

# STUDENT COMMENT

## FEARLESS FORECASTS: CORPORATE LIABILITY FOR EARNINGS FORECASTS THAT MISS THE MARK

On February 2, 1973, the Securities and Exchange Commission (hereinafter the SEC or the Commission) issued a policy statement declaring that it had decided "to take the first steps toward" the inclusion of companies' own earnings forecasts in the SEC's disclosure system.<sup>1</sup> The question whether the earnings predictions prepared by a company's own personnel should be included in the reports required to be regularly filed with the SEC or in the registration statement required for a public issue of securities remains a controversial issue in the financial community.<sup>2</sup> One of the important stumbling blocks to a more extensive publication of forecasts is the fear of businessmen and their counsel that companies may be exposed to civil liability in the event that forecasts miss the mark. This comment will begin with a brief review of the controversy over public earnings forecasts. It will then explore the question of civil liability for incorrect forecasts, and will conclude with a suggestion as to how such forecasts should be viewed by the courts.

### I. THE DISCLOSURE SYSTEM AND EARNINGS FORECASTS

In the wake of the stock market debacle of 1929, Congress passed a series of laws designed to regulate the issuing and trading of securities.<sup>3</sup> The hallmark of the federal regulatory system is "disclosure," that is, the idea that the best method of protecting the investor is to require that those who issue or trade in securities disclose enough information to allow the investor to make an informed decision.<sup>4</sup> Under the Securities Act of 1933,<sup>5</sup> when securities

<sup>1</sup> SEC, Securities Act Release No. 5362, Securities Exchange Act Release No. 9984 (Feb. 2, 1973) (Statement by the Commission on the Disclosure of Projections of Future Economic Performance) [hereinafter SEC Statement].

<sup>2</sup> However, some of the companies that began publishing their forecasts in the wake of the SEC announcement have since soured on the idea, primarily because of the difficulty of making accurate forecasts in the current unsettled economic conditions. See Annual Reports: The Forecasting Fad is Over, *Bus. Week*, July 27, 1974, at 60.

<sup>3</sup> The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1970); The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (1970); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (1970); The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-52 (1970); and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-21 (1970).

<sup>4</sup> The preamble to the Securities Act of 1933 states that its purpose is: "To 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 . . ." 48 Stat. 74 (1933). The SEC has emphasized that its function is not to pass on the merits of an offering, but merely to ensure that the investor has sufficient information to make a decision.

Under the [1933] Act, speculative or apparently unsound issues can be registered and sold provided the whole truth is told. . . . The basic policy is not to attempt to protect the investor by insulating him from risk but to make available to him the information with which to gauge the risk.

covered by the Act are sold to the public, a registration statement must be filed with the Securities and Exchange Commission containing an extensive amount of information about the company and about the security to be offered, and much of this information must also be included in a prospectus designed to inform investors about the offering.<sup>6</sup> Under the Securities Exchange Act of 1934,<sup>7</sup> companies whose shares are publicly held must participate in a program of continuous information disclosure that includes periodic reports filed with the Commission.<sup>8</sup>

One item of information that has not been a part of the disclosure requirements is a company's own forecasts of its future earnings. Of course, an investor is vitally interested in the prospects of a company in which he may invest, and sellers of securities are eager to tempt the buyer with projections of future profits. Nevertheless, it has been the policy of the SEC that such forecasts should not be a part of the disclosure system. In early "stop order" actions against new issues, the Commission seemed to take a tolerant view of the inclusion of reasonable projections of future performance in registration statements,<sup>9</sup> but opposed predictions that gave the appearance of being more certain than they actually were.<sup>10</sup> Thereafter, how-

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SEC Tenth Ann. Rep. 15 (1945). See Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 34 (1959); 1 L. Loss, *Securities Regulation*, 127-28 (1961). See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 563 (E.D.N.Y. 1971).

<sup>5</sup> 15 U.S.C. §§ 77a-77aa (1970).

<sup>6</sup> Section 7 of the Act, 15 U.S.C. § 77g (1970), sets out the required contents of a registration statement, and § 10, 15 U.S.C. § 77j (1970), describes the contents of a prospectus.

<sup>7</sup> 15 U.S.C. §§ 78a-78hh-1 (1970).

<sup>8</sup> Section 13 of the 1934 Act, 15 U.S.C. § 78m (1970), sets forth the requirements for periodic filings with the Commission. For an argument that the continuous disclosure of the Securities Exchange Act should be the basis of a new regulatory system replacing the dual provisions of the Securities Act and the Securities Exchange Act, see Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340 (1966).

<sup>9</sup> See, e.g., *American Kid Co.*, 1 S.E.C. 694 (1936), where the Commission issued a stop order after finding that an estimate of future annual net profits contained in a registration statement was "so grossly exaggerated as to constitute a misrepresentation." The Commission went on to say:

While we recognize that, in estimating profits for new enterprises, registrants cannot be held to too strict a standard and that some degree of tolerance may be permitted, nevertheless the fact that this registrant's estimated profits are out of line with those of established experienced concerns in the same business is misleading in the absence of supporting data which would substantiate this unusual estimate.

*Id.* at 698.

In another stop-order proceeding, *Ypres Cadillac Mines Ltd. (No Personal Liability)*, 3 S.E.C. 41 (1938), the Commission found no fault with a registration statement containing an estimate of the future selling price of the shares. The Commission said:

An estimate can not be used, of course, which is lacking in any foundation, but this is not the situation in the instant case as the record shows. While the estimate was based upon optimistic assumptions, we cannot find that it involved a misrepresentation of its bases. Accordingly we do not find the answer to this item to be deficient.

