Item 303’s Role in Private Causes of Action under the Federal Securities Laws

Brian Neach
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INTRODUCTION

Stated simply, a "forward-looking statement" in the context of securities law represents a statement "describ[ing] events or activities that will occur, if at all, at some future date." Although the federal securities statutes contain a specific definition of "forward-looking statement," the term refers generally to a company's predictions, pro-

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1 JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 71 (2d ed. 1997).

2 15 U.S.C. § 77z-2(i)(A)–(D) (Supp. IV 1998); see also id. § 78u-5(i)(1)(A)–(D). According to these statutes, the term "forward-looking statement" includes the following:

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

(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

(C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;

(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C); . . .
jections, forecasts, and opinions regarding its sales, earnings, losses, and any other aspect of its business.\(^3\) Because these statements are "inherently uncertain,"\(^4\) companies making such statements in the absence of any statutory protection could potentially find themselves liable for inaccurate predictions.

Recognizing a need for a balance between the investment community's desire for access to a company's forecasts and the potential for liability stemming from such statements, Congress enacted "safe-harbor" provisions for forward-looking statements in the Private Securities Litigation Reform Act of 1995.\(^5\) These safe-harbor provisions have produced two important effects: (1) reporting companies\(^6\) have enjoyed a reduced threat of liability related to forward-looking statements, thus increasing the quantity of disclosure of such information;\(^7\)

Id. §§ 77z-2(i) (A)-(D), 78u-5(i) (A)-(D). As discussed infra, the SEC further classifies forward-looking statements into two categories: (1) statements regarding future effects of currently known data that—given other requirements are met—must be disclosed; and (2) statements based upon anticipated future events that are only optional disclosures. See 17 C.F.R. § 229.308(a) instr. 7 (2000); infra notes 58–60 and accompanying text. Throughout this Note the term "forward-looking" refers generally to either of the two categories of statements. In discussions where the distinction matters, the first category will be referred to as "required" or "mandatory" disclosures, and the second category will be referred to as "optional" disclosures. Additionally, because this Note focuses on disclosures made in a company's SEC filings, unless otherwise indicated the term "forward-looking statement" refers only to statements made in such filings.


4 Cox et al., supra note 1, at 71.


6 "Reporting companies" consist generally of the following classifications of companies: (1) companies with a class of securities listed on a national securities exchange, 15 U.S.C. § 78(a) (1994), (2) companies with assets greater than $10 million that have a class of equity securities held by at least 500 persons, id. § 78(b); 17 C.F.R. § 240.12g-1 (2000), and (3) companies that have filed a registration statement under the Securities Act of 1933 that has become effective, 15 U.S.C. § 78o(d) (1994 & Supp. IV 1998).

and (2) plaintiffs' attorneys\(^8\) have had to pursue creative alternatives in order to establish a company's liability for misstatements and omissions regarding forward-looking statements.\(^9\) For the plaintiff's attorney seeking recovery in a securities cause of action, the first effect has provided a deluge of forward-looking statements that could potentially result in extensive liability to the company; however, the availability of safe-harbor provisions for these statements has turned the deluge into a trickle in terms of what could actually result in liability to the company.

Although attorneys still aggressively pursue causes of action related to forward-looking statements,\(^10\) most commentators agree that the statutory safe-harbor protection will reduce instances of liability in these cases.\(^11\) The fact that forward-looking statements receive such a high degree of protection must be particularly frustrating for an attorney pursuing a securities cause of action because such statements can easily prove wrong, or at least not completely correct, thus potentially indicating a misstatement or omission. But the protection of forward-looking statements is not an entirely new problem for plaintiffs' attorneys—courts developed a "bespeaks caution" doctrine before any statutory protection developed,\(^12\) and the Securities and Exchange Commission (SEC) promulgated a safe harbor for forward-looking statements under Rule 175.\(^13\) Needless to say, plaintiffs' attorneys had already developed several alternative theories to get around these safe harbors.

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8 As this Note is limited to a discussion of securities laws, any reference to “plaintiffs' attorneys” will mean an attorney who represents a private plaintiff in a federal securities cause of action.


One of these alternatives, and the one upon which this Note focuses, is an allegation of a violation of "Item 303." Item 303 requires a company that files certain documents with the SEC to discuss, in its "Management’s Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) section, known trends and uncertainties that affect the company’s liquidity, capital resources, and results of operations. Although at first blush the regulation seems to require disclosure of all forward-looking information, the use of the word "known" operates purportedly as a distinction between disclosures grounded in current knowledge and purely predictive disclosures. This distinction is hazy, however, because even with mandatory disclosures reporting companies must describe the known trend or uncertainty’s effects on future operations.

This hazy distinction serves as the bullet in the attorney’s revolver that allows for a retrospective look at a company’s disclosures in MD&A that might reveal a misstatement or an omission of a required disclosure with no safe-harbor protection. Although mandatory forward-looking statements—that is, predictions of future effects of currently known trends or uncertainties—made in MD&A constitute protected statements under the statutory safe harbor, if management fails to make any statement in MD&A regarding a particular un-

14 Id. § 229.303. The term “Item 303” refers to the regulation’s placement within Regulation S-K, id. §§ 229.10-.915, which dictates the type and extent of information that companies must include in various filings with the SEC.

15 Id. § 229.303.

16 See id. § 229.303(a) inst. 7; infra notes 59–60 and accompanying text.


18 See 15 U.S.C. §§ 77z-2(i) (1) (C), 78u-5(i) (1) (C) (Supp. IV 1998). These sections define a forward-looking statement as any statement of “future economic performance,” including statements in a “discussion and analysis of financial condition” included pursuant to rules and regulations of the SEC. Before the statutory safe harbor was enacted, the SEC stated that mandatory Item 303 disclosures received protection as forward-looking statements under Rules 175 and 3b-6. See Management’s Discussion and Analysis, Securities Act Release No. 6835, 54 Fed. Reg. 22,427, 22,429 & n.22 (May 18, 1989). The same “future economic performance” language used in the enacted statutes appears in those rules. See 17 C.F.R. §§ 230.175(c)(3), 240.3b-6(c)(3) (2000). Thus, a reasonable conclusion is that, at least as far as the SEC is concerned, mandatory Item 303 disclosures of forward-looking information will receive protection under the statutory safe harbor.
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certainty or trend the safe harbor would not apply to the statement.\textsuperscript{19} Put another way, the statutory safe harbor does not protect statements that were never made.\textsuperscript{20} Thus, a plaintiff's attorney could scan prior SEC filings and, to the extent that the attorney can tie the trend, uncertainty, or event to a subsequent change in stock price, the defending company would not have the ability to use the statutory safe harbor. The potency of the bullet is intensified by the fact that courts have held consistently that violations of mandatory disclosures within Item 303 establish the "duty to disclose" element of a securities cause of action.\textsuperscript{21}

Despite its potential as a liability-imposing device, courts that have entertained allegations of Item 303 violations have returned somewhat mixed results. While some courts have focused attention on whether an Item 303 violation can give rise to an independent cause of action,\textsuperscript{22} at least one court held that allegations of Item 303 violations support a claim under sections 11\textsuperscript{23} and 12(a)(2)\textsuperscript{24} of the Securities Act of 1933.\textsuperscript{25} Most courts, however, have merely taken the middle road and held that allegations of Item 303 violations in combination with other factors could support a securities liability claim.\textsuperscript{26}

The mixed results from the courts in securities cases involving Item 303 violation allegations are not surprising. The confusion stems

\textsuperscript{19} In general, safe-harbor protection applies when management identifies the statement as forward-looking and provides "meaningful cautionary statements." \textit{See} 15 U.S.C. §§ 77z-2(c)(1), 78u-5(c)(1) (Supp. IV 1998).

\textsuperscript{20} \textit{See} Coffee, supra note 9, at 993-95 (discussing the possibility of potential liability for an omission in MD&A).

\textsuperscript{21} \textit{See}, e.g., Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296-97 (9th Cir. 1998); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1222 & n.37 (1st Cir. 1996).

\textsuperscript{22} \textit{See} \textit{In re} Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 n.7 (3d Cir. 1997) ("It is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs."); \textit{In re} Wells Fargo Sec. Litig., 12 F.3d 922, 930 n.6 (9th Cir. 1993) (stating that plaintiffs acknowledge "that Regulation S-K does not provide an independent cause of action").


\textsuperscript{24} Id. § 77l(a)(2).

\textsuperscript{25} \textit{Steckman}, 143 F.3d at 1296.

\textsuperscript{26} \textit{See} Shaw, 82 F.3d at 1222 & n.37 (holding that a violation of a SEC reporting requirement, if material, is actionable in a Rule 10b-5 cause of action); Wallace v. Sys. & Computer Tech. Corp., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,212, at 95,079 (E.D. Pa. Apr. 19, 1996) (Mem.) (noting that although an Item 303 violation does not inevitably lead to liability under Rule 10b-5, the information was not so unimportant as to allow the court to deem it immaterial as a matter of law); Simon v. Am. Power Conversion Corp., 945 F. Supp. 416, 431 & n.20 (D.R.I. 1996) (relying on the "uncontroversial proposition" that an affirmative duty to disclose material information, whatever the source of the duty, is actionable under the securities laws).
mainly from the unclear disclosure standard the SEC developed for Item 303, as well as from the varying statutory and court-developed standards of liability that control in private causes of action under the securities laws. This Note addresses much of the uncertainty surrounding allegations of Item 303 violations in private causes of action under the securities laws. Furthermore, this Note will attempt to develop a workable standard of review that courts can use when presented with such allegations.

Part I of this Note provides a brief introduction to the various filing requirements imposed upon companies under the statutes and rules of the federal securities laws, including an explanation of Item 303's role in these filings. Part I also discusses Item 303's specific requirements regarding disclosure of known trends and uncertainties. Part II compares Item 303's disclosure standards to materiality standards developed under other aspects of the federal securities laws. This discussion highlights the difference between materiality, based largely upon Supreme Court decisions, and Item 303's disclosure standard. The analysis in Part II will show that Item 303's disclosure standard is highly fact-specific and is such that a court cannot simply conclude that a violation of the standard should or should not result automatically in liability in a private cause of action. Part III consists of background on the various provisions of the federal securities laws that provide relief to investors in private causes of action, and it explains how Item 303 fits within the liability scheme. Part IV attempts to develop a framework, based in part upon principles drawn from Professor Melvin Eisenberg's article regarding standards of conduct and standards of review in corporate law, that will allow courts to decide cases involving allegations of Item 303 violations.

I. Item 303's Role Under Filing Requirements of the Federal Securities Laws

A. Where Must Companies Make Item 303 Disclosures?

Companies must file reports with the SEC, and in some instances must send certain documents to shareholders, in a number of situations. Under authority of sections 13(a) and 15(d) of the Securities Exchange Act of 1934 is codified at id. §§ 78a–78mm (1994 & Supp. IV 1998).

