misrepresentations. *Id.*

factors."[92] As a result, the court concluded that the defendants had sufficiently warned investors by disclosing more than generalized statements of risk.[93] In order to protect the free flow of material information, the court held that with respect to the alleged omissions, the securities laws do not require management to "bury [investors] in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking."[94] Thus, the court employed the bespeaks caution doctrine to promote the SEC's goal of informed decision making and found no liability on the part of the defendants.[95]

In general, the bespeaks caution doctrine provides that disclosures of soft information are not actionable when the disclosures are accompanied by specific cautionary language which sufficiently reveals the risks involved.[96] The doctrine is significant because courts use it to terminate securities litigation on motions to dismiss or motions for summary judgment.[97] The policy behind the doctrine is to discourage suits which allege "fraud by hindsight."[98] In cases where a plaintiff alleges sufficiently that an issuer made disclosures of soft information in a disclosure document without good faith or a reasonable basis, courts will not apply the doctrine.[99] But when a disclosure document contains a disclosure of soft information accompanied by adequate cautionary language, the doctrine applies and the issuer of that document benefits from additional and broader protection.[100]

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92. *Id.* at 515. For example, the prospectus stated that "[t]he Company is undertaking substantial development, manufacturing and marketing risks . . . [and] . . . [t]here can be no assurance that the Company will successfully complete the development of its new products or that it will be successful in manufacturing the new products in high volume or marketing the products in the face of intense competition . . . ." *Id.*

93. *Id.* at 515-16. For example, the prospectus stated that production depended on the availability of several advanced components, some of which had not yet been manufactured by their suppliers in volume. *Id.* at 516. Also, the prospectus warned investors that Convergent would utilize certain advanced manufacturing processes which had not yet been widely used in the United States. *Id.*

94. *Id.* at 516 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 448-49 (1976)).

95. *Id.*

96. Block & Hoff, *supra* note 1.

97. Block & Hoff, *supra* note 1.

98. Fleischman & Berger, *supra* note 53, at 19. For a discussion of fraud by hindsight, see *infra* notes 214-20 and accompanying text.

99. Fleischman & Berger, *supra* note 53, at 19.

100. Block & Hoff, *supra* note 1, at 7.

III. FACTS AND HOLDING

A. *Facts of Taj Mahal*

In November 1988, Taj Mahal Funding[101] offered $675 million in first mortgage investment bonds to the public.[102] The bonds carried a 14% interest rate.[103] Taj Mahal Funding issued the bonds to raise capital to purchase and complete construction of the Taj Mahal,[104] as well as to open the Taj Mahal for business.[105] The prospectus, which provided for the offering and sale of the bonds, estimated the completion cost of the Taj Mahal to be $805 million.[106] In addition, the prospectus explained that $675 million in bond proceeds, a $75 million contribution by Donald Trump, investment income derived from those sums, a contingent additional loan of $25 million from Donald Trump, and loans from other sources comprised the $805 million needed to fund the Taj Mahal project.[107]

After the bond sale, the *Taj Mahal* defendants experienced severe financial trouble and intended to file for protection under Chapter 11 of the Bankruptcy Code.[108] These proceedings were to include a reorganization plan.[109] The defendants, however, could not pay back the principal and interest on the bonds, and as a result, various bondholders filed separate complaints.[110] Each complaint alleged that the prospectus is-

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101. The *Taj Mahal* defendants were Donald J. Trump, Robert S. Trump, Harvey S. Freeman, the Trump Organization Inc., Trump Taj Mahal Inc., Taj Mahal Funding Inc., Trump Taj Mahal Associates Limited Partnership (composed of Donald J. Trump, and Trump Taj Mahal Inc. as the general partners, and Donald J. Trump as the sole limited partner) [hereinafter the Partnership], and Merrill Lynch, Pierce, Fenner & Smith Inc. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 364 & n.1 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). Taj Mahal Funding Inc. actually issued the bonds and then immediately loaned the proceeds to the Partnership. *Id.* at 364 n.1.

102. *Id.* at 364. Merrill Lynch acted as the sole underwriter. *Id.*

103. A 14% interest rate was a high rate compared to the usual 9% yield offered on quality corporate bonds at the time. *Id.*

104. The Taj Mahal was widely known as Atlantic City's largest and most lavish casino resort. *Id.* at 365. When the Taj Mahal opened in April 1990, it was at least twice the size of any other casino in Atlantic City. *Id.* The Taj Mahal included: a 42-story hotel tower containing approximately 1,250 guest rooms, an adjacent low-rise building encompassing roughly 155,000 square feet of meeting, ballroom, and convention space, a 120,000 square foot casino, and numerous restaurants, lounges, and stores. *Id.* The entire Taj Mahal complex occupied approximately 17 acres of land. *Id.*

105. *Id.* at 364-65.

106. *Id.* at 365. The estimated completion cost of the Taj Mahal included the first fifteen payments of interest on the bonds. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* The various bondholders filed complaints in the United States District Courts for the Southern District of New York, the Eastern District of New York, and the District of New

sued by the defendants contained material misrepresentations and material omissions in violation of both the 1933 Act and the 1934 Act.[111]

The plaintiffs' consolidated complaints alleged four counts. Count one asserted that the prospectus contained misrepresentations and omissions of material facts in violation of sections 11, 12(2), and 15 of the 1933 Act.[112] Count two asserted that the same misrepresentations and omissions were fraudulent in violation of sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5.[113] Count three asserted that the defendants breached their fiduciary duty.[114] Finally, count four asserted that the defendants engaged in false advertising.[115]

The plaintiffs based their claims on the text of the prospectus.[116] "Their strongest attack focuse[d] on the 'Management Discussion and Analysis'("MDA") section of the prospectus, which [included the following statement]: 'The Partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal).' "[117] The plaintiffs contended "that this

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Jersey. *Id.* The District Court of New Jersey received the complaints for consolidated pretrial proceedings pursuant to 28 U.S.C. § 1407. *Id.* 28 U.S.C. § 1407(a) states that "[w]hen civil actions involving one or more common questions of fact are pending in different districts, such actions may be transferred to any district for coordinated or consolidated pretrial proceedings." 28 U.S.C. § 1407(a) (1988).

111. *Taj Mahal*, 7 F.3d at 365.

112. *Id.* Section 11(a) of the 1933 Act provides in pertinent part:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue—(1) every person who signed the registration statement; (2) every person who was a director of . . . or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted, . . . (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a) (1988). Section 12(2) of the 1933 Act establishes the liability of any seller or offeror of a security who:

> by means of a prospectus or oral communication . . . includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such truth or omission . . . .