*Id.* at 52.

<sup>10</sup> *Comstock-Dexter Mines, Inc.*, 10 S.E.C. 358, 372 (1941) (estimate of extent of gold

ever, the Commission developed the policy that predictions of future performance were out of place in a prospectus or registration statement.<sup>11</sup> Underlying this policy are the beliefs that projections are inherently unreliable, that there is a danger of abuse by stock market manipulators, that the unsophisticated investor would give undue credence to projections, and that projections are not "facts" and therefore do not fit within the factual disclosure system.<sup>12</sup> It was believed that, given the requisite amount of information about a company's past and present situation, an investor could make his own predictions that would probably be as valid as those of management or investment analysts.<sup>13</sup>

Thus, predictions are barred from registration statements and prospectuses attending new issues. They are likewise barred from the continuous disclosure process set up by the Securities Exchange Act.<sup>14</sup> In addition, companies that are in the process of issuing new securities are strongly discouraged from making predictions in public statements, because the Commission has taken the position that any such public prediction might be interpreted as an "offer to sell" forthcoming securities before the registration statement becomes effective, which constitutes a violation of the Securities Act of 1933.<sup>15</sup> As a result, companies that are "in registration" do not issue predictions about their future performance.<sup>16</sup>

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ore included as a fixed asset on the balance sheet); *Thomas Bond, Inc.*, 5 S.E.C. 60 (1939) (profit possibilities of a new cosmetic company in exact percentage "lend[s] an appearance of predictability of future profits which is improper for a corporation which has yet to start business." *Id.* at 71).

<sup>11</sup> The elimination of forecasts from registration statements and prospectuses was accomplished through informal administrative action; companies know they must not include them in order to avoid a stop-order proceeding. A report on disclosure prepared by SEC staff members and submitted to the Commission in 1969 noted that "[i]t has been the Commission's long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission." SEC, *Disclosure to Investors, A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts* 96 (1969) [hereinafter cited as *The Wheat Report*].

<sup>12</sup> The authors of *The Wheat Report*, *supra* note 11, argued: "A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the commission would be accorded a greater measure of validity by the unsophisticated than they would deserve." *The Wheat Report*, *supra* note 11, at 96. See also Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 *Bus. Law.* 300 (1961). Mr. Heller, a former assistant director of the SEC's Division of Corporate Finance, noted that attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which in fact does not exist, and he concluded that "the Securities Act, like the hero of 'Dragnet,' is interested exclusively in facts." *Id.* at 307.

<sup>13</sup> See *The Wheat Report*, *supra* note 11, at 96; Heller, *supra* note 12, at 307.

<sup>14</sup> *The Wheat Report*, *supra* note 11, at 96. See also Schneider, Nits, Grits and Soft Information in SEC filings, 121 *U. Pa. L. Rev.* 254, 257-58 (1972).

<sup>15</sup> SEC, *Securities Act Release No. 5180* (August 16, 1971) (Guidelines for the Release of Information by Issuers whose Securities are in Registration) states that "any publication of information by a company in registration other than by means of a statutory prospectus should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value."

<sup>16</sup> The American system of discouraging disclosure of management's projections for the

Although banned from required disclosure, and also from public dissemination while a company is "in registration," predictions apparently form a significant part of the corporate information that is communicated to the public. A 1966 survey disclosed that between one-fourth and one-third of all widely held companies were issuing earnings projections to the financial press.<sup>17</sup> In addition, about one-third of the companies surveyed actively contacted securities analysts to discuss the company's prospects, and virtually all said they would respond to unsolicited inquiries from analysts dealing with projections.<sup>18</sup> Some companies have included projected earnings in their annual reports,<sup>19</sup> but most companies that make public their projections do not send them to shareholders.<sup>20</sup>

Recently sentiment has been growing among some members of the financial community in favor of an end to the SEC's opposition to publication of earnings forecasts.<sup>21</sup> The arguments for increased dissemination of forecasts are both theoretical and practical. The theory is that since a forecast of future economic performance is the most fundamental piece of information bearing on the decision to invest, the investor would be greatly aided in his decision if he had access to the forecasts prepared by the management of the company.

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future contrasts with the system that has developed in Great Britain. The object of the British regulatory framework has been said to be identical to that of its American counterpart: "to ensure that full disclosure is made of all information needed to enable a potential investor to assess the worth of the securities." L. Gower, *Modern Company Law* 291 (3rd Ed. 1969). Under the British system, as described by one commentator, companies that are listed on the London Stock Exchange, or which are seeking to be listed, *must* include in a prospectus a statement of the company's prospects. Such forecasts are also encouraged, though not required, when a company is involved in a merger or takeover bid. As a general rule, earnings forecasts are made for the remainder of a fiscal year; they sometimes cover longer periods, but generally the maximum period covered does not exceed 18 months. The predictions are certified by outside accountants, who check to see that proper accounting procedures have been followed. In practice such projections are only made by established companies (new issues do not come under the prospectus requirement) and the accountants would not certify a forecast of a new company without a history of earnings and forecast preparation. However, there are significant differences between the British and American securities markets that make any direct comparison difficult. These include the fact that there is nothing in Britain comparable to the over-the-counter market in the United States; thus the stock exchanges, and the London Stock Exchange in particular, play a much more important part in market regulation than do their American counterparts. There is also a much less litigious climate in Britain as to prospectus contents. Carmichael, *Reporting on Forecasts: a U. K. Perspective*, J. of Accountancy, Jan. 1973, at 37.