27 See discussion infra Part II.
28 See discussion infra Part III.A–D.
31 Id. § 78o(d) (1994).
ties Exchange Act of 1934 (Exchange Act), the SEC promulgated rules requiring companies to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and periodic reports on Form 8-K to disclose relevant financial matters. In the context of public offerings, sections 7 and 19(a) of the Securities Act of 1933 (Securities Act) provide the SEC with similar authority to promulgate rules and regulations related to the filing of registration statements. Finally, Rule 14a-3, promulgated under section 14(a) of the Exchange Act, requires companies to send shareholders an annual report prior to any proxy solicitation that relates to an annual shareholders' meeting.

In 1980, the SEC integrated the filing requirements under the Securities Act and the Exchange Act by placing disclosure requirements for both Acts in Regulation S-K. Generally, under the SEC's integrated disclosure system, all SEC filings that include financial information also must include information required by Regulation S-K; specifically, these filings must include Item 303 of Regulation S-K. Additionally, under Rule 14a-3(b), the annual report must include the MD&A section required by Item 303. Item 303 of Regulation S-K contains the disclosure requirements for MD&A. Thus, disclosures, or lack thereof, within Item 303 can affect a company's liability in relation to periodic filings, proxy statements, as well as registration statements made in the context of public offerings.

32 See 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13 (2000). The companies subject to the periodic filing requirements of section 13 are the same three classifications of companies named in supra note 6.
34 See id. §§ 77g, 77s. The Securities Act of 1933 is codified at id. §§ 77a to 77z-3 (1994 & Supp. IV 1998).
35 See 17 C.F.R. § 240.14a-3 (2000). Section 14 of the Exchange Act only applies to companies registered under sections 12(b) and 12(g) of the Exchange Act. See id. § 240.14a-2. Thus companies required to file periodic reports under section 15(d) of the Exchange Act are not subject to the proxy rules. Section 15(d) companies are those whose stock is traded “over-the-counter” and have fewer than 500 shareholders and/or less than $10 million in assets. See 15 U.S.C. § 78j(g) (1994); 17 C.F.R. § 240.12g-1 (2000).
39 Id. § 229.303.
B. What Must Companies Disclose Pursuant to Item 303?

Item 303's disclosure requirements focus on three particular subjects: (1) liquidity; (2) capital resources; and (3) results of operations. For each subject, the company's management must identify "known trends" that are "reasonably likely" to have a material effect. In an effort to avoid bright-line materiality and disclosure standards that companies could potentially manipulate through various means (for example, off balance sheet financing), the SEC intentionally wrote Item 303 with flexible and general requirements. Given these general requirements, it is not surprising that reporting companies have had a difficult time determining just what information to disclose.

Perhaps the first question in analyzing whether Item 303 requires disclosure of a particular piece of information is: What exactly is a known "trend" or "uncertainty"? The SEC provides some concrete examples in an administrative release, but some might ponder their applicability to the real world: reduction in product prices; erosion in market share; changes in insurance coverage; environmental liabilities; or the likely non-renewal of a material contract. A more enlightening viewpoint of what the SEC considers a trend or uncertainty...

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40 Id. § 229.303(a) (1)-(3). Specifically, the regulation requires the following:

1. Liquidity. Identify any known trends or any known ... events or uncertainties that will result in or that are reasonably likely to result in ... liquidity increasing or decreasing in any material way.

2. Capital Resources. ... Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost.

3. Results of operations. ... Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

Id. Practically all of the case law related to Item 303 issues deals with disclosures related to results of operations; therefore, this Note will typically refer to that aspect of Item 303, but the same analysis applies to liquidity and capital resource disclosures.

41 Id. § 229.303(a) (1), (a) (2) (ii), (a) (3) (ii). The SEC intended management to use MD&A to provide investors with an "enhanced understanding" of financial information. Id. § 229.303(a) instr. 1.


43 According to the 1989 Release, the SEC reviewed the filings of 218 companies and issued 206 letters of comment regarding deficiencies in Item 303 disclosure. See id., 54 Fed. Reg. at 22,428.

can be derived by reviewing a few of the administrative proceedings the SEC has pursued against alleged Item 303 violators. Some examples include failing to disclose forward-looking information regarding exposure and risks associated with loan repurchase transactions,\textsuperscript{42} failure to discuss inventory obsolescence,\textsuperscript{46} and a failure to disclose the reliance of the development of a microprocessor upon copyrighted technology.\textsuperscript{47}

Perhaps the most infamous trend occurred in a SEC administrative proceeding against Caterpillar.\textsuperscript{48} Ridiculously high inflation in Brazil and a favorable exchange rate greatly benefited Caterpillar's Brazil operations during 1989.\textsuperscript{49} When a new administration took over the Brazilian government, Caterpillar's internal management discussed the potential effects of the new Brazilian administration's policies on 1990 income results with the board of directors, but Caterpillar's filings with the SEC contained no disclosures regarding the Brazil operations.\textsuperscript{50} When Caterpillar's Brazilian earnings dropped substantially, the SEC brought an enforcement action. Although no accounting provisions (under either the SEC or Financial Accounting Standards Board principles) required Caterpillar to report its Brazil operations on a segmented basis,\textsuperscript{51} the SEC claimed that the possibility that the past trend of higher earnings in Brazil would cease should have been disclosed in MD&A.\textsuperscript{52} Due to management's and the board's knowledge of the trend, the SEC found that the failure to disclose resulted in a deficient Item 303 disclosure thus leading to a violation of the reporting requirements of section 13(a) of the Exchange Act.\textsuperscript{53}

The purported known trends and uncertainties that appear in private causes of action tend not to take on the crystal-clear form found in \textit{In re Caterpillar, Inc.} In fact, courts analyzing these issues

\textsuperscript{45} See \textit{In re Am. Sav. & Loan Ass'n}, Exchange Act Release No. 25,788, 41 SEC Docket (CCH) 78 (June 8, 1988).
\textsuperscript{49} Id. at 63,051–52.
\textsuperscript{50} Id. at 63,052.
\textsuperscript{51} This is due to the fact that the Brazilian subsidiary comprised less than ten percent of the total assets and revenues of Caterpillar. See \textit{id.} at 63,055 & n.9.
\textsuperscript{52} Id. at 63,055.
\textsuperscript{53} Id. at 63,056.
have arrived at contradictory results. Where declining sales were a sufficient trend in one case, they were insufficient to survive a motion to dismiss in another. Similarly contrasting, a defect in a company’s software product in one case could not meet the requirement of a known trend leading to the dismissal of the claim, while the same type of claim survived a motion to dismiss in another case of action.

Even this limited review of SEC actions and cases reveals that the list of information that resides under the “known trends and uncertainties” umbrella is as varied as the number of industries that file with the SEC. Even if a reporting company can sort out what its “trends or uncertainties” are, Item 303 still might not necessarily mandate disclosure. Reporting companies do not generally have to disclose forward-looking information, but, according to the SEC, Item 303 does purportedly require certain types of predictions or projections. The SEC states that the distinction between optional and required disclosures “rests with the nature of the prediction required” and attempts to separate the two with the following explanation: “Required disclosure is based on currently known trends, events, and uncertainties that are reasonably expected to have material effects . . . . In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend, or uncertainty.”

According to the SEC, a given known trend or uncertainty can have any number of future impacts with a lessening degree of predictability. The results are fact- and industry-specific, a point that takes on increased relevance in Part IV.

In 1989, the SEC attempted to provide reporting companies with some guidance for determining what disclosures Item 303 requires in a release on MD&A (1989 Release). Perhaps the most important component of the 1989 Release was the SEC’s proposed two-pronged analysis used to determine whether Item 303 requires disclosure of a

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55 In re Verifone Sec. Litig., 11 F.3d 865, 869 (9th Cir. 1993).


58 See 1987 Release, supra note 44, 52 Fed. Reg. at 13,717 (“Both required disclosure regarding the impact of presently known trends . . . and optional forward-looking information may involve some prediction or projection.”).

59 Id.

60 Id.

61 See 1989 Release, supra note 42.
known trend or uncertainty.\textsuperscript{62} Despite the standard's logical two-step process, negotiating the prongs with real-world business situations is actually quite complicated. For one, both prongs contain maddening double negatives; beyond this annoyance, the second prong superimposes a "reasonably likely" test onto a materiality standard.\textsuperscript{63} Perhaps due to these complications, courts rarely use the two-prong analysis in Item 303 cases; for those courts that have, the analysis takes on enormous importance in determining whether a company is liable in a securities action.\textsuperscript{64}

\section*{II. Item 303's Fuzzy Disclosure Standard}

A federal securities cause of action requires, at a minimum, a misstatement or omission of a \textit{material} fact.\textsuperscript{65} In cases involving an omission of a material fact, a plaintiff must also establish a duty to disclose.\textsuperscript{66} A duty to disclose can arise when a statute or regulation requires disclosure.\textsuperscript{67} Thus, because Item 303 is a required disclosure within the SEC's integrated disclosure regulations, Item 303 impli-

\begin{footnote}[62]{According to the 1989 Release:
Where a trend, demand, commitment, event or uncertainty is known, management must 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 . . . is not reasonably likely to occur.
See id., 54 Fed. Reg. at 22,430.
\textsuperscript{63} See id.
\textsuperscript{64} See, e.g., Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1297-98 (9th Cir. 1998) (holding that an Item 303 violation is presumptively material, but finding that the second prong of the 1989 Release's standard did not require disclosure); \textit{In re Anchor Gaming Sec. Litig.}, 33 F. Supp. 2d 889, 895 (D. Nev. 1999) (dismissing a claim that the defendant violated Item 303 regarding adverse earning trends because the defendant could not have recognized such a trend only two weeks into the quarter).
\textsuperscript{65} See infra notes 91-92, 97, 104, 122 and accompanying text. Note, however, that a duty to disclose applies only where a plaintiff claims that a defendant made an omission, rather than a misstatement.
\textsuperscript{66} See, e.g., Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1202 (1st Cir. 1996) (stating that the "mere possession of material nonpublic information does not create a duty to disclose") (citing Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987) (citing Chiarella v. United States, 445 U.S. 222, 225 (1980))).
\textsuperscript{67} See, e.g., Shaw, 82 F.3d at 1202; \textit{In re Time Warner, Inc. Sec. Litig.}, 9 F.3d 259, 267 (2d Cir. 1993). Courts have alluded to three situations where a duty to disclose might arise: (1) when insider trading occurs, (2) when a statute or regulation requires disclosure, and (3) when a company previously made a statement of a material fact.
cates a duty to disclose. It follows then, that if Item 303 requires disclosure of a certain trend or uncertainty, a failure to make the disclosure, if material, can establish at least one—and possibly two—of the elements necessary for liability in a private cause of action under the federal securities laws. The real issue therefore, and the one that seems to create the most confusion with the courts, is whether all required Item 303 disclosures are material under the federal securities laws.

A. Existing Standards of Materiality Under Federal Securities Laws

In Basic, Inc. v. Levinson, the Supreme Court stated that material information under the federal securities laws is that information for which there is a “substantial likelihood” that it would have “been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information.” In Basic, the Court stated further that, in the context of merger negotiations, materiality will depend upon a balancing of the probability and the magnitude of any particular uncertainty. Although the Basic decision applied only to merger negotiations, lower courts have extrapolated Basic’s probability/magnitude test to situations involving the prediction of other types of future results.