15 U.S.C. § 77*l*(2) (1988). Section 15 of the 1933 Act establishes liability for those "controlling persons" who violate the substantive provisions of the 1933 Act. *See* 15 U.S.C. § 77o (1988).

113. *Taj Mahal*, 7 F.3d at 366. See *supra* note 28 for the provisions of § 10(b) of the 1934 Act. Like § 15 of the 1933 Act, § 20(a) of the 1934 Act establishes liability for those "controlling persons" who violate the substantive provisions of the 1934 Act. *See* 15 U.S.C. § 78t(a) (1988). For the provisions of Rule 10b-5, see *supra* note 28.

114. *Taj Mahal*, 7 F.3d at 366.

115. *Id.*

116. *Id.* at 365.

117. *Id.* The plaintiffs also alleged that the prospectus was materially misleading in its estimation that the Taj Mahal would be worth approximately $1.1 billion on its opening date. *Id.* at

statement was materially misleading because the defendants possessed neither a genuine nor a reasonable belief in its truth."[118]

The defendants emphasized, however, the "numerous disclaimers and cautionary statements" that accompanied and specifically addressed this statement.[119] For example, the prospectus contained cautionary language stressing

> the intense competition in the casino industry; the absence of an operating history for the Taj Mahal which could serve as a basis for its valuation; the unprecedented size of the Taj Mahal casino in Atlantic City; and the enterprise's potential inability to repay the interest on the bonds in the event of a mortgage default and subsequent liquidation of the Taj Mahal.[120]

The defendants moved to dismiss the complaints pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure,[121] asserting that the plaintiffs had failed to state an actionable securities claim.[122] The defendants also contended that the plaintiffs failed to plead their fraud allegations with sufficient particularity pursuant to Rule 9(b) of the Federal Rules of Civil Procedure.[123]

The district court granted the defendants' motion under Rule 12(b)(6), finding that the abundance of cautionary statements directly addressing the alleged misrepresentations and omissions rendered the plaintiffs' claims nonactionable as a matter of law.[124] The court did not reach the issue of the defendants' motion to dismiss based on Rule

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373 n.17. Appraisal Group International (AGI) provided this estimate in its independent appraisal. *Id.* In addition, the plaintiffs contended that this estimate lacked an adequate basis in fact because AGI based the estimate on the "capitalization of income approach" when it was impossible to make a reasonable estimate of the Taj Mahal's future income. *Id.*

Contrary to the allegations, the court found that the prospectus described the Taj Mahal as a new enterprise without any operating history or history of earnings, and moreover, that the prospectus clearly stated the speculative nature of AGI's estimate and the consequent uncertainty about the Taj Mahal being worth $1.1 billion on its opening date. *Id.* The court also held that this cautionary language, along with the general warnings throughout the prospectus concerning the investment's speculative nature, rendered AGI's estimate immaterial. *Id.*

118. *Id.* at 365.

119. *Id.*

120. *Id.*

121. The purpose of Rule 12(b)(6) of the Federal Rules of Civil Procedure is to allow a defendant to test whether, as a matter of law, the plaintiff is entitled to legal relief even if everything alleged in the complaint is true. Scheuer v. Rhodes, 416 U.S. 232, 236 (1974).

122. *Taj Mahal*, 7 F.3d at 366.

123. *Id.* Rule 9(b) of the Federal Rules of Civil Procedure states that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b).

124. *See In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 793 F. Supp. 543, 568 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). Chief Judge Gerry wrote the opinion for the district court. *Id.* at 545.

9(b).[125] In addition, the court rejected the plaintiffs' motion to amend their complaints in order to add allegations based on an outside accounting firm's appraisal of the Taj Mahal.[126] The plaintiffs urged consideration of the outside appraisal stressing that this appraisal contained projections that "mirror[ed] more accurately the actual economic performance of the Taj [Mahal]" than the projections provided in the prospectus.[127] After disposing of the federal claims, the district court dismissed, without prejudice, plaintiffs' claims based on state common law[128] for lack of pendant jurisdiction.[129]

B. *The Third Circuit's Decision*

The plaintiffs appealed the district court's decision to the Third Circuit Court of Appeals.[130] The Third Circuit reasoned that each of the alleged securities fraud violations required, at a minimum, "proof that the defendants made untrue or misleading statements or omissions of material facts."[131] The court noted that opinions, predictions, and other soft information are not per se actionable under the securities laws, but may be actionable if the speaker does not genuinely and reasonably believe in the truth of the soft information.[132] The court also

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125. *Id.* at 549 n.6.

126. *Id.* at 566. The Laventhol Report, issued by the accounting firm Laventhol & Horwath, contained an appraisal of the future value of the Taj Mahal. *Id.* Laventhol issued this report before the commencement of the transaction which transferred ownership of the Taj Mahal to Donald Trump. *Id.* at 567. The introductory letter to the report stated:

> [This] report is intended solely for the information of the officers, directors and shareholders of Resorts International, Inc. [the original developer of the Taj Mahal project] and, if desired, the Casino Control Commission of New Jersey. Otherwise, neither this report nor its comments may be referred to or quoted in any registration statement, prospectus, . . . or document without our prior written consent.

Id.

127. *Id.* For a discussion of the AGI appraisal, which the Partnership included in the prospectus, see *supra* note 117. The district court found that "the Laventhol Report was neither prepared for use in a prospectus, nor authorized for reference in a prospectus, nor commissioned by defendants, nor even commissioned by Resorts with the sale to Trump in mind." *Id.* The court determined that introduction of the report would do nothing more than attempt to establish fraud by hindsight. *Id.* Even if the court ignored all its defects, the report only offered proof regarding the differences between the two statements of the Taj Mahal's projected financial status, not regarding fraud on the part of the defendants. *Id.*

128. The state common law claims, dismissed without prejudice, alleged breach of fiduciary duty and false advertising. *Id.* at 546.

129. *Id.* at 568. The district court held that since it dismissed the plaintiffs' federal claims in their entirety, it had no jurisdiction over the pendant state law claims. *Id.* at 568 (citing United Mine Workers v. Gibbs, 383 U.S. 715 (1966)).

130. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). Judge Becker wrote the opinion for the Third Circuit. *Id.*

131. *Id.* at 368.