<sup>17</sup> Burson-Marsteller Associates, *Patterns in Corporate Disclosure* (1966), cited in 2 A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5* § 7.2(1), at 148.

<sup>18</sup> *Id.*

<sup>19</sup> See Shank & Calfee, *Case of the Fuqua Forecast*, 51 Harv. Bus. Rev., Nov.-Dec. 1973, at 34.

<sup>20</sup> Bromberg, *supra* note 17, § 7.2(1), at 148.

<sup>21</sup> See, e.g., Kripke, *The Myth of the Informed Layman*, 28 Bus. Law. 631 (1972); Mann, *Prospectuses: Unreadable or Just Unread? - A Proposal to Reexamine Policies Against Permitting Projections*, 40 Geo. Wash. L. Rev. 222 (1971); Reiling & Burton, *Financial Statements: Signposts as well as Milestones*, Harv. Bus. Rev., Nov.-Dec. 1972, at 45; Comment, 21 U.C.L.A.L. Rev. 242 (1973) (arguing that disclosure of internal forecasts should be required in all but the most extreme situations of unreliability).

Increased publication of forecasts is urged on the premise that the traditional prospectus, with its often complex financial statements and impenetrable jargon, has not been an aid to the average investor. It is argued that forecasts would help the average investor to make an educated decision, and also aid the sophisticated investor or stock market analyst, who could compare the figures prepared by management with his own predictions of a company's prospects.<sup>22</sup>

The practical argument in favor of public disclosure of projections is that since such projections are already available to some stock-market experts—bankers and those investments analysts who have an inside track to the management of many corporations—such information should be available to the ordinary investor as well.<sup>23</sup> Judicial recognition that a company's earnings forecasts may be so important to the investment decision that they constitute "inside information" requiring disclosure<sup>24</sup> has added impetus to the call for public release of all earnings forecasts.

In response to this new recognition of the importance of company forecasts to the investment decision, the SEC held hearings on the forecast question late in 1972,<sup>25</sup> and issued its statement shortly afterwards.<sup>26</sup> The Commission said that it had determined to "take the first steps" toward the integration of projections into disclosure, but would not *require* any company to issue projections. Instead the Commission announced it would *permit* companies that met certain requirements (including a history of earnings and internal budgeting) to include projections in registration statements and other re-

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<sup>22</sup> See generally Mann, *supra* note 21. In Mann's view, the bar against projections has two detrimental effects: (1) it reduces the utility of prospectuses as an aid in making investment decisions, and (2) it reduces the flow of information to investors and investment intermediaries while a registration statement is pending. He concludes:

Projections prepared by the issuer, reviewed by counsel familiar with the liabilities provisions of the Securities Act, scrutinized by the staff of the Commission and accompanied by a full statement of the assumptions upon which they are based, should be accorded a greater measure of validity than oral projections made by a securities salesman trying to earn a commission.

40 Geo. Wash. L. Rev. at 231.

<sup>23</sup> See Comment, *supra* note 21, at 246-47.

<sup>24</sup> See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). See also *SEC v. Glen Alden Corp.*, [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,280, at 97342 (S.D.N.Y. 1968). In *Glen Alden* the Commission obtained a consent judgment to block Glen Alden from releasing material information to certain persons in violation of Rule 10b-5. The persons involved were broker-dealers and investment companies, and the information included sales, earnings and cash-flow projections.

<sup>25</sup> Among those who testified was Wallace E. Olsen, executive vice president of the American Institute of Certified Public Accountants, who favored a trial period for allowing projections, but opposed any procedures under which the projections would be vouched for by outside accountants. This reservation was echoed by Harvey Kapnick, chairman of the accounting firm of Arthur Andersen & Co., who said that involving outside accountants in vouching for forecasts, would tend to weaken the accountants' credibility. Among those opposing the idea of more public forecasting was James J. Needham, the chairman of the New York Stock Exchange. See the testimony summaries in *J. of Accountancy*, Jan. 1973, at 9.

<sup>26</sup> SEC Statement, *supra* note 1.

ports filed with the Commission if the projections were properly made. Although the statement did not spell out the standards to be imposed, it did suggest that there would be requirements that a projection "relate at a minimum to sales and earnings, that it be expressed in an exact figure or within a reasonable range, that the underlying assumptions be set forth, and that it be for a reasonable period, such as a fiscal year."<sup>27</sup> The Commission also stated that it was considering rules: (1) requiring that any company that issued a prediction to anyone outside the company file a copy of the prediction with the Commission; and (2) helping to clear up the problem of potential liability by setting out the "circumstances under which a projection would not be considered to be a misleading statement of a material fact . . . ." <sup>28</sup>

## II. CIVIL LIABILITY

Perhaps the thorniest problem attending any increased publication of forecasts is the possibility of civil liability for a prediction that proves incorrect. Faced with the possibility of devastating liability under the federal securities laws, many businessmen and their lawyers argue that the only way that forecasts could systematically be made public would be under a grant of immunity from the government.<sup>29</sup> This comment will now examine potential sources of liability and evaluate the threat they pose to a large-scale disclosure program.