B. “Materiality” Standard for Item 303 Disclosure

Because Item 303 contemplates disclosure of the future effects of trends and uncertainties, it seems sensible to compare its standard to that of Basic’s test, which is intended to be used to measure the materiality of future events. However, a simple comparison of the literal

that is misleading “in light of undisclosed information.” See, e.g., Shaw, 82 F.3d at 1202 n.3; Time Warner, 9 F.3d at 267–68.


69 485 U.S. 224, 231–32 (1988) (adopting expressly the standard of materiality stated in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), for the section 10(b) and Rule 10b-5 context). Similarly, and likely not coincidentally, the SEC’s definition of “material” for purposes of registration and reporting limits the information to “those matters to which there is a substantial likelihood that a reasonable investor would attach importance” in deciding whether to buy or sell a security. 17 C.F.R. § 240.12b-2 (2000).

70 Basic, 485 U.S. at 238, 250.

71 See, e.g., In re Gen. Motors Class E Stock Buyout Sec. Litig., 694 F. Supp. 1119, 1127–29 (D. Del. 1988) (applying the Basic test to statements regarding the company’s internal restructuring); see also Cox et al., supra note 1, at 71 (stating that “there is every reason to believe” that the materiality of soft information, including forward-looking statements, “should be assessed by the probability/magnitude standard in Basic”).
Language of the SEC's two-step analysis in the 1989 Release to the Supreme Court's language in Basic reveals a marked difference between the two standards. First, the Supreme Court uses the term "substantial likelihood;"\(^{72}\) this language connotes a higher standard for materiality than does the "reasonably likely" language of the 1989 Release. Second, the two-pronged analysis of the 1989 Release seems to break the Basic probability/magnitude test into two parts: the first prong addresses only the probability of the uncertainty, while the second prong addresses only the magnitude. In fact, the SEC stated in the 1989 Release that the probability/magnitude test for materiality "is inapposite" to Item 303 disclosure.\(^{73}\)

The inapplicability of the Basic test to the two-pronged analysis in the 1989 Release appears self-evident, because the first step makes no mention of the magnitude of the trend or uncertainty—under the 1989 Release, management does not consider the magnitude of the trend or uncertainty until the second prong. On the other hand, the Basic test contemplates the magnitude of the uncertainty no matter what the level of probability might be. Thus, the SEC's two-pronged analysis for Item 303 disclosure does not purport to determine whether or not particular information is material, but only provides management with a duty to disclose information that may or may not be material.

Yet even if Item 303 does not purport to make all of its required disclosures material, it could be possible that working through the 1989 Release's analysis with any given set of facts demonstrates that Item 303 has a higher threshold for disclosure than does normal materiality. If Item 303's threshold for disclosure is always higher than that of normal materiality, then the set of required disclosures under Item 303 would always necessarily include disclosures required by normal materiality. Thus, the logical conclusion would be that any violation of Item 303 is *per se* a material violation of a duty to disclose.\(^{74}\)

Working through the requirements of the 1989 Release, however, does not seem to result in all required disclosures being material; thus negating the tempting efficacy of such a conclusion.

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\(^{72}\) Basic, 485 U.S. at 231.

\(^{73}\) 1989 Release, supra note 42, 54 Fed. Reg. at 22,430 n.27.

\(^{74}\) This parallels somewhat the conclusion of the court in Stechman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998). See infra text accompanying notes 169–74.
1. Fleshing Out the 1989 Release's Two-Prong Analysis

Before attempting to work through a given scenario, an understanding of the “nuts and bolts” of the 1989 Release’s two-prong analysis requires development. As noted, the first prong of the analysis requires management to determine whether the uncertainty is likely to come to fruition; if management determines it is not reasonably likely to occur, no disclosure is required.75 Professor Ted J. Fiflis proposes that the first prong should require management to assume the probability at 100% unless it can determine the likelihood is “close to zero,”76 while former SEC Commissioner Edward H. Fleischman suggests that “reasonably likely” exists in the 40% probability range.77

Under Fiflis’s formulation, an occurrence that management determines has a probability of 20% might be close enough to zero to merit non-disclosure; under Fleischman’s 40% standard, the same probability is such that management can determine that the event is not reasonably likely to occur. Perhaps the most important point to take from both formulations is that if the likelihood of an uncertainty coming to fruition approaches or exceeds 40%, management cannot deem it “reasonably likely not to occur” and will therefore have to proceed to the second prong.

Once management has determined that the probability of an uncertainty or trend is either indeterminable or too likely to call it “not reasonably likely to occur,” the second prong requires management to evaluate objectively the consequences of the known trend or uncertainty; disclosure is required unless management determines a material effect is not reasonably likely to occur.78 Using Fiflis’s formulation—and the literal language of the second prong—management must simply compare the expected effect of the trend or uncertainty in dollars to the usual dollar amount for materiality to determine whether the second prong mandates disclosure. At this point, it seems clear that Item 303’s threshold for disclosure is lower than the Basic standard because management can no longer discount the magnitude of the uncertainty with a probability factor.

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Relying on Fiflis's and Fleischman's assertions, one commentator reasons that, as between Basic's probability/magnitude test and Item 303's two-pronged analysis, Item 303 has a lower threshold for disclosure. However, at least one other commentator states that Item 303 has an equivalent or higher threshold for disclosure than "ordinary" materiality. One underlying reason for the latter conclusion is that the two-pronged analysis provides management with a "business judgment layer of protection." This reasoning seems off the mark though, because the 1989 Release states that management's determinations "must be objectively reasonable, viewed as of the time the determination is made." Thus, even though management must use its own judgment in making determinations of "reasonably likely," those determinations would be subject to a court's, or perhaps the SEC's, assessment of management's judgment. Furthermore, stating that Item 303 posits a higher threshold for disclosure means that there would be known trends, events, and uncertainties about which normal materiality requires disclosure but that never cross the Item 303 threshold. This reasoning belies the SEC's statement that MD&A should provide an enhanced understanding of the company's financial condition.

2. Some Hypotheticals

Interesting as they may be, abstract speculations about higher or lower standards for disclosure are not extremely helpful for the management of a company that must determine whether to disclose a particular uncertainty. Like many other aspects of the law, including securities law, the facts and circumstances will often provide the ultimate answer. Take, for example, a company that is approaching the time for renewal of a government contract that provides substantially all of the company's revenues. If management determines that a 20% likelihood exists that the government will not renew the contract, it would seem that the uncertainty is not reasonably likely to occur. Therefore, the first prong of the 1989 Release's analysis would not

79 See Romajas, supra note 3, at S256.
80 Mitu Gulati, When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure, 46 UCLA L. Rev. 675, 726 (1999) (stating that the "set of information that Item 303 defines as ripe and ready to be disclosed is a subset of the set of all material information").
81 Id.
83 See 17 C.F.R. § 229.303(a) instr. 1 (2000) (stating that discussion and analysis shall be of information the registrant believes will "enhance a reader's understanding of its financial condition").
require disclosure. Unlike the 1989 Release’s analysis, the Basic test considers the magnitude in conjunction with the probability; a 20% probability that a company will lose all its revenue would seem to cross Basic’s “substantial likelihood” of being material. On these facts then, management might have to disclose the possibility of the non-renewal of the contract despite there being no duty to disclose under Item 303; this scenario suggests the conclusion that Item 303 has a higher threshold for disclosure than does normal materiality.

Just as easily envisaged is a situation where Item 303 mandates disclosure but normal materiality would not. For example, management determines that a 30% chance exists that a lawsuit will result in a judgment affecting potentially 15% of the company’s assets.\textsuperscript{84} Because, at least under Professor Fiflis’s formulation, management cannot determine the loss is not reasonably likely to occur, management must then assume the loss will occur and consider the financial effects. In this instance, management will probably not be able to say that a potential loss of 15% of the company’s assets is not reasonably likely to have a material effect; therefore, the 1989 Release and Item 303 mandate disclosure. Normal materiality may or may not require disclosure in this instance because the 15% potential loss is discounted by the 30% probability; but the point is that Item 303 definitively mandates disclosure that normal materiality might not. This conclusion suggests that Item 303, at least in some cases, has a lower threshold for disclosure than does normal materiality. It stands to reason then, that disclosures required under Item 303 do not always implicate normal materiality standards; thus violation of Item 303’s duty to disclose does not \textit{per se} render a misstatement or omission material.

III. \textbf{ITEM 303 AS A COMPONENT OF LIABILITY IN PRIVATE CAUSES OF ACTION UNDER THE FEDERAL SECURITIES LAWS}

Given the difference in opinions among commentators regarding Item 303’s disclosure standards, it should come as no surprise that courts have had a difficult time deciding what to do with allegations of an Item 303 violation. Because the main battle in securities litigation cases centers on the motion to dismiss, the courts have taken a rather cautious approach to deciding the issue one way or the other. With the exception of the Ninth Circuit Court of Appeals in \textit{Steckman v.}

\textsuperscript{84} Although disclosure of material legal proceedings is required separately from MD&A, see id. § 229.103, the 1989 Release states that MD&A should contain a discussion of all “material impacts upon financial condition or results of operations, including those arising from disclosure provided elsewhere in the filing.” 1989 Release, \textit{supra} note 42, 54 Fed. Reg. at 22,428 n.14.
Hart Brewing, Inc., and to a lesser extent the First Circuit in Shaw v. Digital Equipment Corp., courts have avoided any specific holdings regarding Item 303's status within the framework of securities liability. Instead, courts have typically preferred to determine whether the particular disclosure implicated a "trend" or "uncertainty" within the meaning of Item 303, or whether the particular information was truly "forward-looking" and thus not mandatory under Item 303. Although standards of review can be malleable, a cynical observer might view these approaches as a way of deciding cases based upon findings of fact, thus rendering the decisions more difficult to overturn upon review.

Whatever the reason for courts' reluctance to decide this issue, what is most important is that Item 303's role in affecting liability in private securities actions remains largely undefined in most circuits. Although this lack of definition might have a great deal to do with Item 303's nebulous disclosure standard, another possible explanation is that standards of liability in securities cases vary greatly from one provision to the next. Because both registration statements under the Securities Act and periodic reports under the Exchange Act require Item 303 disclosure, decisions regarding Item 303 overlap the negligence provisions of the Securities Act with the antifraud provisions of the Exchange Act. This overlap contributes to Item 303's continuing lack of definition because, for example, a court cannot readily transplant a decision in a Rule 10b-5 case—which has aspects of fraud—into an action under section 11 of the Securities Act—which implicates a negligence standard. However, a detailed look at the various liability provisions reveals that a novel concept—reading the statutes and rules themselves—can help to clear at least some of the confusion. This Part will provide background on the various private causes of action under the securities laws that might implicate liability for deficient Item 303 disclosure. With this background as a basis for

85 143 F.3d 1293 (9th Cir. 1998).
86 82 F.3d 1194 (1st Cir. 1996).
87 See, e.g., In re Sofamor Danek Group, Inc., 123 F.3d 394, 402 (6th Cir. 1997) (stating that the defendant had no way of knowing "with the degree of assurance" implied by Item 303 that certain merchandising practices would have a material adverse impact upon future earnings and therefore implicated information that was "forward-looking"); Oran v. Stafford, 34 F. Supp. 2d 906, 912 n.6 (D.N.J. 1999) (holding that adverse medical reports concerning one drug manufactured by a pharmaceutical company was not a trend or uncertainty); In re Canandaigua Sec. Litig., 944 F. Supp. 1202, 1209-10 (S.D.N.Y. 1996) (stating that the pricing of a company's new product below the market level of competitors was a "far cry" from creating a trend or uncertainty obligating disclosure).
88 See infra Part IIIA-B.
comparison, this Part will then analyze how courts have treated Item 303 and its place within the liability framework, with particular focus on the contrast between the Steckman and Shaw decisions.