132. *Id.*

found that the plaintiffs failed to sufficiently allege that the defendants made a material misrepresentation.[133]

The court based its decision in *Taj Mahal* on the issue of materiality.[134] The materiality standard applied to all of the plaintiffs' securities claims.[135] In applying the materiality standard, the court stated that "materiality is a relative concept, so that a court must appraise a misrepresentation or omission in the complete context in which the author conveys it."[136] Thus, the court looked at the prospectus as a whole in its materiality analysis.[137]

The court found that the prospectus contained an abundance of warnings and cautionary language which directly related to the prospective financial success of the Taj Mahal and the Partnership's ability to pay back the bonds.[138] The court stated that "due to the disclaimers and warnings [that] the prospectus contain[ed], no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment which might yield a high rate of return, but which alternatively might result in no return or even a loss."[139] The court further noted that the allegedly misleading statement concerning the defendants' ability to pay back the debt on the bonds "was buried amidst the cautionary language."[140] Thus, the court

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133. *Id.* at 369.

134. *Id.* For a discussion of the concept of materiality, see *supra* notes 25-31 and accompanying text.

135. *Taj Mahal*, 7 F.3d at 369. The materiality concept applies to claims under § 10(b) of the 1934 Act and Rule 10b-5. Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988). The materiality concept also applies to claims under §§ 11(a) and 12(2) of the 1933 Act. Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 641 (3d Cir. 1989).

136. *Taj Mahal*, 7 F.3d at 369.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at 371. The allegedly misleading statement is contained in the MD&A section of the prospectus, immediately following the sizable "Special Considerations" section—a section noted for its customary extensive, detailed disclaimer and cautionary language. *Id.* at 370.

The "Special Considerations" section of the prospectus explained that because of its size and scale, a variety of risks existed which could affect the Partnership's ability to repay the bondholders. *Id.* For example, the prospectus stated that: the first interest payment was due before the summer season so that the Partnership would not have the benefit of cash flow from the peak season; the Taj Mahal was not completed so it had no operating history; the Taj Mahal would be the largest casino/hotel complex in Atlantic City and no one possessed experience operating such a large complex; and, moreover, no assurance could be given that the Taj Mahal would be profitable or that it would generate enough cash flow to provide for the payment of its debt burden. *Id.*

In addition, the "Security for the Bonds" section described the potential effect of the Partnership's default on its mortgage payment as a situation where, if mortgage default occurred prior to the completion of the Taj Mahal, "there would not be sufficient proceeds [from a foreclosure sale of the Taj Mahal] to pay the principal of, and accrued interest on, the bonds." *Id.* (quoting prospectus at 9). The "Special Considerations" section also specified the high level of competition for customers facing the Taj Mahal. *Id.* For example, the section stated that the Atlantic City

held that the bondholders could not prove that the alleged misrepresentation was material,[141] and "the statement at issue was, at worst, harmless."[142]

On appeal, the Third Circuit approved the district court's use of the bespeaks caution doctrine.[143] Acknowledging that the application of the doctrine depends on the specific text of the offering document or other communication at issue, the Third Circuit agreed that the doctrine is applied on a case-by-case basis.[144] The court further applied the doctrine, stating that "cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law."[145] The Third Circuit also noted that courts may apply the doctrine to both affirmative misrepresentations and omissions concerning soft information.[146] "To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge."[147] The *Taj Mahal* court concluded that the prospectus at issue "truly bespeaks caution because, not only does [it] generally convey the riskiness of the investment, but its warnings and cautionary language directly address the substance of the plaintiffs' challenge."[148]

The Third Circuit noted that the Supreme Court had implicitly accepted the bespeaks caution doctrine in *Virginia Bankshares, Inc. v. Sandberg*.[149] In *Virginia Bankshares*,[150] the Supreme Court explained that an issuer's subjective disbelief or motivation, by itself, does not support a claim under section 14(a) of the 1934 Act.[151] The Court further stated that while a misleading statement does not automatically lose its deceptive edge when combined with others that are true, the true statements may discredit the misleading statement enough to

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hotel market was intense and a casino's profit per square foot of casino floor space would decline in 1990 because of the increase in casino floor space, including the opening of the Taj Mahal. *Id.*

141. *Id.* at 369.

142. *Id.* at 371.

143. *Id.* The district court followed the lead of a number of courts of appeals which have dismissed securities claims under Rule 12(b)(6) of the Federal Rules of Civil Procedure because cautionary language in the offering document negated the materiality of an alleged misrepresentation or omission. *Id.* For a discussion of the bespeaks caution doctrine, see *supra* notes 52-100 and accompanying text.

144. *Taj Mahal*, 7 F.3d at 371.

145. *Id.*

146. *Id.*

147. *Id.* at 371-72.

148. *Id.* at 372.

149. *Id.*

150. 501 U.S. 1083 (1991).

151. *Id.* at 1096. Section 14(a) of the 1934 Act authorizes the SEC to adopt rules for the solicitation of proxies, and prohibits their violation. *See* 15 U.S.C. § 78n(a) (1988).

make the risk of real deception disappear.[152] Finally, the Court concluded that since liability under the 1934 Act depends on materiality as well as deceptiveness, disclosure of accurate facts can render a misleading statement too unimportant to support a cause of action for liability.[153] In its review of *Virginia Bankshares*, the Third Circuit concluded that the Supreme Court had impliedly accepted the logic of the bespeaks caution doctrine by recognizing that cautionary statements in a disclosure document may neutralize the effect of a misleading statement and render it nonactionable.[154]

The Third Circuit systematically rejected each of the plaintiffs' five specific allegations concerning material omissions.[155] First, the court disposed of the plaintiffs' allegation that the prospectus made a material omission in its failure to disclose Donald Trump's "precarious" financial status.[156] The court found that the prospectus clearly stated that Donald Trump would only contribute $75 million of his own funds to the Taj Mahal venture, although under special circumstances, he might lend the venture up to an additional $25 million.[157] Given the explicit limitations on Donald Trump's financial obligations, the court held that Trump's actions concerning the balance of his assets were not material because he had paid the promised amounts as specified in the prospectus.[158]

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152. *Virginia Bankshares*, 501 U.S. at 1097.