Prior to the enactment of the federal securities laws, the remedy available to an investor claiming he had been swindled in a securities transaction was an action to rescind the sale contract on the grounds of misrepresentation or fraud,<sup>30</sup> or a suit for damages under a fraud theory.<sup>31</sup> However, these avenues provided little help to most investors, and even less help to those who had bought stock on the basis of glowing predictions of future profits and dividends. The rescission remedy was unavailable if the stock had been resold and was thus unavailable for tendering back.<sup>32</sup> Both rescission and damage actions became of even less utility, because of the lack of privity between the company and the stockholders, when the modern investment-banking system replaced the 19th-Century system under which stock was sold directly by the corporation or its agents.<sup>33</sup>

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* At the time this comment was written the Commission had not yet promulgated the long-awaited rules; its silence suggested that problems raised by projections had been greater than expected.

<sup>29</sup> See *The Wheat Report*, *supra* note 11, at 95.

<sup>30</sup> See, e.g., *Zeh v. Alameda Community Hotel Corp.*, 122 Cal. App. 366, 10 P.2d 190 (1932).

<sup>31</sup> See, e.g., *Ray County Sav. Bank v. Hutton*, 224 Mo. 42, 123 S.W. 47 (1909).

<sup>32</sup> See Schulman, *Civil Liability and the Securities Act*, 43 *Yale L.J.* 227, 232 (1935); F. Harper & F. James, *The Law of Torts* § 7.10, at 571 (1956).

<sup>33</sup> Schulman, *supra* note 32, at 239. The transition is described by Judge Medina in *United States v. Morgan*, 118 F. Supp. 621, 635-50 (S.D.N.Y. 1953).

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The most important problem with both equitable and damage actions was that they could be maintained only where there had been a misrepresentation of a "material fact." Predictions were not ordinarily considered to be facts.<sup>34</sup> However, an exception was sometimes made when the forecaster knew that the forecast was incorrect and could not be achieved. In that case, courts found that a "material fact," *i.e.*, the state of the forecaster's mind, had been misrepresented.<sup>35</sup> Some courts refused to find liability even where the forecasts were made with no expectation of their being fulfilled.<sup>36</sup> In the words of the Supreme Court of Missouri, speaking in 1909:

Frauds, either in civil or criminal law, are not based on prognostications. Who may know what a day may bring forth? No man stands condemned in the law because hope springs in his breast, or because out of the fullness of his heart his mouth speaketh in that regard. Therefore the law does not interdict prophesying the expression of sanguine business hopes and beliefs in events to come.<sup>37</sup>

Thus it appears that the common law liability facing the businessman who honestly errs in a forecast is minimal. His main concern is liability under the federal securities laws, which impose higher anti-fraud standards than does the common law.<sup>38</sup> The most important provisions for those making forecasts are Rule 10b-5, promulgated under section 10(b) of the Securities Exchange Act of 1934,<sup>39</sup> which provides a civil remedy for investors injured by

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<sup>34</sup> *Sawyer v. Prichett*, 86 U.S. (19 Wall.) 146, 163 (1873); *Farwell v. Colonial Trust Co.*, 147 F. 480 (8th Cir. 1906); *Zeh v. Alameda Community Hotel Corp.*, 122 Cal. App. 366, 10 P.2d 190 (1932); *Farmers' Loan and Mortgage Co. v. Langley*, 166 La. 251, 117 So. 137 (1928); *Stalnaker v. Jones*, 68 W. Va. 176, 69 S.E. 651 (1910).

<sup>35</sup> See, e.g., *Faust v. Parker*, 204 Iowa 297, 213 N.W. 794 (1927); *Electric Hammer Corp. v. Deddens*, 206 Ky. 232, 267 S.W. 207 (1924).

<sup>36</sup> See, e.g., *Zeh v. Alameda Community Hotel Corp.*, 122 Cal. App. 366, 10 P.2d 190 (1932).

<sup>37</sup> *Ray County Sav. Bank v. Hutton*, 224 Mo. 42, 64, 123 S.W. 47, 54 (1909).

<sup>38</sup> See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

<sup>39</sup> 15 U.S.C. § 78j(b) (1970) as implemented in Rule 10b-5, 17 C.F.R. 240.10b-5 (1973), which provides:

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

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, 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.

Liability might also arise under other provisions of the securities laws, notably §§ 12(2) and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77l, 77q, but these sections are more limited in scope.

corporate statements that are untrue or misleading,<sup>40</sup> and section 11 of the Securities Act of 1933,<sup>41</sup> which provides a civil remedy for investors who purchase a new issue when the false or misleading statement is contained in the registration statement. Thus, the problem is: how can forecasts of future corporate performance be evaluated under these provisions?

At least one commentator has expressed the view that since forecasts are "opinions" rather than "facts," they should not be included in the SEC's disclosure system since they could not result in liability and would therefore be capable of abuse.<sup>42</sup> However, it is submitted that they can be judged to be "true" or "false" as other kinds of statements are judged. When considering the question whether a forecast is "true" or "false" it seems clear that whether the forecast is realized or not does not determine the answer. For example a well-prepared forecast that is not achieved because of a completely unforeseeable disaster should not thereby become "false." The forecast should be judged as of the moment it is made, with future events important only as evidence of what the situation was at that moment.

It is submitted that the key to a determination of the truth or falsity of an earnings forecast, is recognizing that the "truth content" of a forecast is not that it will come true, but: (1) that the forecast is made in good faith—sincerely believed by those who make it; and (2) that it was made after a careful examination of the facts and in the exercise of prudent judgment—that it was made with due diligence.<sup>43</sup> This is the "fact" that is represented by a forecast—publication in good faith and preparation with due diligence. It therefore follows that whether a prediction comes true does not *ipso facto* determine whether it was "true" or "false." The outcome is merely evidence bearing on the questions whether the forecast was made in good faith and prepared with due diligence. It also follows that a "false" forecast can come true—in that case a wrong has been done, but no harm has resulted.