A. Section 10(b) and Rule 10b-5 Causes of Action: Secondary Market Sales

Promulgated under section 10(b) of the Exchange Act, Rule 10b-5 is the primary tool available to investors to seek recovery for misstatements or omissions in connection with the purchase of a security. The "in connection with" language serves as the touchstone that allows sellers and purchasers on the secondary market, for example, national stock exchanges, to bring a cause of action for a Rule 10b-5 violation. Although not expressly stated in the statute or the rule promulgated thereunder, it is now accepted beyond question that Rule 10b-5 provides an implied private cause of action to persons who buy or sell stock on the secondary market.

Of course, merely losing money on stock does not allow an investor who has received the short end of the stick to walk into court and collect. To maintain a Rule 10b-5 cause of action, a plaintiff must generally plead the following: (1) the defendant made an untrue statement of a material fact or omitted a material fact necessary to make the statements made not misleading, (2) the defendant had the requisite scienter, and (3) the omission or misstatement caused the plaintiff's injury. Alternatively, when there is a duty to disclose information to shareholders, an issuer that fails to disclose material facts violates Rule 10b-5(c) when the omission is intentional or reckless. Although courts initially resisted ruling Item 303 allegations as sufficient
cient for a Rule 10b-5 cause of action, the recent trend reveals courts ruling that Item 303 violations can qualify for the duty to disclose element. In a Rule 10b-5 cause of action therefore, once a plaintiff establishes that an Item 303 omission was material, thus meeting the duty to disclose and materiality elements, a successful cause of action still requires that the plaintiff prove the scienter and causation elements. Regardless of any duty to disclose, an omission of a mandatory Item 303 disclosure may render the financial statements misleading and thereby amount to a violation of Rule 10b-5(b).

B. Liability Under Section 11 of the Securities Act

At its most basic, section 11 of the Securities Act allows a purchaser of stock in a public offering to recover for a material omission or statement of an untrue fact in a registration statement. Unlike

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94 See, e.g., In re Verifone Sec. Litig., 11 F.3d 865, 870 (9th Cir. 1993); Alifu v. Pyramid Tech. Corp, 764 F. Supp. 598, 607–08 (N.D. Cal. 1991).
96 Rule 10b-5(b) makes it unlawful, “in connection with the purchase or sale” of a security, to “make any untrue statement of a material fact or to omit . . . a material fact necessary in order to make the statements made . . . not misleading.” 17 C.F.R. § 240.10b-5(b) (2000). Although not a private cause of action, the SEC’s action against Caterpillar—wherein the SEC claimed that Caterpillar should have disclosed information regarding its Brazilian subsidiary so as to make the financial statements not misleading—represents a good example of a Rule 10b-5 omission claim. See In re Caterpillar, Inc., SEC Accounting and Auditing Enforcement Release No. 363, [1991–1995 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,830, at 63,055–56 (Mar. 31, 1992); supra notes 48–53 and accompanying text.
97 See 15 U.S.C. § 77k(a) (1994). A registration statement is the document that a company must file with the SEC prior to most selling activities in connection with a public offering. In general, the person acquiring the security can sue the company, every person who signed the registration statement, underwriters, directors, and certain other professionals connected with the offering. See id. § 77k(a)(1)–(5). The pertinent part of the statute states:

(a) In case . . . the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein . . . any person acquiring such security . . . may . . . sue—

(1) every person who signed the registration statement;
(2) every person who was a director . . . ;
(3) every person who . . . is named . . . as being or about to become a director . . . ;
(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him . . . ;
(5) every underwriter . . . .
Rule 10b-5's focus on fraud, the liability provisions under section 11 demand generally that companies and others involved in a filing with the SEC practice reasonable care and/or due diligence. Because of this difference, section 11 does not impose the same scienter and reliance elements required in a Rule 10b-5 cause of action.98 Thus, an allegation of an Item 303 violation in a section 11 cause of action could assume a paramount role in the plaintiff's case because all the plaintiff really needs to show is that the omission was material and that it was "required to be stated therein."99

Determining whether mandatory Item 303 disclosures are "required to be stated therein" entails a simple walk through the provisions of the statutes and regulations of the Securities Act. Section 7(a) of the Securities Act provides authority to the SEC to require information in a registration statement by rule or regulation.100 The integrated disclosure system developed by the SEC requires documents, including registration statements, filed under the Securities Act to include the information mandated by Item 303.101 Thus, because companies must make Item 303 disclosures in the registration statement, an allegation of an Item 303 violation gets a plaintiff halfway to the finish line in a section 11 case. Of course, even if the plaintiff can establish materiality, the potential victory is subject to due diligence defenses of the individual defendants.102

C. Liability Under Section 12 of the Securities Act

A similar step-by-step analysis can be used to determine Item 303's effect on liability under sections 12(a)(1) and 12(a)(2). Because section 12(a)(2) represents the more prevalent of the two section 12 causes of action, that section will be analyzed first. Section 12(a)(2) applies to offers and sales of securities by means of instruments of interstate commerce.103 Specifically, it allows an individual who purchases the security by means of a prospectus to sue the seller for any untrue statements of material facts or omissions of material facts "necessary . . . to make the statements, in light of the circumstances they were made, not misleading."104 The term "prospectus" is a term of art that generally includes within its definition any written or

98 See Shaw, 82 F.3d at 1217.
100 Id. § 77g(a).
101 See supra note 38 and accompanying text.
103 Id. § 77l(a) (2) (Supp. IV 1998).
104 Id.
oral communication that offers to sell or confirms the sale of any security.\textsuperscript{105}

Determining how Item 303 affects section 12(a)(2) liability again merely requires a walk through the relevant provisions. Section 10(a)(1) of the Securities Act requires a prospectus to contain "the information contained in the registration statement."\textsuperscript{106} Assuming then, that the plaintiff receives a prospectus that purportedly meets the standards of section 10(a)(1), "information contained in the registration statement" certainly includes mandatory Item 303 disclosures.\textsuperscript{107} Therefore, any omissions or misstatements related to information that Item 303 mandates would constitute an omission or misstatement under section 12(a)(2). Similar to section 11, a plaintiff alleging an omission or misstatement in Item 303 would be able to make a successful claim if the item is material without having to prove scienter. Also similar to section 11, a section 12(a)(2) claim is subject to a reasonable care defense, but also provides for a defense that states the loss was caused by some factor other than the omission.\textsuperscript{108}

A bold attorney practicing in certain circuits could potentially use section 12(a)(1) to obtain a shortcut to a finding of liability by using an allegation of an omission of a mandatory Item 303 disclosure. Section 12(a)(1) provides that an offeror or seller of a security may be liable to the purchaser if the offer or sale is made in violation of section 5 of the Securities Act.\textsuperscript{109} The pertinent part of section 5 makes it unlawful to use any means or instrumentalities of interstate commerce to transmit a prospectus unless the prospectus meets the requirements of section 10 of the Securities Act.\textsuperscript{110} As noted \textit{supra}, section 10 requires the disclosures mandated by Item 303.\textsuperscript{111} Thus, an omission of an Item 303 disclosure results in a prospectus not meeting the requirements of section 10 and could therefore result in a violation of section 5; this, in turn, would meet the minimal requirement for recovery under section 12(a)(1). In \textit{SEC v. Manor Nursing Centers, Inc.},\textsuperscript{112} a SEC enforcement action, the Second Circuit used such a reading of section 5 in finding that the defendant violated that sec-

\textsuperscript{105} See \textit{id.} § 77b(a)(10). The Supreme Court limited the definition of a prospectus under section 10 to "documents related to public offerings by an issuer or its controlling shareholders." \textit{Gustafson v. Alloyd Co.}, 513 U.S. 561, 569 (1995).


\textsuperscript{107} See \textit{supra} notes 37–39 and accompanying text.


\textsuperscript{109} \textit{id.} § 77l(a)(1).

\textsuperscript{110} \textit{id.} § 77e(b)(1) (1994). Note that section 5 contains no materiality limitation.

\textsuperscript{111} See \textit{supra} notes 106–08 and accompanying text.

\textsuperscript{112} 458 F.2d 1082 (2d Cir. 1972).
If Manor's holding were applied to a private cause of action, a plaintiff could recover for an Item 303 omission and not even have to prove the omission was material. However, at least one circuit has criticized the decision in Manor for creating a *per se* violation of section 12(a)(1) that renders sections 11 and 12(a)(2) of the Securities Act meaningless. Despite the voices of dissent, the idea that an immaterial Item 303 omission could result in section 12(a)(1) liability should concern a securities defense attorney.

**D. Causes of Action Under Section 14 of the Exchange Act: Proxy Rules**

Although the case law is sparse, an omission of a mandatory Item 303 disclosure could potentially result in liability under the Exchange Act's proxy rules. Generally speaking, the proxy rules operate to provide shareholders, particularly small shareholders, with leverage against management and the larger shareholder groups within corporations. The leverage that shareholders receive from the proxy rules includes required dissemination of certain information and a chance to issue proposals for voting on certain corporate matters. For example, for proxy statements that relate to an annual shareholders' meeting, the regulations require that an annual report accompany or precede the proxy statement. Although the regulations require that the annual report contain a MD&A section, courts have typically not allowed liability for omissions in the required annual report due to limiting language found in Rule 14a-3.

In certain proxy solicitations however, Item 303 disclosures are mandated not by Rule 14a-3(b), but by operation of Schedule 14A.