153. *Id.*

154. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 372 (3rd Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). In addition, the Third Circuit pointed out that its approach in *Taj Mahal* was consistent with the Sixth Circuit's understanding of *Virginia Bankshares*. *Id.* at 373 n.16. More specifically, the Third Circuit, in *Taj Mahal*, did not establish a sweeping rule that cautionary statements will always render misrepresentations or omissions immaterial as a matter of law, as the Sixth Circuit apparently did in *Sinay v. Lamson & Sessions*. *Id.* (citing *Sinay*, 948 F.2d at 1040). In *Mayer v. Mylod*, the Sixth Circuit narrowed its decision in *Sinay* which appeared to apply the bespeaks caution doctrine too liberally. *Id.* (citing *Mayer*, 988 F.2d at 639). The Sixth Circuit thus properly recognized that in light of *Virginia Bankshares*, its earlier statement in *Sinay*, indicating that soft information combined with cautionary statements is *per se* nonactionable, was overbroad. *Id.*

155. *Taj Mahal*, 7 F.3d at 374. For the plaintiffs' benefit on appeal, the Third Circuit assumed that the following representations were true:

> 1) the precarious nature of Trump's personal finances; 2) the fact that the Taj Mahal would require an average daily casino win of $1.3 million in order to repay the bonds in full; 3) the thinly-capitalized nature of the Taj Mahal; 4) the expense necessary to attract customers from other casinos to the Taj Mahal and the improbability that the Taj Mahal would be successful in such an effort; and 5) the likely effect of the already weakened economy on the future success of the Taj Mahal.

Id.

156. *Id.*

157. *Id.*

158. *Id.*

Second, the court rejected the plaintiffs' claim that the prospectus failed to disclose that the Taj Mahal needed a $1.3 million average daily casino win to support its debt burden.[159] The court reasoned that the prospectus not only warned investors of the many specific risks involved in the successful completion and operation of the Taj Mahal, but it also directly related the risks to the uncertainty of the Partnership's ability to repay the bonds.[160] Thus, the court determined that an explicit statement in the prospectus that the Taj Mahal needed an average daily casino win of $1.3 million "would have been superfluous."[161]

Third, the court rejected the plaintiffs' contention that the prospectus failed to disclose the specifics of the venture's debt-equity ratio.[162] Contrary to the plaintiffs' allegation, the court found that the prospectus clearly set forth the details of the venture's projected debt component.[163] The court recognized that the securities laws do not require an issuer to "compare itself in myriad ways to its competitors, whether favorably or unfavorably."[164] Therefore, the court decided that it is the responsibility of the prudent investor, not the issuer of securities, to make such comparisons among investments.[165]

Fourth, the court rejected the plaintiffs' allegation that the prospectus failed to disclose that the Taj Mahal would be unlikely to draw enough customers from other casinos to generate sufficient income.[166] The court found that the prospectus contained specific warnings about the high level of competition in the casino business.[167] Referring to the

159. *Id.*

160. *Id.* at 375.

161. *Id.*

162. *Id.* Specifically, the plaintiffs alleged that the prospectus failed to disclose that the construction and operation of the Taj Mahal involved an excessive debt component relative to total capitalization with only $75 million in capital contributions (9% of the $805 million projected costs). *Id.*

163. *Id.* The prospectus laid out the Partnership's plan to finance the $805 million: $675 million from bond sales, $75 million from Trump's capital contribution, and $55 million from other sources (earnings from investment of the unused portions of the bond proceeds and Trump's $25 million loan obligation under special circumstances). *Id.* at 375 n.20.

164. *Id.* at 375. This comparison creates a huge burden on issuers by requiring the issuers to obtain any and all accurate information regarding competitors which a reasonable investor might consider material. *Id.* Also, this requirement might produce undesirable, excessive disclosures of trivial information to investors. *Id.*

165. *Id.* at 375-76.

166. *Id.* at 376.

167. *Id.* The plaintiffs also contended that the prospectus did not disclose that the Taj Mahal would have to expend substantial resources to lure patrons away from competitors to the Taj Mahal. *Id.* at 376 n.21. The Third Circuit disagreed, however, and noted that the prospectus did, in fact, describe the marketing strategy which the Partnership intended to use to attract customers to the Taj Mahal. *Id.* The marketing strategies included advertising, complimentary services, and promotional programs. *Id.*

prospectus' explicit statements stressing the severity of competition in the casino industry,[168] the court found that "the prospectus extensively and graphically disclosed the magnitude of the competition that the Taj Mahal would face."[169] The court therefore determined that the inclusion of soft information predicting that the Taj Mahal would have difficulty in surmounting its competition would not have materially altered the substance of the information provided by the prospectus.[170]

Finally, the court rejected the plaintiffs' allegation that the prospectus failed to disclose the probable effects on the Taj Mahal's success of a weakened Northeastern economy and potential competition from Las Vegas casinos.[171] The court found that the securities laws do not compel the Partnership to disclose obvious facts.[172] Therefore, the court concluded that a reasonable investor should have known of the economic downturn in the Northeast at the time of the bond issuance, and that the inclusion of this information would not have substantially altered the total mix of information in the prospectus.[173]

IV. ANALYSIS

By employing the bespeaks caution doctrine in *Taj Mahal*, the Third Circuit has, in effect, established the bespeaks caution doctrine as a new and broader common-law safe harbor for disclosures of soft information.[174] The Supreme Court's analysis in *Virginia Bankshares, Inc. v. Sandberg*[175] provides support for the Third Circuit's holding in *Taj Mahal*.[176] The Third Circuit's holding is also consistent with decisions made by other courts of appeals which have employed the bespeaks caution doctrine, and the Sixth Circuit's decision in *Mayer v. Mylod*[177] concurs with this prevailing interpretation of the doctrine.[178] In addition, the *Taj Mahal* decision does not contradict SEC policy as contemplated by Item 303 of Regulation S-K and the safe harbor

168. The Third Circuit found that "[t]he prospectus, morever, stated flatly: 'Growth in Atlantic City casino win is expected to be restrained . . . . No assurance can be given with respect to either the future growth of the Atlantic City gaming market or the ability of the Taj Mahal to attract a representative share of that market.' " *Id.* at 376.

169. *Id.* at 376-77.

170. *Id.* at 377.

171. *Id.* The Third Circuit pointed out that, to the contrary, "the prospectus *did* in fact divulge that the Taj Mahal would face competition from Las Vegas casinos." *Id.*

172. *Id.*

173. *Id.*

174. Romajas, *supra* note 51, at 285.

175. 501 U.S. 1083 (1991).

176. *See infra* notes 181-95 and accompanying text.

177. 988 F.2d 635 (6th Cir. 1993).