Thus, under the two most important civil-liability sections of the securities laws, forecasts can be handled as follows. Section 11 of the Securities Act of 1933<sup>44</sup> creates a civil action for damages for investors injured by a registration statement or prospectus that "contained an untrue statement of a material fact or omitted to state

<sup>40</sup> See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1971).

<sup>41</sup> 15 U.S.C. § 77k (1970). The section creates a civil action for damages for buyers of an issue of securities who are injured because the registration statement attending the issue "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." *Id.*

<sup>42</sup> Heller, *supra* note 12, at 307 n.18.

<sup>43</sup> Bromberg, *supra* note 17, suggests that in order to avoid liability, a forecast should have some combination of three factors: "(1) factual or historical basis, (2) investigation, (3) sensible method of computation or formation." Bromberg, *supra* note 17, § 5.3 at 97.

<sup>44</sup> 15 U.S.C. § 77k (1970).

a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."<sup>45</sup> Because of the importance of future earnings to the investment decision, it is likely that all such forecasts would be found to be "material." Under the above test of the truth of forecasts, liability of an issuer<sup>46</sup> would result either when the forecast was made in bad faith, or when it was not prepared with due diligence. That is, liability would result whenever the forecast was "false."

Rule 10b-5 creates an action for damages for false or misleading statements made in connection with the purchase or sale of any security.<sup>47</sup> Under the rule, liability would depend on the approach the court took to the question of *scienter*. The circuits are split on the question, with some courts imposing liability for a misstatement caused by mere negligence, and others requiring a showing of some sort of culpable state of mind—*scienter*.<sup>48</sup> In the former liability for "false" projections would result in all cases of falsity, whether caused by bad faith or lack of due diligence. In the latter circuits, however, liability would only result when the false forecast resulted from bad faith.

Of course, liability under the language of both Rule 10b-5 and section 11 can result from statements that are "true" but "misleading" because of the omission of *other* material facts. In this regard projections that are "true" are no different from other "factual" statements—they can become "misleading" when material facts are unrevealed, so as to cause the statements made to become "misleading."

### III. JUDICIAL TREATMENT OF FORECASTS UNDER THE FEDERAL SECURITIES LAWS

The few courts that have considered erroneous forecasts under the federal securities laws have not articulated a definitive test to determine when liability will result. There are few reported decisions, and even fewer that are final decisions on the merits. *Sprayregen v. Livingston Oil Co.*<sup>49</sup> involved a speech by two directors at a meeting of the New York Society of Securities Analysts. In the speech the directors estimated the income and cash flow for that fiscal year, but underestimated depreciation and depletion. Thus,

<sup>45</sup> Id.

<sup>46</sup> The issuer has no defense, except the argument that the misstatement did not cause any injury. Other persons connected with the preparation of the registration statement have available the "due diligence" defense, under which they can avoid liability if they can show they did their jobs properly. 15 U.S.C. § 77k (1970).

<sup>47</sup> See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1971).

<sup>48</sup> The conflict among the federal circuit courts over the question of "scienter" in relation to Rule 10b-5 is reviewed in the recent case of *White v. Abrams*, 495 F.2d 724, 728-36 (9th Cir. 1974). See also Comment, *Lanza v. Drexel & Co. and Rule 10b-5: Approaching the Scienter Controversy in Private Actions*, 15 B.C. Ind. & Com. L. Rev. 526 (1974).

<sup>49</sup> 295 F. Supp. 1376 (S.D.N.Y. 1968).

when the correct earnings figures were published in the nine-month report, the price of the stock dropped. Plaintiff stockholders sued the company and the public relations firm that had distributed copies of the speech, alleging a violation of Rule 10b-5. The district court denied defendants' motion to dismiss, noting that the complaint alleged that the misstatements had been made "knowingly and intentionally with intent to defraud."<sup>50</sup>

*Blakely v. Lisac*<sup>51</sup> involved an action under Rule 10b-5 for alleged misrepresentations in a prospectus and other statements. Under the heading of "The Offering and Proceeds" in its prospectus, the company had included planned expenditures for new equipment and inventory. The actual expenditures exceeded the prospectus estimates by nearly 40 percent. The defendants argued that there was a reasonable basis for the prospectus figures, and, although the additional expenditures might give rise to an action for a breach of a fiduciary duty, no action under Rule 10b-5 arose. The district court judge found the defendants liable for damages, and said:

I reject [defendants'] narrow reading of the rule, and, in addition, I find that the amounts listed were made without an adequate basis and created the false impression that with the \$288,000 secured from the public offering, the company could establish a properly financed nitrogen freezing business. I believe that 10b-5 is applicable when, either through undue optimism or negligence, the proposed spending is underestimated by almost 40 percent in an offering prospectus.<sup>52</sup>

Although the court's opinion failed to discuss what would have been an adequate basis for the estimates, it appears that liability was imposed because of negligence in the preparation of the forecasts, with the amount of the shortfall the primary evidence of such negligence.

The leading case on the evaluation of forecasts under Rule 10b-5 is *Dolgow v. Anderson*,<sup>53</sup> in which an action was brought by stockholders of the Monsanto Company against the company's principal officers and directors. The plaintiffs alleged that the defendants had manipulated the stock price to their own advantage by misleading the investing public. The basis for the allegation was that certain company officers had sold Monsanto stock while publicly making bullish predictions about the company's future. The suit was brought under several provisions of the federal securities laws, including Rule 10b-5.<sup>54</sup> After extensive pre-trial discovery, the

<sup>50</sup> Id. at 1377.