113 Id. at 1100; see also A.J. White & Co. v. SEC, 556 F.2d 619, 622 (1st Cir. 1977) (holding that a misleading prospectus violates section 5 if material).
114 See SEC v. S.W. Coal & Energy Co., 624 F.2d 1312, 1318-19 (5th Cir. 1980).
115 In re Sofamor Danek Group, 123 F.3d 394 (6th Cir. 1997), is the only proxy case found that touches on the treatment of Item 303 disclosure. One of the reasons for the sparse case law is the general lack of success that proxy fights have encountered against large corporations. See Cox et al., supra note 1, at 827-28.
116 17 C.F.R. § 240.14a-3(b) (2000).
117 Id. § 240.14a-3(b)(5)(ii).
118 See Markewich v. Adikes, 422 F. Supp. 1144, 1147 (E.D.N.Y. 1976); Dillon v. Berg, 326 F. Supp. 1214, 1230 (D. Del. 1971), aff'd per curiam, 453 F.2d 876 (3d Cir. 1971). The limiting language is found in 17 C.F.R. § 240.14a-3(c) (2000) and states that the annual report is not deemed “subject to this regulation otherwise than as provided in this Rule.” Id.
119 The disclosures required by Schedule 14A, 17 C.F.R. § 240.14a-101 (2000), must be included by virtue of Rule 14a-3, id. § 240.14a-3(a). Schedule 14A requires mandatory Item 303 disclosures specifically in proxy statements dealing with authorizations or issuance of shares "otherwise than for exchange" of shares of the company,
Thus, the limiting language in Rule 14a-3 would not apply, and any omissions related to Item 303 could result in liability from an implied private right of action under Rule 14a-9. Some circuits have found that omissions of Rule 14a-9 disclosures are subject to a negligence standard “more closely analogized to section 11 of the Securities Act” and allow a plaintiff to proceed without establishing scienter. Therefore, at least in these circuits, a plaintiff bringing an action for an Item 303 omission in a proxy statement would have to prove the following elements: (1) the proxy statement contains a false or misleading statement with respect to a material fact or an omission of a material fact necessary to make statements therein not misleading, (2) the defendants were negligent in drafting the statement, and (3) the proxy caused an injury to plaintiffs.

Depending upon the court, the question of whether Item 303 violations are per se material has a twofold level of importance in Rule 14a-9 cases. First, the importance is magnified in these cases, because in Mills v. Electric Auto-Lite Co., the Supreme Court held that a shareholder who demonstrates that an omission in a proxy statement is material is entitled to a presumption of reliance. A presumption of reliance can go a long way towards proving causation. Second, the upshot of this presumption is that a plaintiff who finds an omission of a mandatory Item 303 disclosure, and happens to be in a court that

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120 Id. § 240.14a-101 it. 11, and modification or exchange of shares for shares of the company, id. it. 12. See id. it. 13(a)(3).
121 Id. § 240.14a-9(a). Rule 14a-9 prohibits solicitations by means of a proxy statement which is “false or misleading with respect to any material fact,” or “omits to state any material fact necessary in order to make the statements therein not false or misleading.” Id.
122 Gould v. Am.-Hawaiian S.S. Co., 535 F.2d 761, 777 (3d Cir. 1976); see also Shidler v. All Am. Life & Fin. Corp., 775 F.2d 917, 927 (8th Cir. 1985) (stating that “the analogy to section 11 is not without merit, but it is inexact”).
123 See, e.g., In re BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976, 988–89 (E.D. Mo. 1999); Parsons v. Jefferson-Pilot Corp., 789 F. Supp. 697, 701 (M.D.N.C. 1992). As in Rule 10b-5 causes of action, a plaintiff could assert that an omission in Item 303 caused the accompanying financial statements to be misleading. See supra note 93.
124 See Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972) (stating in a Rule 10b-5 omission cause of action that an “obligation to disclose” material information in conjunction with a failure to disclose “establishes the requisite element of causation in fact”); Flamm v. Eberstadt, 814 F.2d 1169, 1173–74 (7th Cir. 1986) (stating that “reliance” means only materiality and causation in conjunction” and that “Angelos . . . essentially removes reliance as an element independent of causation and materiality” (quoting Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 528 (7th Cir. 1985))); see also Cox et al., supra note 1, at 746 (“Reliance is simply the means by which causation is typically established.”).
presumes materiality of such omissions, would have knocked down almost all of the elements of an implied private cause of action with the one allegation. To a securities defense attorney, this is akin to being sent up to the plate to face Pedro Martinez when there is already an 0-2 count.

E. Treatment of Item 303 Violations in Private Causes of Action

Despite the current undefined principles regarding how courts should treat Item 303 violations in private securities causes of action, one optimistic point deserves mention: the current confused principles are better than the complete lack of principles that existed six to seven years ago. At that time, Item 303 was just beginning to emerge as an important component of securities case law due largely to the effects of the SEC’s pursuit of Caterpillar for violating Item 303. The few cases that did show up on the dockets were predominately within the Ninth Circuit, a trend that continues currently. After a period of rejecting Item 303 claims on the basis of either requiring an independent duty to disclose under Rule 10b-5, or on questionable distinctions between mandatory Item 303 disclosures and optional disclosures of forward-looking information, courts in the Ninth Circuit finally began to recognize that allegations of Item 303 violations at least “lend additional support” to Rule 10b-5 claims.

Other circuits underwent a similar development in their Item 303 jurisprudence. Similar to the court in *Alfus v. Pyramid Technology Corp.*, other courts dispensed with plaintiffs’ claims of Item 303 violations by determining that Item 303 does not provide an independent cause of action. This approach, however, could simply not be sustained. Even if Item 303 does not give rise to a private cause of

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125 See, e.g., Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998).
128 See *In re Verifone Sec. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993); *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991).
131 See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1419 n.7 (3d Cir. 1997) (“It is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs.”); *In re Canandaigua Sec. Litig.*, 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996) (“It is far from certain that a duty to disclose under Rule 10b-5 may be satisfied by importing the disclosure duties from S-K 303.”).
action, mandatory Item 303 disclosures still implicate an affirmative
duty to disclose under the securities laws.\footnote{132}

1. \textit{Shaw v. Digital Equipment Corp.:} Item 303 Implicates a Duty to

Disclose

Perhaps recognizing the fallacy in decisions that rendered Item
303 violations inert on the basis that they did not give rise to private
causes of action, courts did not take long to develop a different view of
the role of Item 303. Taking a more appropriate, yet still cautious,
view of Item 303's disclosure requirements in the context of securities
liability, these courts have generally held that allegations of Item 303
violations, if material, could impose liability in Rule 10b-5 actions and
actions under sections 11 and 12(a)(2) of the Securities Act.\footnote{133}

The \textit{Shaw} case is particularly illuminating because it involved
complaints alleging violations of sections 11 and 12(a)(2) of the Se-
curities Act as well as violations of section 10(b) and Rule 10b-5 under
the Exchange Act. The case involved the public offering of Digital
Equipment Corporation (DEC) preferred stock pursuant to a shelf
registration on Form S-3\footnote{134} of nearly $400 million.\footnote{135} DEC apparently
needed the funding badly after a period of large losses and a slower

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\footnote{132} See Gulati, \textit{supra} note 80, at 725–26.
\footnote{133} See, \textit{e.g.}, Simon v. Am. Power Conversion Corp., 945 F. Supp. 416, 431 & n.20
(D.R.I. 1996) (stating that with “an affirmative duty to disclose material informa-
tion . . . nondisclosure is actionable under the securities laws”); Wallace v. Sys. &
deliberate cost increases may have violated Item 303 and the information was “not so
obviously unimportant so as to allow the court to deem them immaterial as a matter
of law”).

\footnote{134} A shelf registration permits a company to file a single registration statement on
Form S-3 covering a specified quantity of securities. \textit{See generally} 17 C.F.R. \textsection 230.415
(2000) (providing the rules for “delayed or continuous offering and sale of securi-
ties”). Form S-3 allows for a streamlined registration process whereby the registrant
accomplishes much of the disclosure through incorporation by reference of its most
recent Form 10-K and Forms 10-Q. \textit{See id.}; Shaw v. Digital Equip. Corp., 82 F.3d 1194,
1205 (1st Cir. 1996). The company can then issue the securities in installments for a
period of up to two years. \textit{See 17 C.F.R.} \textsection 230.415(a)(2) (2000). Typically, the re-
quirements for qualifying for shelf registration are such that it is available to large
companies that are already subject to continuous reporting provisions. \textit{See Wielgos v.
Commonwealth Edison Co.}, 892 F.2d 509, 510 (7th Cir. 1989) (noting that Form S-3
“is reserved for firms with a substantial following among analysts and professional
investors”); \textit{see also} 17 C.F.R. \textsection 230.13(a)–(b) (2000) (requiring the aggregate market
value of registrants using Form S-3 to be $75 million or greater).

\footnote{135} Shaw, 82 F.3d at 1200.
than expected recovery during the 1992 and 1993 fiscal years. DEC filed the registration statement on January 21, 1994 (January is the first month of DEC's third quarter) and sold stock through its underwriters pursuant to the registration statement, a prospectus dated March 11, 1994, and a prospectus supplement dated March 21, 1994. Less than three weeks later, DEC announced a far greater loss than anticipated for the quarter ended April 2, 1994. This same announcement disclosed that DEC was considering "further restructuring," despite a statement in the prospectus supplement that the existing restructuring reserve of $443 million was adequate to cover planned restructuring costs. Following the end of the 1994 fiscal year, DEC announced in July of 1994 that it would take an additional $1.2 billion charge to cover the costs of additional restructuring.

Two classes of plaintiffs brought actions against DEC: (1) purchasers of shares in the public offering in March brought actions under sections 11 and 12(2) of the Securities Act ("Wilensky plaintiffs"); and (2) secondary purchasers of DEC stock brought claims under section 10(b) of the Exchange Act and Rule 10b-5 ("Shaw plaintiffs"). The heart of both complaints alleged that (1) DEC management had knowledge of the facts concerning the large losses during the third quarter; and (2) the representation concerning the adequacy of the reserve was misleading. The district court dismissed both actions.

Regarding the Wilensky plaintiffs, the Third Circuit first determined whether DEC was under a duty to disclose the matters in the registration statement and prospectuses. Among other reasons, the court found a duty to disclose could be implicated by the "known trends and uncertainties" of which Item 303 requires disclosure. Although Form S-3 does not explicitly require the information re-

136 See id.
137 Id.
138 Id.
139 Id.
140 Id.
142 Shaw, 82 F.3d at 1201.
143 Id.
144 Id.
145 See id. at 1202–03.
146 See id. at 1205.
quired by Item 303, Item 12 of the form incorporates by reference the latest annual report on Form 10-K, which does require Item 303 disclosure. Furthermore, Item 11 of Form S-3 requires the company to describe "any and all material changes" which have occurred since the latest annual report. By virtue of this chain of requirements then, DEC could be liable under sections 11 and 12(a)(2) of the Securities Act for omissions and misstatements relating to material changes in its Item 303 disclosures.

Despite DEC's challenge that any statement regarding predictions of the end of the quarter losses were non-mandatory forward-looking statements, the Third Circuit found that the close proximity of the prospectus to the end of the quarter (eleven days) prevented the court, at such an early stage in the litigation, from determining that there was no mandatory disclosure requirement. As such, the court determined that the Wilensky plaintiffs had stated a cognizable claim that DEC had omitted from the registration statement information that, in the language of section 11, was required to be stated therein. The court also found that the statements regarding the restructuring reserves may have been misleading if DEC management knew of the large-scale restructuring and that the statements were not protected by the "bespeaks caution" doctrine.

