DIRECTORS' AND OFFICERS' LIABILITY
LIABILITY FOR STATEMENTS OF SECURITIES ANALYSTS

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Securities analysts play a vital role in fostering healthy securities markets. Despite recent questions about the objectivity of certain securities analyst reports, the investment community still looks to analysts to synthesize into a concise report published corporate information, communications with management and expertise concerning a particular industry. Public companies rely on analysts to varying degrees to educate investors about their company. Communications between corporate management and analysts remain an important part of the process by which many public investors and their advisers gather information to decide whether to buy or sell a security. Many corporate officers communicate regularly with analysts to discuss corporate affairs including financial performance, products and earnings prospects. In addition to creating risks of selective disclosure of nonpublic material information, dealings with analysts often lead to allegations that alleged material misrepresentations or omissions about a company's progress and earnings prospects contained in analyst reports should be attributed to corporate management under Section 10(b), either because management "entangled" itself in a report's preparation, or ratified a report by disseminating it after publication. This column examines when statements contained in analyst reports will and will not be attributed to corporate management, and suggests measures to reduce liability risks arising from dealings with analysts.

To analyze the potential liability of corporate management for alleged material misrepresentations and omissions contained in analyst reports, it is useful to separate the two ways directors and officers typically have become "entangled" with analyst reports. Prior to publication, management "may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material error in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views."[1] Post-publication, analyst reports may become attributable to management when, through dissemination or other adoptive conduct, management expressly or impliedly ratifies the report.

Any attempt to impose liability on corporate management for statements contained in analyst reports must comport with *Central Bank of Denver v. First Interstate Bank of Denver*,[2] in which the Supreme Court foreclosed aiding and abetting liability under Section 10(b). In the context of statements contained in analyst reports purportedly attributable to corporate management, the directors and officers are deemed secondary actors. While *Central Bank* did not eliminate potential liability of secondary actors, it did heighten the threshold required for a secondary actor's conduct to implicate primary liability. Most courts, including the Second Circuit, have adopted a "bright line" approach: a defendant cannot be primarily liable under Section 10(b) unless it actually made an allegedly false or misleading statement.[3] As the Second Circuit has stated, "'[a]nything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).'"[4]

A secondary actor also cannot incur primary liability under Section 10(b) unless (i) it knew or should have known that its statement would be publicly disseminated, and (ii) the statement ultimately disseminated is attributed to the secondary actor at the time of dissemination.[5] Thus, although a defendant must actually make a material misstatement or omission on which a purchaser or seller relied in order to be a primary violator under *Central Bank*, it does not have to directly communicate the misrepresentation or omission to investors to incur liability.

Pre-publication Entanglement

As the Fourth Circuit has stated, "[t]he securities laws require [companies] to speak truthfully to investors; they do not require the company to police statements made by third parties for inaccuracies, even if the third party attributes the statement to [the company]."[6] Generally, directors and officers cannot be liable for analysts' interpretations of their truthful statements.[7] Merely providing an analyst with historical information is not actionable under Section 10(b).[8] A one-way flow of information consisting of truthful and accurate communications from corporate management to an analyst, followed by a separate communication between analyst and customer should not form the basis for liability against corporate management; the director or officer has made no misleading statement.

Conversely, sufficiently pleaded allegations that directors or officers deliberately made false or misleading statements to an analyst with a reasonable expectation that the analyst would re-publish the statements to the market will be treated (when the analyst does so) as if the director or officer made the statement directly to the market.[9] In that circumstance, the analyst has functioned as a conduit of management's own statements. Similarly, sufficiently detailed allegations that management in communications with analysts "'intentionally foster[ed] a mistaken belief concerning a material fact' that was incorporated into reports" will survive facial challenge.[10]

The insulation from liability for third party statements begins to erode as management chooses to comment on or otherwise become involved in the preparation of analyst reports. Even if the plaintiff is unable specifically to allege that management deliberately conveyed false or misleading material information to analysts who then repeated it, liability may attach if corporate management reviews a third-party analyst's draft report and (with scienter) expressly or impliedly adopts or endorses false or misleading statements contained therein.[11] After

Central Bank, the Second Circuit has adhered to its longstanding formulation of this "imprimatur" liability, sustaining specific allegations that directors and officers "sufficiently entangled [themselves] with the analysts' forecasts to render those predictions attributable to [them]."[12]

Because the entanglement theory is an exception to the general rule precluding liability of management for third-party analyst statements, courts have sharply limited the circumstances under which statements in analyst reports may be attributed to management based on its "imprimatur." A Section 10(b) claim cannot be sustained against corporate management for statements (including projections and forecasts) contained in analyst reports absent specific allegations that management (i) was aware of and adopted the final version of the report, and (ii) knew that the challenged statements in the report were unreasonable when made, but failed to disclose the unreasonableness to investors. While a company and its management of course do not commit securities fraud merely by not disclosing all nonpublic material information in their possession, the second requirement acknowledges that a voluntary disclosure of information that a reasonable investor would consider material must be accurate and complete.

