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Second Circuit Limits Protections of Bespeaks Caution Doctrine to Forward-Looking Statements

The US Second Circuit Court of Appeals recently overturned a decision by the District Court for the Southern District of New York, ruling that the "bespeaks caution" defense to securities disclosure claims applies exclusively to forward-looking statements and not to characterizations that communicate present or historical fact. *Iowa Public Employees' Retirement System v. MF Global Ltd.*[1] is significant because it underscores the limits of general risk factor and other cautionary disclosures with respect to inaccurate or incomplete statements of present or historical fact.

The stock price of MF Global Ltd., a futures and options trading company, dropped 45 percent over two days in February 2008, representing a market capitalization loss of US$1.1 billion, after it was revealed that a single trader lost US$141.5 million by speculating in futures that week by evading trading restrictions. It was later disclosed that the loss occurred due to the absence of internal risk controls being applied to brokers trading for their own accounts at the firm. Plaintiff-shareholders of MF Global, led by a group of pension funds, sued the firm, the hedge fund that previously owned it, the underwriters of its July 2007 IPO, and its officers and directors under Sections 11 and 12 of the Securities Act of 1933 alleging, among other things, that MF Global's IPO registration statement and prospectus misrepresented and failed to disclose material facts regarding deficiencies in the company's risk management system.

The lower court dismissed the claims on the grounds that cautionary language included in the risk factor section of the prospectus rendered such statements or omissions non-actionable under the so-called "bespeaks caution" doctrine. A judicially-created rule, the bespeaks caution doctrine renders forward-looking statements accompanied by sufficient cautionary language non-actionable under securities laws if such statements are proved incorrect in the future. The rationale is that no reasonable investor could find a statement accompanied by adequate cautionary language materially misleading. Protection for forward-looking statements is also provided by the statutory safe harbor of the Private Securities Litigation Reform Act of 1995; however, the forward-looking statement safe harbor does not apply to certain offerings, including IPOs.[2] As a result, even if the statements in question were forward-looking, MF Global would not have been able to rely on the statutory safe harbor.

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1 No. 09-3919-cv, 2010 WL 3547602 (2d Cir. Sept. 14, 2010).

2 Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

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In reversing the dismissal, the Second Circuit held that the lower court misstated the threshold test and applied the doctrine too broadly. The Court held that, here, the allegation specifies an omission of present fact, the failure to disclose that the company's past or existing risk management procedures did not apply to employees. Specifically, the deactivation of controls for employees was known when the challenged statements were made. Noting the firm's prospectus statements that its risk management system was "robust," the Court stated that this "invite[d] the inference that the system will reduce the firm's risk. However, bespeaks caution does not apply insofar as those characterizations communicate present or historical fact as to the measures taken."[3] In essence, cautionary risk factor language, such as "our risk-management methods may prove to be ineffective," were irrelevant to statements that were not forward-looking.

Although this decision relates to liability under Sections 11 and 12 of the Securities Act in connection with a registered equity offering, the holding and the Court's analysis are applicable to disclosure in all types of securities offerings. As a practical matter, the decision should lead issuers to review their risk factors and ask themselves in each case whether the risk being disclosed is already ongoing or has occurred in the past. By way of example, a statement by a company that it may be unable to meet certain material industry standards in the future would be unlikely to preclude claims arising from a current failure to meet those industry standards. A company would likely need to disclose something about these current facts as well as review its disclosures carefully for present statements of fact and/or any possible inferences to the contrary. Companies are likely to face difficult judgments relating to how to disclose the current state of risk management systems but should consider the need for clear disclosure both with respect to affirmative statements of current fact (as was the case in *MF Global*) or possible omissions of such facts.

The *MF Global* decision also indicates the level of scrutiny courts give to statements in offering documents before applying the bespeaks caution doctrine. A series of recent cases have made it more difficult for plaintiffs to survive the pleading stage of federal securities claims under Rule 10b-5, both by limiting the pool of potential defendants and by tightening the pleading standards. The *MF Global* decision may make it easier for certain claims under Sections 11 and 12 of the Securities Act (and related claims under the Securities Exchange Act of 1934) to survive a motion to dismiss.

3 *MF Global Ltd.*, 2010 WL 3547602, at *2.

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