

BEWARE OF VAPORWARE: PRODUCT HYPE AND THE SECURITIES FRAUD LIABILITY OF HIGH-TECH COMPANIES

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INTRODUCTION

"*Vaporware* is a product that the vendor keeps promising is about to arrive any moment (*real soon now*)—but it goes so long past its shipment date that no one really believes it will ever really ship. Sometimes it never does."¹

On May 30, 1991, a jury in northern California found that Apple Computer, Inc., while promoting its Lisa computer and Twiggy disk drive to potential consumers, had made overly optimistic statements that misled investors under the federal securities laws. The verdict the jury rendered would have resulted in damages exceeding \$100 million.² Although the trial judge ultimately set the verdict aside,³ the point was made: potentially huge securities liability can arise from statements made by corporate officials to promote their companies' products. Nothing in the judge's decision to set aside the verdict changed the fact that at another time and place a jury could render an equally large verdict on similar facts.⁴

Beyond the law of false advertising, antitrust, and products liability, corporate executives and their counsel now have this perilous new hazard to contend with when promoting products. The risk of liability is especially great in high-tech industries due to the pervasive problem of

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1. ROBIN WILLIAMS, JARGON: AN INFORMAL DICTIONARY OF COMPUTER TERMS 576 (1993).

2. Ken Siegmann, *Apple Verdict Stuns Lawyers*, S.F. CHRON., June 1, 1991, at B1. This case will be referred to hereinafter as *Apple*.

3. The case was eventually settled out-of-court for \$16 million, with more than half of that amount going to plaintiffs' attorneys. Victoria Slind-Flor, *Spoils of Apple*, NAT'L L.J., Apr. 13, 1992, at 2.

4. In setting aside the verdict, the judge noted that the jury had found two individual Apple employees liable, yet exonerated their employer, Apple, creating an irreconcilable conflict given an employer's agency liability for the torts of its employees. See *In re Apple Computer Sec. Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,252, at 91,341 (N.D. Cal. Sept. 6, 1991).

"vaporware"—the practice by virtually all high-tech companies of pre-announcing products that may be months, if not years, away from the market.⁵ Indeed, these products often *never* reach the market, and if they do, they often incorporate few of the features that were once so optimistically promised.

Although the federal securities laws contain numerous anti-fraud provisions, the 1934 Securities Exchange Act's Section 10(b)⁶ and its complementary Rule 10b-5⁷ have eclipsed the others.⁸ At any one time, there are at least 500 to 700 class action securities fraud suits pending against American corporations,⁹ most centering their claims upon Section 10(b) and Rule 10b-5.¹⁰ In the 1990-1991 period, 300 such class action suits were filed¹¹—nearly triple the annual rate in the 1988-1989 period.¹² Such suits seldom involve claims for less than \$25 million, often exceed \$200 million, and occasionally top \$1 billion.¹³

In part because of the extremely high costs of litigating such suits (an average of \$692,000 per suit),¹⁴ most are settled out of court.¹⁵ *Small*

5. For some background on the origins of the term "vaporware," see Esther Dyson, *Beware the Hypervapor!*, FORBES, July 13, 1987, at 478.

6. 15 U.S.C. § 78j(b) (1988) [hereinafter Section 10(b)].

7. 17 C.F.R. § 240.10b-5 (1993) [hereinafter Rule 10b-5].

8. See J. ROBERT BROWN, THE REGULATION OF CORPORATE DISCLOSURE § 28.2 (1994) ("Without a doubt, Rule 10b-5 quickly became the most significant anti-fraud provision.").

9. William Tucker, *Shakedown?*, FORBES, Aug. 19, 1991, at 98.

10. Depending on the facts, many other claims may be relevant and are often included in securities class action suits. These may include private claims for damages under Sections 11 and 12 of the 1933 Securities Act, 15 U.S.C. § 77(j), (k) (1988), the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968 (1984 & Supp. 1991), and various state statutory and common law claims.

Nor can companies ignore the SEC's authority under the Securities Enforcement Remedies Act of 1990 ("SERA") to bring civil actions to impose fines of up to \$100,000 against individuals and \$500,000 against companies, as well as the power to refer certain matters to the Department of Justice for criminal proceedings.

11. Richard B. Schmitt, *More Companies Succeed in Defending Charges That They Defrauded Investors*, WALL ST. J., Apr. 30, 1992, at B1.

12. Harvey L. Pitt & Karl A. Groskaufmanis, *Shareholder Suits Suggest Some Lessons*, NAT'L L.J., Aug. 10, 1992, at 24 [hereinafter Pitt & Groskaufmanis, *Lessons*]. See also Linda Himelstein, *Monkey See, Monkey Sue*, BUS. WK., Feb. 7, 1994, at 112 ("[S]hareholder class actions filed in federal courts have increased by 57% in the past four years, while the number of companies sued has risen only 4.6%.")