178. *See infra* notes 196-203 and accompanying text.

rules,[179] and public policy supports the *Taj Mahal* decision.[180] Moreover, the Third Circuit's review of the bespeaks caution doctrine is a positive contribution to securities regulation. The *Taj Mahal* opinion encourages the disclosure of material soft information. If issuers draft their disclosure documents consistent with the guidelines set forth in *Taj Mahal*, the bespeaks caution doctrine will protect those issuers from liability for disclosures of soft information which fail to be indicative of future events.

A. Supreme Court Precedent

In rejecting the claimed materiality of the alleged misstatements and omissions in the Taj Mahal prospectus, the Third Circuit explained that materiality "is a relative concept, so that a court must appraise a misrepresentation or omission in the complete context in which the author conveys it."[181] The Third Circuit's approach is fully consistent with the long-established test for materiality employed by the Supreme Court and other courts of appeals.[182]

In expanding on the materiality test, the Supreme Court has provided that alleged misrepresentations or omissions in an issuing docu-

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179. *See infra* notes 204-13 and accompanying text.

180. *See infra* notes 214-40 and accompanying text.

181. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 369 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

182. *See supra* notes 25-31, 52-95 and accompanying text. The Second Circuit, however, has addressed the bespeaks caution doctrine both as an issue of materiality and reliance. *Compare* I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 763 (2d Cir. 1991) (considering bespeaks caution doctrine in terms of materiality) *with* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) (dismissing securities claims where prospectus contained abundant and specific warnings and where plaintiffs' "reliance on the oral statements presumptively made by [defendant was] . . . not justified as a matter of law").

The majority of courts continue to base the bespeaks caution doctrine on a materiality analysis. *See* cases cited *supra* note 1. The majority approach results, in part, because § 12(2) of the 1933 Act does not contain a reliance element. *See supra* note 112. As a result, a reliance analysis is inapplicable to such securities claims. "The question of reliance—the role of the disclosure in class members' decisions to invest—is not considered in [1933] Act cases." Langevoort, *supra* note 7, at 492. Furthermore, in cases under § 10(b) of the 1934 Act and Rule 10b-5, "the question of reliance is either presumed away or deferred until much later." Langevoort, *supra* note 7, at 492. The development of the doctrinal elements of securities fraud has led to an "erosion of the requirement of reliance." Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750, 761 (1992).

A similar dilution of the reliance requirement has occurred in other areas of securities law. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (finding no requirement to show reliance where defendant breached duty to disclose a material fact); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970) (finding no requirement to show that material misstatements in proxy materials decisively affected shareholders' vote). Indeed, to show "reliance" under the securities laws, plaintiffs do not even have to prove that they heard or learned of a misstatement, and it is unnecessary to show that they relied on the misstatement in the conventional sense. Kahan, *supra*, at 761.

ment must be considered in context and can be rendered immaterial by other information within the document.[183] Several Supreme Court decisions, including *TSC Industries* and *Basic Inc.*, addressed the materiality of undisclosed facts surrounding proposed corporate acquisitions, not statements of opinion by management. In *Virginia Bankshares*, the Supreme Court explicitly held for the first time that statements of reasons, opinions, or beliefs by corporate managers may be actionable under the securities laws if those statements are not genuinely held to be true.[184] Consistent with *TSC Industries*, however, the Supreme Court stated that otherwise actionable misstatements may not support liability if accompanied by sufficient objectively true statements:

> While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. Since liability under § 14(a) must rest not only on deceptiveness but materiality as well (i.e., it has to be significant enough to be important to a reasonable investor deciding how to vote), petitioners are on perfectly firm ground insofar as they argue that publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability.[185]

With this implicit acceptance of the bespeaks caution doctrine, the Supreme Court concluded that the disclosures by the defendant bank in *Virginia Bankshares* did not render alleged misstatements nonactionable because the explanatory disclosures were themselves "half truth[s] . . . [or] arguably even worse."[186]

The Third Circuit noted that "the Supreme Court's reasoning in [*Virginia Bankshares*] supports rather than undermines the application of the bespeaks caution doctrine in [*Taj Mahal*]."[187] The alleged misstatement at issue in *Virginia Bankshares* concerned the bank directors' written opinion as to the current value of the bank's stock.[188] The

183. "[An omitted fact is material if there is] 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." TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). "[M]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information." Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988) (applying *TSC Industries* test to § 10(b) and Rule 10b-5).

184. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1087 (1991).

185. *Id.* at 1097 (citation omitted).

186. *Id.* at 1098.

187. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 372 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

188. *Virginia Bankshares*, 501 U.S. at 1088. The plaintiff alleged "that the directors had not believed that the price offered was high or that the terms of the merger were fair, but had recommended the merger only because they believed they had no alternative if they wished to remain on the board." *Id.* at 1088-89.

Court found that the materiality of the misleading statement was not neutralized by the evidence presented by the defendants.[189] Therefore, even though the Court did not find enough cautionary statements present in *Virginia Bankshares* to negate the deceptiveness of the bank's misleading statement, the Court held that adequate cautionary statements may, in certain circumstances, render expressions of management belief as to existing matters nonactionable.[190]

Based on the holding in *Virginia Bankshares*, it follows that adequate cautionary statements surrounding even "softer" information, such as management predictions of future events, possess a mitigating effect which may render the predictions nonactionable.[191] This was precisely the Third Circuit's reason for dismissing the plaintiffs' claims of securities violations in *Taj Mahal*:

> [W]e can state as a general matter that, when 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.[192]

The *Taj Mahal* court emphasized that "a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation."[193]

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189. *Id.* at 1098. The defendants' fairness opinion lacked any direct cautionary language. *Id.* The defendants claimed that they could not be found liable under the securities laws because the proxy contained sufficient information that would enable shareholders to determine on their own that the defendants' recommendations were misleading. *Id.* at 1097.

The defendants' evidence, however, did not persuade the Court. *Id.* at 1098. For example, the defendants claimed that they provided further explanation as to their approval of the merger by indicating that they would remain on the board of directors. *Id.* Yet the Court found that the defendants did not admit that their positions on the board were contingent on their approval of the merger. *Id.* The Court also found that there was evidence of a higher book value than the directors had disclosed, and that the directors failed to mention that the bank's value as a going concern was more than $60 a share, compared to the merger price of only $42 a share. *Id.*

190. *Id.* at 1097-98. In *Virginia Bankshares*, the defendants' statement reasonably rested on a factual basis that provided justification for the statement's accuracy, but when the plaintiffs successfully proved the falsity and misleading nature of the disclosed factual basis, the defendants' statement became materially misleading. *Id.* at 1095-96.