<sup>51</sup> [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,788, at 93,415 (D. Ore. 1972).

<sup>52</sup> Id. at 93417.

<sup>53</sup> 53 F.R.D. 664 (E.D.N.Y. 1971).

<sup>54</sup> Plaintiffs alleged violations of §§ 5, 12, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77e (selling securities without an effective registration statement), 77l (selling securities by

federal district court held that there was no substantial possibility that plaintiffs would succeed on the merits; having denied plaintiffs the opportunity to proceed in a class action, the court granted defendants' motion for summary judgment.<sup>55</sup> The court found that there was no credible evidence that the defendants had been pessimistic about the company's prospects during the period in question, even though some of them had sold Monsanto shares.<sup>56</sup> Dealing with the question of whether the public forecasts made by Monsanto and some of its officers had been false or misleading, the court noted that "to a substantial extent these projections were fulfilled."<sup>57</sup> As for the projections that were not achieved, the court said:

Monsanto's reporting to its stockholders, to the public and to the financial community was a fair and accurate reflection of the facts and the best estimates available to the Monsanto management. Moreover, Monsanto timely reported events which materially affected Monsanto's estimates and prospects and indicated the changes in Monsanto's estimates and prospects that could be expected.<sup>58</sup>

The court concluded that the public statements "were not false or misleading and were not devices to inflate or manipulate, and did not inflate or manipulate the market price of Monsanto stock."<sup>59</sup> The court in *Dolgow* clearly applied a negligence standard, based on the "reasonable businessman," and seemingly was very tolerant of missed forecasts caused by external events that were unforeseeable.

This sketchy case law suggests that businessmen need not greatly fear any increased liability under Rule 10b-5 for their forecasts, since even those courts that apply the broadest version of the Rule will evaluate the unfulfilled forecast upon its reasonableness at the time made. However, the recent case of *Beecher v. Able*,<sup>60</sup> which resulted in a finding of liability under section 11 for an erroneous forecast made by a large and sophisticated company, may

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means of a misleading or false prospectus) and 77q (using a scheme to defraud in the sale of securities), as well as §§ 9, 10(b), 16, 18 and 29 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i (manipulating securities prices), 78j (using manipulative and deceptive devices in connection with the purchase or sale of securities), 78p (directors and officers must file monthly report indicating any change in their holdings in their own companies), 78r (liability for misleading statements), and 78cc (invalidity of any contract made in violation of any provision in this chapter), and of Rules 10b-5, 17 C.F.R. § 240.10b-5 (1973) (manipulative and deceptive devices in the purchase and or sale of securities) and 16a-1, 17 C.F.R. § 240.16a-1 (1973) (filing of statements by officers, directors and principal shareholders), and of unspecified sections of the Rules of the New York Stock Exchange.

<sup>55</sup> 53 F.R.D. at 691.

<sup>56</sup> *Id.* at 670.

<sup>57</sup> *Id.* at 677.

<sup>58</sup> *Id.* at 679.

<sup>59</sup> *Id.*

<sup>60</sup> 374 F. Supp. 341 (S.D.N.Y. 1974).

suggest otherwise. The opinion is also significant because the court sets up guidelines for companies that issue forecasts.<sup>61</sup>

*Beecher* arose under section 11 of the 1933 Act,<sup>62</sup> which provides that a company is liable to persons who buy a new issue of securities and lose money on it because of a "false" or "misleading" statement contained in the registration statement. The company's liability is absolute whether the offending statement resulted from design or inadvertence.<sup>63</sup>

The suit in *Beecher* resulted from the 1966 sale of a \$75 million issue of convertible subordinated debentures by Douglas Aircraft Company. By the end of that fiscal year, Douglas had suffered severe financial setbacks that considerably reduced the value of the debentures. A class-action suit was filed on behalf of the purchasers, alleging that Douglas had made false and misleading statements in the registration statement filed with the Securities Exchange Commission in connection with the issue. Plaintiffs argued that three items in the registration statement were false or misleading: (1) a statement concerning the use to which the proceeds would be put; (2) the inclusion of an after-tax loss rather than the corresponding pre-tax figure; and (3) a forecast that "it is very likely that net income, if any, for fiscal 1966 will be nominal."<sup>64</sup> Plaintiffs argued that the third statement was false and misleading because the company proceeded to lose \$52 million by the end of the fiscal year. After a trial limited to the issue of whether the registration statement contained false or misleading statements,<sup>65</sup> U.S. District Judge Constance Baker Motley held that each of the three statements challenged was false and misleading.<sup>66</sup>

In 1966, Douglas Aircraft Company was a large aerospace concern manufacturing military and civilian aircraft and participating in the government's space program.<sup>67</sup> Douglas had an elaborate

<sup>61</sup> See text at note 67 infra.

<sup>62</sup> 15 U.S.C. § 77k (1970).

<sup>63</sup> Id.

<sup>64</sup> 374 F. Supp. at 345.

<sup>65</sup> The district court directed that the trial would be bifurcated. The first part was limited to the question of whether there was liability stemming from the prospectus, and the second was to be directed to the question of damages. 374 F. Supp. at 344.