The court then addressed the section 10(b) and Rule 10b-5 claims of the Shaw plaintiffs. Stating that the "same standard of materiality applies to claims under section 10(b) and Rule 10b-5 as to claims under sections 11 and 12(2)," the court found that the same omissions and misstatements that were actionable for the Wilensky plaintiffs were sufficient for the section 10(b) and Rule 10b-5 claims. Although the Shaw court swaddled its decision regarding the sections 11 and 12(2) claims in discourse that highlighted the notion that "[t]he obligations that attend the preparation of [public offering] filings embody nothing if not an affirmative duty to disclose a

148 See id. it 11(a), in 2 Fed. Sec. L. Rep. (CCH) ¶ 7153, at 6251; see also Shaw, 82 F.3d at 1205.
149 See Shaw, 82 F.3d at 1205.
150 Id. at 1211. See also Gulati, supra note 80, at 739-42, where the Shaw case is discussed in the context of Gulati’s theories regarding the timing of disclosure for "ripe" and "unripe" intraquarterly information.
151 Shaw, 82 F.3d at 1211.
152 Id. at 1214.
153 Id. at 1217.
154 Id. at 1222.
broad range of material information,"155 the court noted that the same omissions are actionable under section 10(b) and Rule 10b-5 if the scienter and reliance elements are established.156 Recognizing the divergence from decisions in other courts,157 the Shaw court stated that it was not creating a private right of action under section 10(b) for violation of any SEC rule, but that its holding is limited to the "proposition that . . . plaintiffs who . . . rely upon the completeness of a registration statement or prospectus may sue under Section 10(b) and Rule 10b-5 for nondisclosures of material facts omitted from those documents in violation of the applicable SEC rules and regulations."158

Although some courts still seem to cling to the idea that an Item 303 violation needs the impetus of an implied private right of action to result in liability for a violator,159 most courts have begun to follow the logic of Shaw.160 This is a positive trend because the Shaw court recognized where Item 303 should reside within the securities liability framework—as merely potentially initiating a duty to disclose. Despite the logic of its decision, an interesting point about the Shaw decision is that the court never went through the SEC's two-pronged analysis found in the 1989 Release. Despite this, the court managed to reach the same conclusion that such an analysis might have produced.161 However, it does seem that deference should be given to the SEC's interpretations of its own rules and regulations, at least to the extent that it does not infringe on the courts' jurisdiction.162

155 Id. at 1202 (citation omitted).
156 Id. at 1221 ("[I]t is hardly a novel proposition that the 1934 Act and the 1933 Act 'prohibit some of the same conduct.'" (quoting Herman & Maclean v. Huddleston, 459 U.S. 375, 383 (1983) (internal citations omitted in original))).
157 See cases cited supra note 131.
158 Shaw, 82 F.3d at 1222 n.37 (citations omitted).
159 See, e.g., In re Quintel Entm't, Inc. Sec. Litig., 72 F. Supp. 2d 283, 293 (S.D.N.Y. 1999) (refusing to recognize an Item 303 cause of action "[i]n light of the absence of authority for the position that a failure to comply with . . . [Item 303] can be the basis of a § 10(b) action"). The "absence of authority" noted in Quintel seems a bit surprising as Shaw and Sleckman had both already been decided.
160 See, e.g., Simon v. Am. Power Conversion Corp., 945 F. Supp. 416, 431 n.20 (D.R.I. 1996) (finding that a failure to disclose discovery of a product defect was an actionable omission of a mandatory Item 303 disclosure); see also Milman v. Box Hill Sys. Corp., 72 F. Supp. 2d 220, 230 (S.D.N.Y. 1999) (finding that an omission of disclosure regarding poor reception of new products violated Item 303 and, if material, could constitute a violation of the Securities Act). Confoundingly, the Milman decision was in the same district as the decision in Quintel.
161 See infra notes 225–28 and accompanying text.
162 See infra notes 183–85 and accompanying text.
2. Item 303 Implicates a Duty to Disclose and Then Some: The Steckman Decision

Just when a number of courts had seemingly found a nice, safe place for Item 303 to reside within securities cases, one court took the allegation of an Item 303 violation to the extreme. In a panel decision, the Ninth Circuit in Steckman held that allegations of Item 303 violations, without more, were sufficient to support a claim under sections 11(a) and 12(a)(2) of the Securities Act.163 The defendants in Steckman were Pyramid Breweries, Inc. (formerly Hart Brewing, Inc.), its officers, and the underwriters of the offering.164 After strong growth over a four-year period, Pyramid conducted an initial public offering in December of 1995.165 The initial offering price was $19 per share, but by June of 1996 the stock price had dropped to $12.15 per share.166 The thrust of the plaintiffs' complaint was that Pyramid had failed to disclose in the MD&A section of the prospectus and registration statement flat fourth quarter earnings of which it must have had knowledge by the time of the offering in December.167

The defendant underwriters, relying apparently on the Ninth Circuit's decision in In re Verifone Securities Litigation,168 claimed that a complaint alleging violation of Item 303 was not "sufficient to state a cause of action under the Securities Act."169 Stating that the underwriters' defense posed "threshold issues," the Steckman court discussed whether allegations of Item 303 violations also sufficiently state a claim under sections 11 and 12(a)(2) of the Securities Act.170

According to the Steckman court, the decisions in Verifone and other similar cases did not apply because they were brought under

163 See Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998).
164 Id. at 1294.
165 Id.
166 Id. at 1294–95.
167 Id. at 1295. The plaintiffs claimed that Pyramid must have known of the flat fourth quarter earnings because in the middle of the first quarter of 1996 it was able to announce that those earnings would deviate from analysts' expectations. Id.
168 11 F.3d 865 (9th Cir. 1993).
169 Steckman, 143 F.3d at 1296. The underwriters' reliance on Verifone seems a bit strange. The Verifone court really did not speak as to the meaning of an Item 303 violation within a securities cause of action; what the court did find was that the defendant did not violate Item 303 because the information the plaintiffs claimed should have been disclosed was forward-looking and thus not required under Item 303. See Verifone, 11 F.3d at 870. The Verifone court did hold however, that violation of stock exchange reporting requirements could not be imported as a violation of section 10(b) and Rule 10b-5. Id.
170 Steckman, 143 F.3d at 1296.
section 10(b) and Rule 10b-5, which are implied causes of action.\textsuperscript{171} Because section 11(a) liability occurs where "a registrant ‘omit[s] to state a material fact required to be stated’ in the registration statement . . . any omission of facts ‘required to be stated’ under Item 303" produces section 11 liability.\textsuperscript{172} Similarly, a prospectus containing omissions or misstatements related to Item 303 results in section 12(a) (2) liability.\textsuperscript{173}

The \textit{Steckman} court indicated that its decision rested on the fact that sections 11 and 12(a) (2) provide express causes of action, while Rule 10b-5 cases have "only an implied right of action."\textsuperscript{174} What the court did not indicate is why that should matter; certainly none of the courts rejecting Item 303 as a basis for Rule 10b-5 liability mentioned the implied nature of the cause of action as being a factor.\textsuperscript{175} Perhaps, the court was simply referring to the "affirmative duty of disclosure" that exists in the context of the Securities Act and public offerings as opposed to the periodic reporting requirements under the Exchange Act;\textsuperscript{176} but whatever weight this argument might carry the \textit{Steckman} court did not rely on it. Despite its reference to the difference between implied and express causes of action, the real basis for the \textit{Steckman} court’s holding seemed to be its conclusion that Item 303 violations are “presumably material.”\textsuperscript{177}

Tracing where the \textit{Steckman} court got its “presumably material” language reveals a holding with no real basis in law. The \textit{Steckman} court based its conclusion on language in a Third Circuit case, \textit{In re Craftmatic Securities Litigation}, stating that “disclosures mandated by law are presumably material.”\textsuperscript{178} In turn, the \textit{Craftmatic} court borrowed its “presumably material” language from a law review article written by

\begin{footnotesize}
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  \item \textsuperscript{171} \textit{Id.}
  \item \textsuperscript{172} \textit{Id.} (quoting language from section 11(a) of the Securities Act).
  \item \textsuperscript{173} \textit{See id.}
  \item \textsuperscript{174} \textit{Id.}
  \item \textsuperscript{175} \textit{See, e.g., In re Sofamor Danek Group, Inc., 123 F.3d 394, 402 (6th Cir. 1997); In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 n.7 (3d Cir. 1997); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1222 & n.37 (3d Cir. 1996); In re Verifone Sec. Litig., 11 F.3d 865, 869 (9th Cir. 1993); In re Canandaigua Sec. Litig., 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996).}
  \item \textsuperscript{176} \textit{Shaw, 82 F.3d at 1202; see also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (stating that the Securities Act “was designed to provide investors with full disclosure of material information concerning public offerings”).}
  \item \textsuperscript{177} \textit{See Steckman, 143 F.3d at 1296 (quoting \textit{In re Craftmatic Sec. Litig., 890 F.2d 628, 641 n.17 (3d Cir. 1990) (amended decision)).}
  \item \textsuperscript{178} \textit{890 F.2d 628, 641 n.17 (3d Cir. 1990) (quoting Victor Brudney, A Note on Materiality and Soft Information Under the Federal Securities Laws, 75 VA. L. REV. 725, 727 (1989)), quoted in Steckman, 143 F.3d at 1296.}
\end{itemize}
\end{footnotesize}
Professor Victor Brudney stating the proposition that “[t]he particular items of information mandated . . . under the 1933 Act or under sections 12, 13, and 14 of the 1934 Act are presumably automatically deemed to be ‘material.’”\textsuperscript{179} The article does not provide any source for this proposition; thus indicating that the \textit{Stedman} court’s decision rested on a rather fragile foundation.

There are at least three problems with the “presumably material” language: (1) it ignores the separation of materiality from a duty to disclose; (2) if carried to its furthest extreme, it could shift the burden of proof for the materiality element away from the plaintiff for seemingly minor omissions, such as the company’s address;\textsuperscript{180} and (3) such presumptions replace the Supreme Court’s standard of materiality with SEC interpretations. This Note has already addressed the issues surrounding the first problem.\textsuperscript{181} Regarding the second problem, one might state that, of course, no court would reasonably presume a material omission for something as unimportant to an investor as the company’s address. But therein lies the problem—where does a court draw the line on which one side lie those requirements that a court can “reasonably” presume material, and on the other those that are reasonably unimportant to an investor? The presumption must apply to either all required disclosures mandated by the SEC, or none. Any other conclusion would result in ad hoc decisions regarding the relative importance, or perhaps unimportance, of particular line items.

The third problem is much deeper and lies somewhat beyond the scope of this Note. In brief, intertwining a presumption of materiality with SEC-required disclosures completely undercuts the Supreme Court’s decisions regarding materiality.\textsuperscript{182} Although the \textit{Stedman} court reasoned that it must give “substantial deference to the SEC’s interpretation of the securities laws,”\textsuperscript{183} the SEC has never pronounced that mandatory Item 303 disclosures are always material. Even if the SEC had made such a pronouncement, whether the Supreme Court would allow the SEC to overrule its own decisions regarding materiality seems a questionable conjecture. The Supreme


\textsuperscript{180} \textit{See, e.g.}, \textit{Securities and Exchange Comm’n, Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934}, at 1, in 5 Fed. Sec. L. Rep. (CCH) ¶ 31,102, at 22,065 (1999). Page 1 of the form contains the line used to fill in the registrant’s address of its principal executive offices. \textit{See id.}

\textsuperscript{181} \textit{See supra} Part II.