191. Management's predictions of future events are disclosures of "softer" information because they do not rely on an easily determinable factual basis like the defendants' statement in *Virginia Bankshares*. In *Virginia Bankshares*, whether the offer price of $42 was high and whether the proposed merger was fair to minority shareholders depended on provable facts about the bank's assets and its actual and potential levels of operation. *Id.* at 1094.

192. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 371 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

193. *Id.*

To suffice, the cautionary statements must be substantive and specifically tailored to the future projections, estimates, or opinions in the prospectus.[194] Therefore, the Third Circuit did not adopt a *per se* rule[195] and is thus consistent with the Supreme Court's statement in *Virginia Bankshares* that abundant and specific cautionary statements may be so persuasive and overwhelming as to negate any conceivable significance of the challenged misstatement or omission of soft information.

B. *The View of Other Courts of Appeals*

The Third Circuit's analysis in *Taj Mahal* is consistent with the approach followed by each of the other courts of appeals which have employed the bespeaks caution doctrine. The First, Second, Eighth, and Ninth Circuits have employed the bespeaks caution doctrine in holding that statements of soft information accompanied by cautionary language are not actionable as securities violations.[196] The Third Circuit followed the rationale of these cases in dismissing the plaintiffs' claims as a matter of law. As the district court noted in *Taj Mahal*, *Taj Mahal* presented an easier decision because the prospectus "include[d] even more specifically tailored disclaimers directly addressing each challenged statement, than did the offering materials in [the above mentioned] appellate decisions."[197]

The Third Circuit's decision in *Taj Mahal* does not conflict with that of the Sixth Circuit in *Mayer v. Mylod*.[198] *Mayer* clarified the

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194. *Id.* at 371-72.

195. The Third Circuit stated that "we do not establish a sweeping rule that cautionary statements will always render misrepresentations or omissions immaterial as a matter of law." *Id.* at 373 n.16.

196. *See* Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991) (prospectus that "warned potential investors in a meaningful way" about risks of investment did not give rise to a securities law claim); I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 761, 763 (2d Cir. 1991) (alleged misstatement read "together and in context" with cautionary statements in prospectus was not materially misleading because prospectus clearly bespoke caution "rather than encourag[ed] optimism"); Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 949 F.2d 243, 245 (8th Cir. 1991) (bond offering prospectus that allegedly misrepresented defendant's ability to service bond debt was not actionable in light of the "repeated, specific warnings of significant risk factors and the disclosures of underlying factual assumptions"); *In re* Convergent Technologies Sec. Litig., 948 F.2d 507, 516 (9th Cir. 1991) (dismissing securities law claims because prospectus for new venture provided "more than generalized statements of risk" and contained detailed cautionary language). For an in depth discussion of these cases, see *supra* notes 68-79, 85-95 and accompanying text.

197. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 793 F. Supp. 543, 556 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

198. 988 F.2d 635 (6th Cir. 1993) (reversing lower court's dismissal of claim that defendant concealed its true financial position by making false and misleading statements to bolster its financial status based on the court's holding that statements of opinion or belief, as well as defend-

Sixth Circuit's prior position in *Sinay v. Lamson & Sessions Co.*[199] In *Sinay*, the Sixth Circuit stated that "[e]conomic projections are not actionable if they bespeak caution."[200] In *Mayer*, the Sixth Circuit recognized that "the central point of *Sinay*, that a claim is insufficient as a matter of law if optimistic opinions are coupled with cautionary statements, partially conflicts with *Virginia Bankshares* because *Virginia Bankshares* contemplates a weighing of the true with the untrue statements in an announcement for liability to result."[201]

The Third Circuit acknowledged the Sixth Circuit's holding in *Mayer* by stating that *Mayer* "properly recognized that in light of *Virginia Bankshares* [, the Sixth Circuit's] earlier statement [in *Sinay*], which one could have read to indicate that economic projections coupled with warnings and cautionary statements are per se nonactionable, was overbroad."[202] Consequently, no conflict exists between the Third Circuit and the Sixth Circuit. The Third Circuit avoided a conflict by firmly stating that it was not establishing "a sweeping rule that cautionary statements will always render misrepresentations or omissions immaterial as a matter of law."[203]

C. *Current SEC Policy*

The disclosures required by Item 303 of SEC Regulation S-K[204] do not preclude dismissal of the plaintiffs' claims in *Taj Mahal*. Whether Item 303 precludes the Third Circuit's determination that the alleged misstatement regarding the Taj Mahal's ability to service its debt burden was immaterial as a matter of law represents the primary question. Item 303 requires issuers to inform the securities markets of

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ant's purely factual statements, if proven to be untrue, are actionable under federal securities law).

199. 948 F.2d 1037 (6th Cir. 1991).

200. *Id.* at 1040. This statement could be read as an overbroad *per se* rule despite the Sixth Circuit's later statements that in determining whether a statement is actionable, "the court must scrutinize the nature of the statement to determine whether the statement was false when made" and "the court must emphasize whether the 'prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis.' " *Id.* (citations omitted).

201. *Mayer*, 988 F.2d at 639 (citing Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991)).

202. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 373 n.16 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

203. *Id.* The Sixth Circuit in *Mayer* did not hold that the materiality of soft information can never be decided at the pleading stage. *Mayer*, 988 F.2d at 639-40. Moreover, *Mayer* is distinguishable from the *Taj Mahal* case. The challenged statements in *Mayer* related to the present status of an issuer's loan portfolio and its current financial position, not projections or soft information. *Id.* at 636-37. *Mayer* also failed to mention the existence of any substantive cautionary language in the prospectus, such as that contained in the Taj Mahal prospectus, to offset the issuer's optimistic assessment of its loan portfolio. *See id.* at 639-40.

204. *See supra* notes 46-51 and accompanying text.

information, trends, and uncertainties that are helpful in understanding a business' financial conditions and operations.[205] Discussion of precisely such trends, uncertainties, and risks pervaded the Taj Mahal prospectus, and the court found such discussion unobjectionable.[206] The court did not hold that Item 303 disclosures regarding liquidity or debt service are immaterial as a matter of law. Instead, the court held that within the specific context of the Taj Mahal prospectus and its abundant, specifically-tailored warnings, the challenged statement could not have influenced a reasonable investor.[207] Thus, Item 303 does not conflict with the principle that statements involving soft information should be read in context and are not actionable if accompanied by sufficient cautionary statements and discussions of risk.[208]

The *Taj Mahal* decision also does not conflict with Rule 175.[209] Simply stated, Rule 175 provides that a "forward-looking" statement is actionable only if an issuer makes the statement "without a reasonable basis" or discloses it without "good faith."[210] Like Item 303 of Regulation S-K, Rule 175 does not conflict with the principle that the materiality of soft information must be determined within the context in which representations are made. Accordingly, there is no need for the safe harbor of Rule 175 if an offering document contains sufficient cautionary language.