<sup>66</sup> Id. at 346. The court found that although Douglas said in its registration statement that "a portion" of the net proceeds from the debenture issue would be used to pay off short-term bank borrowings and that "the balance" would be used to finance the build-up of inventories, in fact Douglas intended to use, and did use, "substantially all" of the proceeds to eliminate current liabilities. Id. at 355. The court also found Douglas liable for failing to include in its prospectus a pre-tax loss of \$7,517,000 for the second quarter of 1966. Id. at 357. The company did include a statement that there had been a *net* loss of \$3,463,000 but the court found that "it would have been difficult for the ordinary investor to figure out the size of the pre-tax loss," and the omitted fact was material, since "a reasonable bond investor would have considered the fact important in the making of his decision whether to invest." Id. The court reasoned that the post-tax loss takes advantage of prior tax events which have given the corporation a tax credit, so that "pre-tax loss more accurately reflects the *current* financial health of the corporation." Id.

<sup>67</sup> This statement of facts was culled from the *Beecher* opinion; from the opinion in *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973) (a

internal system to prepare income projections, and in the years 1961 to 1965, the company's forecasts had been reasonably accurate. However, problems arose in the spring of 1966. Conditions in the aerospace industry had become increasingly unsettled because the Vietnam war had produced acute shortages of manpower and essential parts. In addition, some suppliers were failing to meet their commitments to Douglas. On June 1 Douglas' directors approved the issuance of a new issue of debentures. A registration statement and preliminary prospectus was prepared and filed by June 7. In mid June, Douglas' management received the alarming news that the Aircraft Division of the company had lost several million dollars during the month of May. A team of 50 to 70 engineering, estimating and accounting specialists was assigned to investigate the Aircraft Division, and it was determined that inventory writedowns and other factors would reduce the expected six-month earnings figures. A press release was issued on June 24 describing the situation, and the registration statement and prospectus were amended. The amendment described some of the difficulties and concluded with the fateful statement: "Therefore, it is very likely that net income, if any, for fiscal 1966 will be nominal." By the end of the fiscal year Douglas had sustained a net loss of \$52 million, resulting largely from a \$77 million pre-tax loss sustained by the Aircraft Division.

The district court held that the statement quoted above amounted to a prediction that the company would break even.<sup>68</sup> The court, noting that forecasting is an "art" and "largely a matter of judgment,"<sup>69</sup> concluded that predictions are not actionable merely because things do not turn out as expected.<sup>70</sup> However, reasoning that investors are likely to attach great importance to forecasts made by management, the court said: "Therefore, in view of the policy of the federal securities laws of promoting full and fair disclosure, a *high standard of care* must be imposed on those who, although not required to do so, nevertheless make projections."<sup>71</sup>

The court then set out these requirements for earnings projections:

[A]n earnings forecast must be based on facts from which a reasonably prudent investor would conclude that it was highly probable that the forecast would be realized. Moreover, any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying

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related case stemming from the same set of facts) and from Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC, Securities Exchange Act Release No. 8459 (1968), reprinted in [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629, at 83347.

<sup>68</sup> 374 F. Supp. at 347.

<sup>69</sup> Id. at 348.

<sup>70</sup> Id.

<sup>71</sup> Id. (emphasis added).

assumptions, might be deterred from crediting the forecast. Disclosure of such underlying assumptions is "... necessary to make ... [the forecast] ... not misleading ... ." 15 U.S.C. § 77k(a).

Factors bearing on the reasonableness of a forecast would include the corporation's record of success in forecasting earnings, the care exercised in the preparation and review of cost and sales estimates, doubts expressed by persons engaged in the process of review, the reasonableness of the underlying assumptions, and any facts not known to management which were accessible in the exercise of reasonable care.<sup>72</sup>

After announcing these standards for the evaluation of forecasts, the court concluded that the statement concerning future income was "false" because "it was not highly probable that the company would break even" and the statement was "misleading" in that "it omitted to state facts necessary to make that prediction not misleading."<sup>73</sup>

Essentially, the court held Douglas liable because it found that a reasonably prudent bond purchaser would not have concluded, from the facts available to Douglas management at the time the prospectus was issued, that it was *highly probable* that the forecast would be realized, and that substantial losses would be avoided, even though the court also found that Douglas' management had some basis for concluding that it would not have substantial losses for fiscal 1966.<sup>74</sup> The facts that the court found material were these: all previous forecasts for fiscal 1966 had failed; a substantial and unforeseen loss had occurred in the second quarter; and these unpleasant surprises were the result of management's inability to predict the level of efficiency attained by its aircraft manufacturing division.<sup>75</sup> These occurrences "should have put management on notice that forecasts were risky, and that, unless the conditions which produced the second quarter results ... were actually corrected, results during the remainder of 1966 might be equally disappointing."<sup>76</sup>

The court also found that the company unreasonably expected that its cost estimates for its Canadian subsidiary would not be greater than originally anticipated, in light of the fact that the cost estimates of the subsidiary were at variance with those of the Aircraft Division.<sup>77</sup> Additionally, the court noted that in predicting a break-even situation in 1966, the company forecasters relied upon a substantial and sustained improvement in the performance of the Aircraft Division:

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<sup>72</sup> Id. (citations omitted).

<sup>73</sup> Id. at 346.

<sup>74</sup> Id. at 348-50.

<sup>75</sup> Id.

<sup>76</sup> Id. at 350.

<sup>77</sup> Id. at 351.