The requirements of adoption and knowledge of unreasonableness must pleaded with the specificity demanded by the Private Securities Litigation Reform Act and Fed. R. Civ P. 9(b).[13] The complaint at a minimum must allege facts identifying (i) the specific misleading statements or forecasts and the name of the corporate insider who adopted them; (ii) specific interactions between the analyst and the insider that give rise to the entanglement; and (iii) the dates on which the interactions giving rise to the entanglement occurred.[14] Plaintiffs may not invoke the group pleading doctrine to attribute analyst reports to individual directors and officers because such reports are not group published.[15] Thus, conclusory allegations "that the challenged statement was based on information provided by [company] management does not suggest the kind of control or cooperation in the issuance of the report necessary to render [directors or officers] liable for its content."[16]

In the Second Circuit's seminal entanglement decision *Elkind v. Liggett & Myers, Inc.*,[17] the court held that although management had reviewed and commented on analyst reports, by limiting its "suggestions" to factual and descriptive matters, and enforcing a corporate policy against commenting on earning forecasts, it could not be liable for failing to disclose that it did not agree with optimistic forecasts offered by analysts. Judge Stein's recent application of these principles in *In re Revlon, Inc. Sec. Litig.*[18] illustrates how at the pleading stage courts will scrutinize allegations on an individualized basis to separate claims with adequate factual color from impermissibly vague allegations. Plaintiffs alleged that senior management regularly provided analysts with corporate information, and reviewed and approved draft analyst reports for consistency with internal knowledge before publication. The court rejected most of plaintiffs' allegations regarding misleading statements in analyst reports, concluding that even where specific reports were identified, plaintiffs failed to identify the "executive responsible for any particular communication to an analyst nor stated where and when a particular communication took place." The court did sustain allegations limning a particular analyst conference at which identified executives spoke about "'the current condition of the company and known trends affecting the company,'" when they allegedly knew but failed to disclose additional material adverse information, and a specific analyst report was issued based on the conference.

Post-publication Adoption

Corporate management also must understand that statements made about (or conduct endorsing) an analyst report after its publication can result in sustainable allegations that management adopted or ratified the report. Allegations of ratification must show that management post-publication manifested its belief that an analyst's forecasts or other statements are accurate, or at least accord with management's views. Depending on the circumstances, distributing or citing analyst reports to potential investors may constitute an implied representation that the reports are accurate.[19] The practice of some companies to provide the market with "comfort statements," *i.e.*, generalized statements that they are "comfortable" with analyst projections, also is perilous. While the Fourth Circuit has declined to permit liability on comfort statements that do not rise to the level of a guarantee,[20] the Third Circuit has sustained such allegations, asserting that "[t]o say that one is 'comfortable' with an analyst's projection is to say that one adopts and endorses it as reasonable. When a high-ranking corporate officer explicitly expresses agreement with an outside forecast, that is close, if not the same, to the officer's making the forecast."[21] Similarly, the SEC has stated that "under certain circumstances an issuer that disseminates false third party reports may adopt the contents of those reports and be fully liable for the misstatements contained in them, even if it had no role whatsoever in the preparation of the report. If an issuer knows, or is reckless in not knowing, that the information it distributes is false or misleading, it cannot be insulated from liability because management was not actively involved in the preparation of that information."[22] A "no comment" policy (which under the securities laws is equivalent to silence) regarding analyst projections is the safest course, although the SEC has suggested that a disclaimer of adoption also may be effective.[23]

Conclusion

Management involvement with analyst reports is fraught with risks. Directors and officers who review analyst reports and correct errors prior to publication may need to choose between leaving a statement uncorrected which, because it is contradicted by internal information, may be misleading, and correcting the statement by disclosing internal information despite corporate interests in preserving confidentiality. Still riskier, selectively disclosing information to analysts may engender insider trading issues. If information provided to analysts to correct a draft report is material, non-public information, its selective disclosure to analysts may be the first step toward charges of illegal "tipping" of insider information.[24] Selective disclosure to analysts of material, non-public information must be negated with an immediate press release publicly disclosing the information.