Rule 175 is silent on the matters at issue in *Taj Mahal*.[211] This silence explains why none of the courts of appeals that have employed the bespeaks caution doctrine have cited Rule 175.[212] The Third Cir-

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205. 17 C.F.R. § 229.303(a) (1993).

206. *Taj Mahal*, 7 F.3d at 369-71.

207. *Id.* at 373.

208. The Solicitor General's *amicus curiae* brief filed on behalf of the SEC and FDIC in *Virginia Bankshares* stated that: "[E]valuation of the 'total mix' [of information] may reveal that the relevant objective facts were disclosed with sufficient prominence to render a misrepresentation of reasons or purposes obviously unimportant, and, therefore, immaterial as a matter of law." Solicitor General's Brief at 12, Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (No. 89-1448) (citing TSC Indus. v. Northway, Inc., 426 U.S. 438, 450 (1976) (*available in* LEXIS, Genfed Library, Briefs File)). Item 303's limited relevance to the *Taj Mahal* case consists of disclosures made by the defendants in accordance with Item 303 requirements. The materiality of any particular disclosure required by Item 303 must be determined under traditional tests.

209. For a discussion of Rule 175, 17 C.F.R. § 230.175, see *supra* notes 36-45 and accompanying text.

210. 17 C.F.R. § 230.175(a) (1993). Rule 175 does not attempt to define what is or is not materially misleading. In addition, the rule does not require an issuer to include any cautionary language with statements of soft information.

211. Even if Rule 175 was relevant, the Third Circuit determined that the plaintiffs failed to adequately allege that the issuer either disbelieved or lacked a reasonable basis for belief in the predictions made. *See Taj Mahal*, 7 F.3d at 368. Thus, the Third Circuit rejected allegations equivalent to the basis of actionability under Rule 175. *Id. See* 17 C.F.R. § 230.175(a).

212. For example, none of the five courts of appeals that recently embraced the bespeaks caution doctrine mentions Rule 175 in its opinion. *See supra* notes 68-95 and accompanying text.

cuit's approach in *Taj Mahal* complements, and is thus consistent with, the safe harbor provided by Rule 175.[213]

D. Public Policy

In *Taj Mahal*, the district court was aware "of the dangers raised by claims of 'fraud by hindsight' " in securities cases involving predictive statements.[214] Indeed, the challenged statement in *Taj Mahal* consisted of a prediction relating to the Taj Mahal's ability to service its debt burden.[215] "Predictions of future [events] stand on a different footing . . . because they will almost always prove to be wrong in hindsight."[216] In the case of stock, for example, if hindsight could establish fraud, "any drop in the price of shares would result in lawsuits from disappointed investors."[217]

The securities market is fraught with inherent risks. The securities laws do not serve as investment insurance, transposing every prediction of success that fails to materialize into an action for securities fraud.[218] In short, "the falsity of a statement does not depend on 'whether the prediction in fact proved to be wrong.' "[219] The district court in *Taj Mahal* concluded that "the prohibition against fraud by hindsight claims and the 'bespeaks caution' doctrine go hand in hand."[220] Thus, the *Taj Mahal* decision is consistent with the prohibitive policy against fraud by hindsight.

Another policy concern focuses on maintaining a constant flow of material information to an investor. This constant stream of information allows an investor to make an informed decision with respect to a security. As "the first to address comprehensively the proper scope, ap-

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213. The courts' application of Rule 175 and the bespeaks caution doctrine as safe harbors for soft information "brings the law in [this] area . . . more in-line with the framework established by the SEC." Romajas, *supra* note 51, at 285.

214. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 793 F. Supp. 543, 556 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). "The story [of fraud by hindsight] is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud." DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).

215. *Taj Mahal*, 7 F.3d at 365.

216. Raab v. General Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993). The Fourth Circuit Court of Appeals stated that if growth was less than predicted the buyers would sue, and if growth was more than predicted the sellers would sue. *Id.* Lawsuits would become a certainty, and impending liability would deter companies from discussing their prospects, depriving the securities markets of that information. *Id.*

217. *Id.* at 291.

218. *Id.*

219. Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991) (quoting Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 203-04 (5th Cir. 1988), *cert. denied*, 488 U.S. 926 (1989)).

220. *Taj Mahal*, 793 F. Supp. at 557.

plication and limitations to the bespeaks caution doctrine,"[221] the *Taj Mahal* case encourages the free flow of material information to investors. *Taj Mahal* "provides meaningful standards which a court may utilize to invoke the bespeaks caution doctrine to dismiss a complaint at the early stages of litigation."[222] As clarified in *Taj Mahal*, the bespeaks caution doctrine now affords an issuer additional and broader protection from liability when adequate cautionary language accompanies a disclosure of soft information.[223] This protection promotes the free flow of material information to investors by educating issuers on the most effective methods to disclose soft information without the threat of liability.

Further consideration of public policy suggests that some potential problems exist with respect to the bespeaks caution doctrine. Initially, there is the question of whether sufficient cautionary language actually protects an investor from being misled by statements of soft information. Historically, the SEC was reluctant to allow disclosures of soft information because of the issuer's bias in promoting the investment and the difficulty that investors might have in evaluating soft information.[224] "Even moderate common sense suggests that predictions of the future are inherently uncertain and subject to failure. But that does not mean that projections and estimates lack substantive content to reasonable investors."[225] When a disclosure document does not contain cautionary language, it is thus plausible for a reasonable investor to rely on a statement of soft information despite its speculative nature.

Another concern questions whether the addition of cautionary language affects the investors' reliance. If investors only contend that a statement of soft information generated an impression of assurance re-

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221. Block & Hoff, *supra* note 1, at 7. Fleischman and Berger derived the following advice for issuers from *Taj Mahal*:

> Those who draft and disseminate offering documents should make sure that all economic projections, forecasts and predictions are surrounded by cautionary language that unambiguously and specifically warns investors of the high risks associated with the investment. General boilerplate warnings probably will be ineffective as a shield from liability. But as long as there is a reasonable basis for projections—which are accompanied by specific cautionary language—defendants should be insulated from liability for predictions made in the offering documents that subsequently prove to be incorrect.