While the court has found that defendant might reasonably have given some weight to the steps it had taken to correct its problems, the prospects of making improvements sufficient to avoid substantial losses were far too uncertain to warrant a forecast which included the suggestion that Douglas would have no substantial losses in fiscal 1966.<sup>78</sup>

Supporting its conclusion, the court cited statements made by Douglas officers during the period indicating their uncertainty as to whether the forecasts could be achieved and containing their admissions that the forecasts contained some degree of optimism.<sup>79</sup> In light of these facts, the court held that the forecast was "false."<sup>80</sup>

Finally, the court concluded that, in order to keep the forecast from being misleading, the company should have disclosed that prior forecasts for fiscal 1966 had failed, and in addition, that the prediction was based upon the assumption that conditions in the Aircraft Division required improvement if the company reasonably could expect to avoid substantial losses.<sup>81</sup>

Since it appears that the court in *Beecher* imposed a standard higher than that of due care on the grounds that the prediction was gratuitous<sup>82</sup> the decision seems questionable. Douglas included the statement as a warning specifically aimed at avoiding liability, rather than as a rosy prediction of the future. Additionally, the policy of the securities law of encouraging public dissemination of important corporate information would seem to militate against imposing an extremely high standard on projections. Under the analysis advanced in this article, Douglas' prediction would have been found to be "false," if, as the court suggests, a reasonable man would not have made such a forecast in that situation.<sup>83</sup>

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<sup>78</sup> Id. at 352.

<sup>79</sup> Id. at 353. In a July 8 report to the board of directors, Douglas president Donald W. Douglas, Jr. noted that there was "a fair possibility of an even greater loss." Id. In late June a vice president had reported "it should be kept in mind that . . . estimates contain a degree of optimism in that they assume a recovery from present levels of the cost." Id. A report prepared late in July by an operations official stated that the Aircraft Division's second-quarter predictions were "ambitious in the face of the actual trends occurring at the time of the forecasts for both assembly cost and schedule" and added that accomplishing the forecasts would be "a difficult task." Id.

<sup>80</sup> Id. at 354.

<sup>81</sup> Id.

<sup>82</sup> See text at note 71 supra.

<sup>83</sup> There is some evidence to suggest that the court would have found liability under an ordinary negligence standard. A Fortune magazine article written at the time of the Douglas debacle reported: "Douglas' executives confessed that there had been a serious breakdown in corporate communication and controls. . . . The executives admitted that they had not seen so much trouble coming. Like the public at large, they were caught completely unprepared for it." Douglas Aircraft's Stormy Flightpath, Fortune, Dec. 1966, at 166-67. Business Week reached a similar conclusion: "The lack of adequate information and control systems showed itself with appalling clarity this spring when Douglas hastily had to amend a prospectus issued for the sale of \$75-million in convertible debentures. The first version had made no mention of a second-quarter loss." Why Douglas is in a Downdraft, Bus. Week, Oct. 23, 1966, at 176.

If the standard of high *probability of realization*, rather than *reasonableness*, is applied to all forecasts, it is doubtful that many will be made.<sup>84</sup> Furthermore, if forecasts were required to be made public, such a standard would result in forecasts too conservative to be much help to investors. The *Beecher* decision should be limited to its special facts, that is, to cases where a projection is made in a registration statement or prospectus.

It is submitted that the *Beecher* court's requirement that questionable assumptions should be included may not be realistic. There is at least some question whether a statement such as "This forecast is based on our expectation that the efficiency problems in the Aircraft Division have been turned around and steady improvement will occur," would have made the forecast in the Douglas case less "misleading." It can be seen that this assumption is in turn based on others, that the chain could go still farther back, and that, in the end, an element of "art" remains. If a forecast is based on dubious assumptions it should not be made; if it is based on reasonable ones, then there is no need to include them. Disclosure of any *facts* whose absence makes the statement as a whole misleading is always required.<sup>85</sup> Perhaps the best interpretation of the *Beecher* decision is that omission of certain material facts—the failure of prior earnings forecasts, the unsuspected loss in the second quarter, and the inability to predict the efficiency of the aircraft division—rendered the registration statement misleading, and that these would have been held to be material omissions regardless of whether a "forecast" had been included in the prospectus.

#### IV. CONCLUSION

The best method of evaluating forecasts under the securities laws is to consider them "false" when they are not believed by the forecaster; or when they are honestly promulgated but negligently prepared. Requiring that underlying assumptions be stated does not seem to be of much value to make a misleading forecast any less misleading. If underlying *facts* cast enough doubt on the prediction to make it unreasonable, then it is "false" and should not be made.

As for the question whether forecasts should be permitted or required in SEC filings, the answer depends on the answers not only to philosophical questions concerning the purpose of disclosure, such as: to whom should disclosure be addressed; but also to practical questions as well, such as: where do the "average investors" get their information?

In the event that predictions do become a more common aspect

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<sup>84</sup> "[A]ny SEC rules involving forecasts should assure forecasters that liability will not attach to non-negligent errors in judgment or mistakes in evaluating material assembled for the forecast. A standard stricter than this would make forecasts unthinkablely perilous." Gillis, *Legal Aspects of Corporate Forecasts*, *Fin. Analysts J.*, Jan.-Feb. 1973, at 72, 76.

<sup>85</sup> 15 U.S.C. §§ 77k, 78j(b) (1970).

of disclosure, it seems clear that under a negligence standard, the fear of liability should not be too great. Businessmen operate under a negligence standard in other areas of disclosure, with the circuit courts differing on whether a merely negligent statement will support an action for damages under Rule 10b-5.<sup>86</sup> Its application to forecasts should give no cause for alarm, as long as it is recognized that even the best forecasts sometimes do not come true.

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<sup>86</sup> See note 48 *supra*.