\textsuperscript{182} \textit{See, e.g.}, Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); \textit{supra} Part II.A.

\textsuperscript{183} \textit{Stedman}, 143 F.3d at 1297.
Court has stated that its deference to SEC interpretations "is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history." 184

The problems with the Steckman holding regarding the presumed materiality of Item 303 violations are troubling particularly in light of the fact that the holding was unnecessary. In going through the two prongs of the SEC's 1989 Release, 185 the court determined that Pyramid's slowdown in sales and increased costs after a period of growth might very well have been a "known trend" within the meaning of the 1989 Release. 186 Furthermore, Pyramid could have reasonably expected the slowdown in the middle of the fourth quarter that occurred just before the IPO. 187 The court therefore found that the first prong did not allow the defendant to escape disclosure and proceeded to the second prong. 188 However, the court found that the second prong did not require disclosure. 189 Pyramid, although not experiencing predicted results, was still experiencing eighty-eight percent growth over sales in the fourth quarter of the prior year. 190 Even more important, Pyramid had consistently experienced earnings slowdowns in the fourth quarters of each of the prior two years. 191 Based upon this, the court found that Pyramid could not have reasonably expected that the slowdown in the fourth quarter of 1995 would have given management any reasonable expectation of a material effect on earnings, and the second prong therefore did not require disclosure. 192

As heartening as it may be to the Item 303 purist (assuming there is such a creature) to see a court analyze a company's MD&A disclosure in terms of the 1989 Release's two-pronged test, the Steckman 184 Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 566 n.20 (1979). In SEC v. Sloan, 436 U.S. 103 (1978), the Court stated that "the courts are the final authorities on issues of statutory construction, and 'are not obliged to stand aside and rubber stamp their affirmation of administrative decisions that they deem inconsistent with a statutory mandate or that frustrate the congressional policy underlying a statute.' " Id. at 118 (quoting Volkswagenwerk Aktiengesellschaft v. Fed. Mar. Comm'n, 390 U.S. 261, 272 (1968) (quoting NLRB v. Brown, 380 U.S. 278, 291 (1965) (internal citations omitted))).
185 See 1989 Release, supra note 42, 54 Fed. Reg. at 22,430. For the full text of the two-pronged analysis, see supra note 62.
186 Steckman, 143 F.3d at 1297.
187 Id.
188 Id.
189 Id. at 1298.
190 Id.
191 Id.
192 Id.
NOTE: ITEM 303'S ROLE IN SECURITIES LAW

The court's holding on the presumed materiality of Item 303 disclosures does not place the regulation in its proper role. Furthermore, because the court grounded its decision on an application of the facts to the 1989 Release's two-prong analysis, the effect of its important holding regarding the presumed materiality of Item 303 violations may not have been completely apparent. Thus, Item 303's role in the context of securities liability still remains undefined and provides reporting companies with no meaningful guidelines.

IV. APPLYING DIVERGING STANDARDS OF CONDUCT AND STANDARDS OF REVIEW TO ITEM 303 CASES

What seems clear from the holdings in various private securities causes of action is that Item 303's special role within the SEC's reporting requirements and its unique "materiality" standard have contributed to uncertainty as to whether liability should attach from an Item 303 violation. Whereas the Steckman court viewed all Item 303 violations as "presumably material," other courts—like the Shaw court—have at least questioned whether Item 303 violations are sufficient for liability in a private cause of action. The varied holdings in these cases reflect the crux of the problem with establishing any bright-line rule regarding Item 303 violations: mandatory Item 303 disclosures encompass a broad spectrum of both material and immaterial information. The unfairness of the Steckman court's holding becomes evident when applied to a reporting company that complies fully with all Item 303 disclosures that are material (in the Basic sense), yet could still be liable for seemingly minor omissions.

Courts should recognize the range of information with which management of reporting companies must contend and at least consider whether alleged omissions or misstatements come anywhere near reaching a level of materiality necessary for liability to attach.

193 But see Renee Deger, Taking Stock: Appeals Court Rules Secret Trends Legal, THE RECORDER, May 21, 1998, at 4. The article quotes a plaintiff's attorney as stating that the Steckman court's holding regarding Item 303 violations was "the fact before the court stated it." Id.

194 See, e.g., Oran v. Stafford, 226 F.3d 275, 281 (3d Cir. 2000) (noting that the difference between "materiality standards for Rule 10b-5 and SK-303 differ significantly," and therefore that an Item 303 violation does not "automatically give rise to a material omission under Rule 10b-5").

195 Steckman, 143 F.3d at 1296. The court did, however, limit its holding to sections 11 and 12 claims under the Securities Act.

196 See Oran, 226 F.3d at 287; Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1222 & n.37 (1st Cir. 1996).

197 See generally discussion supra Part II.B.2.
Indeed, other areas of law recognize that non-compliance with certain standards does not automatically result in liability. In his article, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, Professor Eisenberg describes various legal regimes where courts recognize that non-compliance with a particular "standard of conduct" does not always cause liability to attach under a court's particular "standard of review." This Part attempts to reconcile Professor Eisenberg's concepts with purported Item 303 violations and, using specific cases, will show that the concepts provide a solid foundation for courts to review such violations.

A. Standards of Conduct and Standards of Review

Eisenberg defines a "standard of conduct" as stating "how an actor should conduct a given activity or play a given role." A "standard of review" describes "the test a court should apply when it reviews an actor's conduct to determine whether to impose liability." In their simplest forms, the two standards are conflated—a good example being "the standard of conduct that governs automobile drivers is that they should drive carefully, and the standard of review in a liability claim" is whether the driver drove carefully.

In corporate law however, the two standards typically diverge. For example, corporate directors and officers are typically subject to a standard of conduct known generally as the "duty of care." Essentially a negligence standard, the duty of care typically requires directors to "reasonably monitor or oversee the conduct of the corporation's business," follow up reasonably on information, and "employ a reasonable decision-making process to make decisions." According to section 4.01(a) of the American Law Institute's (ALI) Principles of Corporate Governance, these duties must be performed "in good faith, in a manner that [the director or officer] reasonably believes to be in the best interest of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise."
Despite the mention of the "prudent" person and "reasonable belief," courts often subject actual decisions of corporate directors and officers to a much less stringent standard—known as the business judgment rule—that only contemplates the reasonableness of the decision.\textsuperscript{207} To receive the good grace of the business judgment rule, at least under ALI standards, the director or officer need only: (1) make a judgment in good faith; (2) not have a personal interest in the subject of the judgment; (3) be informed to the extent that the director or officer reasonably believes necessary; and (4) rationally believe the judgment is in the best interests of the corporation.\textsuperscript{208} A director who meets the business judgment rule requirements is deemed to have fulfilled the duty under section 4.01(a).\textsuperscript{209} A strict reading of the business judgment rule requirements reveals that any objective test of reasonableness or prudence does not apply, except possibly within the context of "good faith" or "rational belief." With these minimal requirements, rational minds would have to agree that the business judgment rule tends to reduce liability for corporate directors' and officers' bad decisions.\textsuperscript{210}

According to Eisenberg, the divergence of the standard of conduct implicated by the duty of care from the standard of review embodied within the business judgment rule is due largely to good policy.\textsuperscript{211} The divergence protects directors and officers from the threat of unfair liability by providing protection against attacks on their decisions. The divergence of the two standards also recognizes the inherent uniqueness of every business decision that prevents directors from simply claiming, as would a doctor or lawyer, that they followed a particular industry or practice standard.\textsuperscript{212} Furthermore, the divergence can be seen as the law's way of telling directors to act with due care, but in order to be fair, the law has courts make directors liable only if the judgment was self-interested, in bad faith, or, alternatively, if the decision-maker did not appropriately inform himself or herself.\textsuperscript{213}

To clarify, this Note does not propose that corporate defendants should have available a business judgment rule as a shield from liabil-

\begin{itemize}
\item \textsuperscript{207} Eisenberg, \textit{supra} note 29, at 441.
\item \textsuperscript{208} \textit{Principles}, \textit{supra} note 206, § 4.01(c).
\item \textsuperscript{209} \textit{Id}.
\item \textsuperscript{210} See Eisenberg, \textit{supra} note 29, at 442–43. The business judgment rule does not, however, save every decision made by a director or officer. See, \textit{e.g.}, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
\item \textsuperscript{211} Eisenberg, \textit{supra} note 29, at 444, 465.
\item \textsuperscript{212} See \textit{id}. at 444 & n.31.
\item \textsuperscript{213} See \textit{id}. at 465.
\end{itemize}
ity in federal securities causes of action. Indeed, the Supreme Court rejected at least one form of such a defense in Basic, Inc. v. Levinson, while at least one other court completely rejected a business judgment defense in a section 10(b) and Rule 10b-5 cause of action. What this Note does seek to do, though, is apply Eisenberg's policy concerns to corporate management faced with the task of having to comply with Item 303's less than apparent disclosure standards.

As discussed supra, Item 303's disclosure standard varies greatly with the facts available to management and, to a certain extent, requires management to make predictions regarding the effects of currently known trends that may not be material. These factors combine to put management in a position where, although it may have diligently prepared the MD&A section, it could be held liable for an omission of a trend or uncertainty that it either considered unimportant at the time, or which had ultimate results that management could not accurately forecast with the information at hand. Thus, similar concerns that Eisenberg focused upon also apply to Item 303 disclosure; courts should therefore recognize the precarious position that the managements of reporting companies face. The remaining question concerns how a court can go about recognizing management's position using the diverging standards.

B. The Standard of Conduct for Item 303 Disclosure

Stated simply, the standard of conduct for Item 303 disclosure is this: a company must make all mandatory Item 303 disclosures in its filings with the SEC. Gauging whether a company has complied with this standard of conduct begins with a look at the reporting requirements dictated by Congress and the SEC. Congress provided the SEC

214 485 U.S. 224, 234 (1988) (finding that assessment of whether merger discussions are significant to investors is not overridden by the corporation's need for secrecy); see also Kitch, supra note 126, at 880 (noting the "absence of any role for business judgment in the Supreme Court's securities law jurisprudence").

215 See Backman v. Polaroid Corp., 893 F.2d 1405, 1990 WL 3832, at *13 (1st Cir.) (refusing "to accept any theory of a business judgment defense to scienter that extends beyond" the good-faith defense), withdrawn and rev'd en banc on other grounds, 910 F.2d 10 (1st Cir. 1990). The applicability of the business judgment defense to causes of action brought under sections 11 and 12 of the Securities Act also seems questionable in consideration of the strict liability nature of those sections. See supra Part III.B–C.