If for business reasons management chooses to review or comment on analyst projections, it is important to implement a coherent process governing interactions with analysts. The crucial first step is to adopt written internal guidelines establishing who has authority to communicate with analysts and review analyst projections, and delineating company policy on the extent to which the company will comment on draft analyst reports. Numerous decisions rejecting allegations seeking to tie corporate management to analyst reports have emphasized company policies against commenting on forecasts and financial projections proposed (and commonly challenged) in analyst reports.[25] Thus, if management chooses to review draft analyst reports, limiting comment to factual and descriptive matters, and declining to comment on earnings projections may go far toward insulating corporate management from entanglement liability. Rather than recommend that an analyst adjust an estimate of earnings, corporate management can often secure the same result by reviewing the assumptions underlying the estimate with the analyst.

Post-publication, the best course is not to distribute third-party analyst reports or post (or link) them to the company web site, although the SEC has suggested that an appropriate disclaimer of adopting report contents may be effective. "No comment" is the safest route. Comfort statements concerning projections should be avoided, as they may be deemed an adoption.

ENDNOTES

1 *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980).

2 511 U.S. 164 (1994).

3 *See Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999); *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997).

4 *Shapiro*, 123 F.3d at 720 (quoting *In re MTC Electronic Technologies Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995).

5 *Wright*, 152 F.3d at 175.

6 *Raab v. General Physics Corp.*, 4 F.3d 286, 288 (4th Cir. 1993).

7 *See, e.g., Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 934 (9th Cir. 1996).

8 *See In re Harmonic, Inc. Sec. Litig.*, 2001 WL 1135629, *14 (N.D. Cal. July 3, 2001); *see also In re Software Publishing Sec. Litig.*, 1994 WL 261365, *12 (N.D. Cal. Feb. 2, 1994) ("While [the company] may have provided the information on which the reports were based, this does not mean the company is liable for their contents.").

9 *See, e.g., Cooper*, 137 F.3d at 624; *In re ICN/Viratek Sec. Litig.*, 1996 WL 164732, *6 (S.D.N.Y. April 9, 1996).

10 *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir.) *cert. denied*, 121 S. Ct. 567 (2000) (quoting *Elkind*, 635 F.2d at 163-64).

11 *Novak*, 216 F.3d at 314; *In re Syntex Corp.*, 95 F.3d at 934; *DeMarco v. Depotech Corp.*, 149 F. Supp.2d 1212, 1231 (S.D. Cal. 2001).

12 *Elkind*, 635 F.2d at 163; *see Novak*, 216 F.3d at 314; *In re Northern Telecom Ltd. Sec. Litig.*, 42 F. Supp.2d 234, 249 (S.D.N.Y. 1998); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp.2d 398, 407 (S.D.N.Y. 1998).

13 The Reform Act provides that complaints purporting to allege securities fraud must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

14 *See, e.g., In re Harmonic, Inc. Sec. Litig.*, 2001 WL 1135629 at *14; *In re Splash Technology Holdings, Inc. Sec. Litig.*, 2000 WL 1727377, *19 (N.D. Cal. Sept. 29, 2000); *In re Northern Telecom Ltd. Sec. Litig.*, 42 F. Supp.2d at 249; *In re Ross Systems Sec. Litig.*, 1994 WL 583114, *11 (N.D. Cal. July 21, 1994).

15 *See In re Ross Systems*, 1994 WL 583114 at *11.

16 *In re Northern Telecom Ltd. Sec. Litig.*, 42 F. Supp.2d at 249.

17 635 F.2d 156 (2d Cir. 1980).

18 2001 WL 293820 (S.D.N.Y. March 27, 2001).

19 *See Stack v. Lobo*, 1995 WL 241448 (N.D. Cal. April 20, 1995).

20 *Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994).

21 *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1429 (3d Cir. 1997).

22 *In the Matter of Presstek, Inc.*, Exchange Act Release No. 39472 (Dec. 22, 1997).

23 *See Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *Presstek*, Exchange Act Release No. 39472.

[24] Remarks of Chairman Arthur Levitt to the "S.E.C. Speaks" Conference, "A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading," February 27, 1998, available at www.sec.gov/news/speech/speecharchive/1998/spch202.txt.

[25] *See, e.g.*, *In re Syntex Corp.*, 95 F.3d at 934; *In re Cirrus Tech. Sec. Litig.*, 946 F. Supp. 1446 (N.D. Cal 1996); *Elkind*, 635 F.2d at 163.