13. Tower C. Snow, Jr., *Stock Crash Needn't Lead to Legal Hash*, WALL ST. J., Nov. 8, 1993, at A14.

14. Brent Bowers & Udayan Gupta, *Shareholder Suits Beset More Small Companies*, WALL ST. J., Mar. 9, 1994, at B1 (citing study by National Venture Capital Association).

15. See Udayan Gupta & Brent Bowers, *Small Fast-Growth Firms Feel Chill of Shareholder Suits*, WALL ST. J., Apr. 5, 1994, at B2 (citing National Economic Research Associates, Inc. study "that of 165 cases resolved in year ending June 1993, 136 were settled, 24 were dismissed, and only five resulted in judgments").

companies pay an average settlement of \$4.5 million per suit, while the overall settlement average is around \$10.8 million per suit.¹⁶ *In toto*, class-action defendants in shareholder suits paid approximately \$1.55 billion in 1992 alone to settle such suits.¹⁷ This trend shows little sign of abating.¹⁸

Most securities litigation arises from securities filings describing corporate earnings and projected financial performance. In light of *Apple*, plaintiffs' class action attorneys who have previously combed annual reports, 10-Qs, 8-Ks, etc. for overly optimistic statements following a reported drop in earnings, now have a similarly powerful incentive to scrutinize earlier product announcements and product press releases when product performance does not measure up to product hype or when products do not hit the market when promised.¹⁹ Even before *Apple* was litigated, computer-related and other high-tech firms were more frequently the target for securities class action suits than companies in other industries,²⁰ perhaps because of the ubiquitous vaporware problem.²¹ The ruling in the *Apple* case thus demands that a new set of guidelines be drawn up for the evaluation of the permissible boundaries of this product hyping.

Part I of this article will describe the role that product marketing plays in the success of computer manufacturers and other high-tech companies

16. Bowers & Gupta, *supra* note 14, at B1.

17. *Id.*

18. Gupta & Bowers, *supra* note 15, at B2.

19. See Harvey Pitt & Karl Groskaufmanis, *When Corporate Hype Means Hyper-Verdicts*, N.J. L.J., July 11, 1991, at 10 [hereinafter Pitt & Groskaufmanis, *Hyperverdicts*] ("The Apple Computer jury verdict will surely encourage shareholder suits—a trend likely to continue even if the jury's decision is overturned . . .").

20. See Tucker, *supra* note 9, at 98 (describing numerous suits against high-tech firms as "a kind of tax on American businesses trying to survive in a tough industry and a tough world"); Andrew Blum, *Securities Class Actions Are Settled for Less*, NAT'L L.J., Jan. 17, 1994, at 17 (stating that a disproportionately large number of securities "class action suits [were] filed against high-technology companies").

21. The modest good news for high-tech companies is that in recent years the federal courts, and even perhaps the SEC, have shown an increased hostility to the "cookie-cutter" class action securities fraud lawsuit. See Bowers & Gupta, *supra* note 14, at B1 (noting that judges are throwing out as many as 40% of shareholder lawsuits); Paul T. Friedman & Jordan Eth, *9th Circuit Acts Quickly on Fraud Suits*, NAT'L L.J., Jan. 24, 1994, at 19 (noting "the nationwide trend toward early scrutiny of securities fraud actions").

In addition, the SEC is considering becoming more active in curbing unnecessary shareholder litigation by intervening in lawsuits it considers frivolous. See Christi Harlan, *SEC's Levitt Talks of Active Attempts to Curb Litigation*, WALL ST. J., Jan. 27, 1994, at B7. Also, numerous bills have been introduced in Congress for the purpose of revamping Section 10(b) in a pro-defendant direction. See generally Susan Antilla, *Changing the Rules for Class Actions*, N.Y. TIMES, Mar. 27, 1994, at F13.

in the U.S. economy and the impact that product marketing activity has upon the securities markets. In so doing, the article will highlight the problem of vaporware, high-tech marketing's dirty little not-so-secret secret. Part II will analyze the basic elements of recovery in a lawsuit brought under Section 10(b) and Rule 10b-5, highlighting cases (including *Apple*) arising from vaporware announcements and other product marketing. Finally, part III will give advice as to how companies can minimize securities litigation exposure stemming from product hyping.