216 See supra Part II.B.2.

217 See, e.g., 17 C.F.R. § 229.303(a)(3)(ii) (2000). This regulation requires management to "describe any known trends or uncertainties" that "the registrant reasonably expects will have a material favorable or unfavorable impact on results of operations." Id.
with primary responsibility for developing disclosure standards under the federal securities laws.\textsuperscript{218} Companies that seek to comply with the disclosure standards of the federal securities laws therefore follow the guidance and interpretations provided by the SEC. The SEC provided such guidance for MD&A disclosure in its 1989 Release. Therefore, any court determining whether a company failed to make a mandatory Item 303 disclosure should retroactively apply the two-pronged analysis in the 1989 Release.\textsuperscript{219}

The \textit{Steckman} court was one of the few courts to use the 1989 Release’s two-pronged analysis to determine whether the company should have disclosed information under Item 303.\textsuperscript{220} In analyzing the first prong, the \textit{Steckman} court found that, based on prior experience, the company could not deem the earnings trend “not reasonably likely to occur.”\textsuperscript{221} Proceeding to the second prong, however, the \textit{Steckman} court found that the company—again, based upon prior years’ earnings trends—could have found that the slowdown was not reasonably likely to have a material effect.\textsuperscript{222} Therefore, the second prong allowed management, based upon specific facts of which it had knowledge, to avoid disclosure of the trend and its possible future effects. Using the two-pronged analysis, the \textit{Steckman} court found that—in the language of this discussion—the defendant had complied with the relevant standard of conduct.

Had the court in \textit{Shaw} used the two-pronged analysis, it might very well have reached a different result on at least one of the allegations. The \textit{Shaw} case involved an allegation that management’s statement in MD&A that a $443 million restructuring reserve was “adequate” was misleading when in July of 1994 management increased the reserve to $1.2 billion.\textsuperscript{223} The gravamen of the plaintiffs’ complaint was that DEC’s statement of an existing $443 million re-

\begin{footnotes}
\footnotetext[218]{\textsuperscript{218} See, e.g., 15 U.S.C. § 77g(a) (1994) ("[R]egistration statement shall contain such other information... as the Commission may by rules or regulations require."); id. §§ 78m(a)(1), 78o(d) (same).}
\footnotetext[219]{\textsuperscript{219} See \textit{Steckman} v. Hart Brewing, Inc., 143 F.3d 1293, 1297 (9th Cir. 1998) (adhering to the formula in the 1989 Release “[s]ince we must give substantial deference to the SEC’s interpretation of the securities laws” (citation omitted)).}
\footnotetext[220]{\textsuperscript{220} See \textit{id.}; see also \textit{Ferber} v. Travelers Corp., 802 F. Supp. 698, 711 (D. Conn. 1992) (analyzing whether defendant had disclosed “known trends” and “uncertainties” regarding real estate investments).}
\footnotetext[221]{\textsuperscript{221} \textit{Steckman}, 143 F.3d at 1297.}
\footnotetext[222]{\textsuperscript{222} \textit{Id.}}
\footnotetext[223]{\textsuperscript{223} \textit{Shaw} v. Digital Equip. Corp., 82 F.3d 1194, 1201 (1st Cir. 1996). The plaintiffs also alleged that management knew of facts regarding higher than expected losses for the third quarter of the company’s 1994 fiscal year (which ended eleven days after the filing of the prospectus). See \textit{id.} at 1207.}
\end{footnotes}
The amount of a restructuring reserve implicates the liquidity and capital resources disclosure requirements of Item 303, which require the disclosure of "known material trends" that are reasonably likely to result in material changes in those areas. The plaintiffs were essentially claiming, then, that Item 303 required DEC to disclose any increased restructuring activities of which it knew at the time of the filings.

An accounting reserve—such as DEC's restructuring reserve—is in effect an amount of money that management sets aside to provide for future costs related to a particular activity or event. Thus, the plaintiffs' allegation that DEC did not disclose known restructuring activities that resulted in a $1.2 billion charge four months later was essentially a claim that DEC failed to disclose known restructuring activities related to a potential reserve that is by definition a prediction of the costs of future restructuring activities. In the framework of the 1989 Release's two-pronged analysis, disclosure was mandatory if: (1) DEC not only knew of increased restructuring activities, but also could not determine that the increased reserve (again, an increase set up four months later to provide for future restructuring costs) was not reasonably likely to occur; and (2) at the time of the filing, in its objectively reasonable assessment, DEC could not determine that the costs of current restructuring activities would not exceed the existing reserve to the extent of not being reasonably likely to have a material effect.

Given that the Shaw court had to accept the plaintiffs' allegations that DEC management had knowledge of increased restructuring activities at the time of the SEC filings, its ability to analyze the first prong was limited. However, the Shaw court could very well have found that the four month period between the statement regarding the $443 million reserve in the SEC filings and the announcement of the $1.2 billion increase was too long to attribute DEC management with any objectively reasonable expectations of the increase. In an unrelated part of the opinion, the Shaw court even mentioned the possibility of "circumstances, [where] the relationship between the nonpublic information that plaintiffs claim should have been disclosed and the actual results or events that the undisclosed information supposedly would have presaged will be so attenuated that the undisclosed information may be deemed immaterial as a matter of

224 See id. at 1211.
225 See 17 C.F.R. § 229.303(a)-(2) (2000).
Despite the court’s mention of the word “immaterial,” another way of stating this in the context of Item 303 disclosure is as follows—although the trend or uncertainty might have been known to management, it was not such that management could have determined, at the time of filing, that it was reasonably likely to have led to the results for which the plaintiff is suing. With this formulation, no Item 303 violation occurred and DEC therefore complied with the standard of conduct. This is not to say that the Shaw court was necessarily wrong in its conclusion; this Note asserts merely that had the Shaw court analyzed DEC’s conduct from the standpoint of the SEC’s interpretations—specifically, using the 1989 Release—it might have reached a different result.

C. The Standard of Review for Item 303 Disclosure

Once a court finds that a reporting company has violated the standard of conduct related to Item 303 disclosure, it next must determine whether liability should attach to the violation. Not all Item 303 violations reach a level of materiality necessary for liability; a court should therefore recognize the appropriateness of a divergent standard of review. This standard of review requires a look at whether the violation in question touches on material facts. Put in the Supreme Court’s wording, a court should review whether the omissions or misstatements affect information for which there exists a “substantial likelihood” that the information would have “been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information.”

Important policy considerations provide a basis for applying this separate standard of review in such instances. Although investors might wish to have access to all the information regarding a company, some commentators have questioned whether too much information might actually be a problem. Hence, Congress gave the SEC the responsibility to “strike[e] a healthy balance” between burdens imposed upon companies and the purported insatiable appetite of in-

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227 Shaw, 82 F.3d at 1210–11 (citations omitted).
228 See discussion supra Part II.B.2.
230 See Cox et al., supra note 1, at 48 (“For users of information, more is always better, especially if the cost of acquiring it is borne by another—the issuer.”).
231 See, e.g., id. at 48 (stating that disclosure rules “driven solely by the information demands of users lack natural constraints on the burdens to be imposed upon issuers”); Kitch, supra note 126, at 850–51; Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 16–17 & n.48 (1983).
vestors for information.\textsuperscript{232} Furthermore, in \textit{TSC Industries, Inc. v. Northway, Inc.}, the Supreme Court recognized that "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good."\textsuperscript{233} This concern led to the Supreme Court's development of a materiality standard in \textit{TSC Industries}.\textsuperscript{234}

An important point is that the court's inquiry should focus on the materiality of the omission or misstatement, not, as some courts have done, on the nature of the cause of action being brought.\textsuperscript{235} Although sections 11 and 12 under the Securities Act contain standards akin to negligence,\textsuperscript{236} while Rules 10b-5 and 14a-9 actions contemplate fraud,\textsuperscript{237} the real issues are: (1) whether the reporting company violated Item 303 and (2) whether the violation reached the requisite materiality level. Whether a material violation of Item 303 occurred in a fraudulent or merely negligent manner is secondary to the initial analysis under the standard of conduct determining whether the violation occurred and the separate standard of review to determine whether the violation was material. This framework recognizes the informational role of Item 303 within the reporting requirements developed by the SEC and provides a more orderly manner for courts to determine whether and how allegations of Item 303 violations should cause liability to attach.

\textbf{CONCLUSION}

The role of Item 303 within the federal securities laws is vital, pervasive, and, unfortunately, entirely unclear. The only thing that appears certain is that Item 303 can produce a duty to disclose under

\begin{itemize}
\item \textsuperscript{232} Cox et al., \textit{supra} note 1, at 48.
\item \textsuperscript{233} \textit{TSC Indus., Inc. v. Northway, Inc.}, 426 U.S. 438, 448 (1976).
\item \textsuperscript{234} \textit{See id. at} 449.
\item \textsuperscript{235} \textit{See, e.g., Oran v. Stafford,} 226 F.3d 275, 281 n.9 (3d Cir. 2000) (refusing to consider an Item 303 violation as sufficient in a Rule 10b-5 cause of action); Stockman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998) (differentiating implied causes of action under Rule 10b-5 from express causes of action under sections 11 and 12 for purposes of determining liability for an Item 303 violation).
\item \textsuperscript{236} The language of section 11 contemplates conduct that includes a reasonable investigation—and reasonable belief based upon such investigation—into the truth of statements in the registration statement and into whether any material omissions existed. \textit{See 15 U.S.C. § 77k(b)(3)(A) (1994).} Section 12(a)(2) contains a similar standard of conduct that requires an individual to "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known," of any untruth or omission. \textit{Id. § 77l(a)(2) (Supp. IV 1998).}
\item \textsuperscript{237} \textit{See 17 C.F.R. §§ 240.10b-5(b)–(c), 240.14a-9(a) (2000).}
\end{itemize}
the federal securities laws.\textsuperscript{238} Although the \textit{Steckman} court attempted to provide Item 303 with more potency by deeming it presumably material for actions under sections 11 and 12(a)(2) of the Securities Act,\textsuperscript{239} such a presumption appears incorrect.\textsuperscript{240} With the exception of \textit{Steckman}, courts have encountered difficulty in determining what role Item 303 should play in a private cause of action. The difficulty is easy to understand as Item 303's disclosure standard is fact-specific and does not always necessarily implicate materiality.\textsuperscript{241}

Despite Item 303's problems, because balance sheets, income statements, and the other hard information included in SEC filings are mere historic pictures of a company's success or failure, courts should provide Item 303 with some bite. Allowing cases to proceed based on omissions or misstatements of mandatory Item 303 disclosure protects Item 303's vital role of providing investors with useful insight into management's view of the company. However, the bite that courts give to Item 303 should be tempered by the acknowledgement that Item 303 disclosures, like other mandatory disclosures under the federal securities laws, in many instances only reflect the SEC's determination of "information that on average will be considered useful, if not important, to investors and shareholders."\textsuperscript{242}

Furthermore, the MD&A disclosures that Item 303 mandates are necessarily a function of management's judgments and decisions regarding the information it has at a particular point in time. Holding management liable under a negligence or strict liability standard of review ignores completely the many factors and variations that affect a business from day to day and their effects on management's judgments. A distinct standard of review that attempts to discern the difference between material and immaterial failures to acknowledge known trends and their reasonably expected effects from future results could operate to dismiss securities cases that should not go beyond a motion to dismiss.

\textsuperscript{238} See supra notes 67–68 and accompanying text.

\textsuperscript{239} See \textit{Steckman}, 143 F.3d at 1296.

\textsuperscript{240} See supra notes 177–80 and accompanying text.

\textsuperscript{241} See supra Part II.B.

\textsuperscript{242} COX ET AL., supra note 1, at 51.