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SECOND CIRCUIT CLARIFIES BESPEAKS-CAUTION DOCTRINE

In a recent decision, the Second Circuit Court of Appeals explained the scope and application of the bespeaks-caution doctrine, a judicially created doctrine that protects an issuer or affiliate from liability based on forward looking statements if the statements are tempered by cautionary language. In *Iowa Public Employees' Retirement System, et al. v. MF Global Ltd., et al.*, the appeals court revived a class action lawsuit brought by a group of pension funds against MF Global Ltd. ("MF Global"), which accused the brokerage firm of misleading investors about its risk management procedures.¹ A three judge panel, led by Chief Judge Dennis Jacobs, vacated the District Court's dismissal of plaintiffs' claims and remanded the case for further proceedings. In so doing, the Second Circuit clarified that the bespeaks-caution doctrine applies only to forward looking statements and that courts must take care in differentiating between forward looking statements and statements rooted in present or historical facts.

Background

On February 27, 2008, a broker at MF Global lost \$141.5 million speculating in wheat futures, by taking positions that exceeded the firm's trading limits and collateral requirements. MF Global absorbed the loss. When news of the trading incident reached the markets, MF Global's stock price fell 28% and continued to fall the day after, resulting in a \$1.1 billion loss. The incident revealed that MF Global's risk controls had not been applied to brokers trading for their own accounts.

In March 2008, a group of pension funds that owned MF Global stock sued MF Global, Man Group (the hedge fund that owns MF Global), the underwriters for MF Global's July 2007 IPO, and MF Global's officers and directors, asserting claims under sections 11, 12(a)(2) and 15 of the 1933 Securities Act. The key allegation was that defendants misrepresented and failed to disclose material information concerning failures of risk management in the prospectus and registration statement that MF Global issued when it went public. On July 16, 2009, the District Court granted defendants' motion and dismissed the case in its entirety.²

The Second Circuit focused on the trial court's treatment of plaintiffs' allegations of misrepresentations and omissions regarding MF Global's risk management system.

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

² *Rubin v. MF Global Ltd. et al.*, 634 F. Supp. 2d 459 (S.D.N.Y. 2009). The District Court dismissed the complaint without prejudice and granted leave to replead upon request. *Id.* at 474-475. The plaintiffs subsequently proffered an amended complaint but the court denied leave to replead.

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The District Court dismissed those allegations on the ground that the prospectus contained sufficient cautionary warnings about the risk management system so as to render any misrepresentations or omissions immaterial as a matter of law pursuant to the bespeaks-caution doctrine. The District Court found it “appropriate to apply the ‘bespeaks-caution’ doctrine here because plaintiffs’ objections to misrepresentations about specific or general shortcomings in MF Global’s risk management system that existed at the time the Prospectus was issued are, if fact, objections to Defendants’ alleged failure to disclose the possibility that the risk management system might be unable to prevent future negative outcomes.”³

Second Circuit’s Decision

The Second Circuit vacated the District Court’s dismissal of the risk management allegations, finding that the trial court applied the bespeaks-caution doctrine “too broadly” and “misstate[d] the threshold test.”⁴

Under the bespeaks-caution doctrine, “[a] forward-looking statement accompanied by sufficient cautionary language is not actionable because no reasonable investor could have found the statement materially misleading.”⁵ The Second Circuit concluded that, in applying the doctrine, the District Court failed to differentiate between forecasts and statements based on present or historical facts. Chief Judge Jacobs concluded that the trial court applied the doctrine to “immunize any statement that the court deemed to be ‘essentially alleging’ the non-disclosure of a risk, regardless of whether the statement looked to the future or was rooted in the known present.”⁶ The Second Circuit explained that “while it is true that predications about the future can represent interpretations of present facts (and vice versa), there is a discernible difference between a forecast and a fact, and courts are competent to distinguish between the two.”⁷

Recognizing that the “line can be hard to draw” in distinguishing a forecast from a fact, but opting not to “undertake to draw one” here, the Second Circuit offered some guidance. “[A] statement specifying the risk of default is distinct from a statement of present or historical financial instability, even though they both bear upon the same risk. And a statement of confidence in a firm’s operations may be forward-looking—and thus insulated by the bespeaks-caution doctrine—even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.”⁸ The Second Circuit also noted that while a statement can have forward looking elements and non-forward looking elements, they are “severable.”⁹ To further guide the District Court, the Second Circuit noted that “characterizations of MF Global’s risk-management system – that the system was ‘robust,’ for example – invite the inference that the system will reduce the firm’s risk. However, bespeaks-caution does not apply insofar as those characterizations communicate present or historical fact as to the measures taken.”¹⁰

The Second Circuit remanded the case to the District Court to analyze plaintiffs’ allegations under this standard.

Practical Implications

The Second Circuit’s decision not only revives plaintiffs’ case, but clarifies the application of the bespeaks-caution doctrine. Although it is settled that the doctrine applies to forward looking statements, a distinction must be drawn between statements that invite an inference of reducing risk in the future and characterizations that communicate a present or historical fact. As the Second Circuit noted, “[t]he bespeaks-caution doctrine is a corollary of ‘the well-established principle that a statement or omission must be considered in context.’”¹¹ The decision confirms this principle.

³ *Id.* at 472.

⁴ 2010 WL 3547602, at *4

⁵ *Id.* at *2.

⁶ *Id.* at *4.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at *5.

¹¹ *Id.* at *2 (internal citations omitted).

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