Fleischman & Berger, *supra* note 53, at 24.

222. Block & Hoff, *supra* note 1, at 7. The Third Circuit's opinion is significant because it specifically noted that the bespeaks caution doctrine may appropriately be invoked on a motion to dismiss. *In re* Donald J. Trump Casino Sec. Litig.--Taj Mahal Litig., 7 F.3d 357, 371 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

223. Block & Hoff, *supra* note 1.

224. *See supra* notes 32-33 and accompanying text.

225. Langevoort, *supra* note 7, at 495. Investors who read a disclosure document might be more apt to pay attention to statements of soft information rather than the more dense narrative disclosure. *Id.*

garding the investment's future success, the security claim is probably unreasonable even without cautionary language.[226] Alternatively, if investors base their beliefs on the issuer's optimism regarding the issuer's superior access to information and the investors' assessments of credibility, general cautionary language in the disclosure document would be meaningless to the investors.[227] Thus, courts should not base the bespeaks caution doctrine upon the notion that cautionary language automatically negates an optimistic disclosure of soft information because the cautionary language might not influence the investor enough to prevent him from relying upon the disclosure.[228]

In addition, judges may credit investors with being more skeptical than the investors actually are; in hindsight, judges might find fault with the investors' reliance upon self-interested issuers.[229] The obvious danger is that the bespeaks caution doctrine allows a judge to dismiss a case, without allowing a jury to consider the issue, based on the judge's perception of how a reasonable investor would assess the materiality of a statement.[230] A jury might be able to more effectively determine how a disclosure influenced a reasonable investor than a skeptical judge. In addition, this concern suggests that courts might adjudicate securities claims more fairly by considering issues pertaining to an investor's reliance. On the other hand, inexperienced, gullible investors might not deserve protection under the federal securities laws.[231] Courts might act in a biased manner for several reasons. Since investors often fail to read prospectuses and other disclosure documents, courts might not be enthusiastic in their search for potentially misleading words that an investor never read.[232] Similarly, courts might suspect that certain securities claims involve fraud by hindsight.[233] In addition, even though some protection for investor reliance is lost by applying a bespeaks caution

226. Langevoort, *supra* note 7, at 497. In this situation, cautionary language adds strength to the determination that the security claim is unreasonable. *Id.*

227. Langevoort, *supra* note 7, at 497. "[I]n terms of persuasion theory, the presence of cautionary language actually may make the projections more influential." *Id.*

228. The Third Circuit in *Taj Mahal* emphasized that it did not adopt a rule that cautionary statements automatically render misrepresentations or omissions immaterial as a matter of law. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 373 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

229. Langevoort, *supra* note 7, at 494. "There is a danger, then, that judges implicitly may invoke the false consensus of a highly personalized 'How would *I* have read the disclosure,' and in so doing, apply a standard of investor rationality that does not reflect the actual behavior of the population at large." *Id.* (footnotes omitted) (emphasis in original).

230. Langevoort, *supra* note 7, at 494 & n.78.

231. Langevoort, *supra* note 7, at 498.

232. Langevoort, *supra* note 7, at 498.

233. *See supra* notes 214-20 and accompanying text.

approach, this loss might be outweighed by the benefit to the judicial system through dismissals of unnecessary litigation.[234]

The two policy concerns require courts to consider an investor's reliance on a particular disclosure of soft information. Reliance, however, is not directly considered in a bespeaks caution analysis or a claim under the 1933 Act. Assertions of reliance have also diminished with respect to claims under the 1934 Act.[235] Even though a materiality analysis may contemplate issues which involve aspects of an investor's reliance,[236] courts might more effectively apply the bespeaks caution doctrine to securities claims by requiring different burdens of proof depending on a plaintiff's particular allegations. For example, in section 10(b) and Rule 10b-5 claims which require scienter,[237] a defendant would need to produce more evidence of specific cautionary statements than in sections 11 and 12(2) claims which only involve negligence.[238]

Requiring a heightened burden of proof for defendants who knowingly lied in disclosures of soft information would thus more equitably focus on the defendant's motivation and intent to mislead investors. If a defendant knowingly lied, a court could rightly conclude that the defendant must have thought the misleading statement would be material to a reasonable investor. As a result, defendants who knowingly lied should have to present more evidence of specific cautionary language within the disclosure document.[239] Under the bespeaks caution doctrine, courts must still consider a disclosure document in its complete context and determine if alleged misstatements or omissions were materially misleading.[240] Thus, by requiring different burdens of proof, the doctrine retains its ability to dismiss unnecessary litigation while also acknowledging certain policy concerns.

V. CONCLUSION

In *Taj Mahal*, the United States Court of Appeals for the Third Circuit clarified the proper role, application, and scope of the bespeaks caution doctrine in analyzing securities claims that allege misstatements or omissions in connection with the disclosure of soft information. The reasoning of the *Taj Mahal* decision provides courts with

234. Langevoort, *supra* note 7, at 498.

235. *See supra* note 182 and accompanying text.

236. *See supra* notes 25-31 and accompanying text.

237. *See supra* note 28 and accompanying text.

238. *See supra* note 112 and accompanying text.

239. The Third Circuit in *Taj Mahal* noted that devious issuers could manipulate the bespeaks caution doctrine. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 371-72 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). As a result, the *Taj Mahal* court required that cautionary language be abundant, precise, and direct. *Id.*

240. *See supra* notes 52-100 and accompanying text.

meaningful standards to follow when dismissing securities claims based on the bespeaks caution doctrine. If issuers draft their disclosure documents consistent with the guidelines set forth in *Taj Mahal*, the bespeaks caution doctrine will protect them from liability for disclosures of soft information which fail to be indicative of future events. Thus, the *Taj Mahal* decision encourages the free flow of material information to investors by allowing certain securities cases to be dismissed at the pleading stage, avoiding unnecessary litigation.

The *Taj Mahal* decision is consistent with Supreme Court precedent and the prevailing view of the other courts of appeals. The decision is also consistent with SEC policy and public policy. Moreover, the *Taj Mahal* case sets a valuable precedent because of its common sense recognition that factually weak securities cases should be dismissed at the pleading stage. Plaintiffs should not be permitted to take a single predictive statement out of context and claim that the statement is materially misleading. Allowing such practices directly contradicts the concept of materiality which requires a court to view the "total mix" of information made available to the reasonable investor.

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