I. HIGH-TECH PRODUCT MARKETING AND ITS IMPACT UPON THE SECURITIES MARKETS

A. High-Tech Product Marketing

The importance of marketing to the success of most businesses cannot be gainsaid.²² Whether selling services or products, a company generally must have an effective, multi-faceted marketing strategy. Nowhere is the importance of effective marketing greater than in high-technology industries.²³ In this country, market forces are currently imposing more uniformity in terms of technological standards upon computers and other high-tech equipment.²⁴ As a result, it is becoming more difficult for companies to distinguish their products with unique technological features. Instead, they must rely increasingly on marketing to provide product differentiation.²⁵

In high-tech industries, efficient manufacturers have often failed due to ineffective marketing.²⁶ In early 1994, for example, Digital Equipment

22. See JOHN SCULLEY, ODYSSEY: PEPSI TO APPLE . . . A JOURNEY OF ADVENTURE, IDEAS, AND THE FUTURE 55 (1987) ("[T]oday marketing is assuming even greater importance for the most successful companies because it is playing an increasing role in adding value to what you sell and in getting that value recognized by the customer."); Wayne G. Fox, *Investment Banking Requirements*, in COMMERCIALIZING SDI TECHNOLOGIES 81-82 (Stewart Nozette & Robert Lawrence Kuhn eds. 1987) ("Marketing is a key factor to business success. Technology doesn't drive business; markets drive business.").

23. WILLIAM L. SHANKLIN & JOHN K. RYANS, JR., ESSENTIALS OF MARKETING HIGH TECHNOLOGY 40 (1987) ("Marketing knowledge and expertise is vital to the success of high-tech firms."); WILLIAM H. DAVIDOW, MARKETING HIGH TECHNOLOGY xviii (1986) ("Increasingly, marketing will determine the fate of [high-tech] companies.").

24. DAVIDOW, *supra* note 23, at xvii.

25. *Id.* So important has marketing become to computer makers that they are raiding potato chip and cookie companies to grab marketers skilled in brand management. Kyle Pope, *New Job Path: From Cookies to Computers*, WALL ST. J., May 9, 1994, at B1.

26. DAVIDOW, *supra* note 23, at xvi (giving examples of Texas Instruments and National

was selling the fastest microchips but struggling mightily due, at least in part, to marketing difficulties.²⁷ Absent effective marketing, even successful brands fade from view.²⁸ More pointedly, entire companies have vanished almost overnight, arguably because of poor marketing of their high-tech products.²⁹ Conversely, other high-tech companies with only slight technological advantages have stayed on top due largely to their marketing abilities.³⁰

Marketing takes on added importance when new products are introduced. The failure rate of new products is very high generally,³¹ and is even higher in high-tech industries like computers.³² Despite the best efforts of marketing experts, the launching of new products remains costly and quite risky.³³ Other than the qualities of the product itself, the most important factor determining the success or failure of a new product is often its promotion.³⁴

Semiconductor entering low-cost calculator and watch markets).

27. John R. Wilke, *Digital's New Chip May Be Too Far Ahead Of Its Time*, WALL ST. J., Feb. 23, 1994, at B4 (noting that Digital's slowest chip is faster than its competitors' fastest chip, yet Digital "doesn't market itself as well as its competitors," according to Digital's CEO).

28. KEVIN J. CLANCY & ROBERT S. SHULMAN, *THE MARKETING REVOLUTION* 6 (1991) ("The average brand in the average category is dying a slow death; its sales erode by about three-tenths of a share point each year.").

29. DAVIDOW, *supra* note 23, at xvi (giving example of Visicorp, which vanished almost overnight after once having a seemingly insurmountable lead in the spreadsheet software market).

30. SHANKLIN & RYANS, *supra* note 23, at 1 ("While IBM is technologically adept, what it really does better than its competition is marketing.").

31. Dee M. Wellan & A.S.C. Ehrenberg, *Successful New Brand: Shield*, 30 J. MARKETING RES. SOC. 35, 35-36 (1988); Christopher Power, *Flops*, BUS. WK., Aug. 16, 1993, at 76 ("Overall, the new-product battleground is a scene of awful carnage.").

32. See generally Nico Krohn, *Not As Easy as 1-2-3*, INFO WORLD, Apr. 1, 1991, at 40 (giving numerous hardware and software examples of new products that flopped).

33. Stephen Factor & Peter Sampson, *Making Decisions About Launching New Products*, J. MARKETING RES. SOC. 185, 196 (1983).

34. DAVID J. LUCK & O.C. FERRELL, *MARKETING STRATEGY AND PLANS* 312 (2d ed. 1985) ("Promotion is the second most critical functional area [besides the product itself] in probably all new products."); Kenneth Traynor & Susan C. Traynor, *Marketing Approaches Used by High Tech Firms*, 18 INDUS. MARKETING MGMT. 281, 286 (1989) ("It is clear that the marketing efforts of high-tech firms are as important, if not more important, than the reliance on state-of-the-art technology.").

There is evidence that the failure of Apple's Lisa computer, a key focus of the *Apple* litigation, was largely a marketing problem. See LEE BUTCHER, *ACCIDENTAL MILLIONAIRE: THE RISE AND FALL OF STEVE JOBS AT APPLE COMPUTER* 177 (1988) (pointing out that Lisa failed despite incorporating the newest technology because its advertising was "schizophrenic," causing John Sculley, when he assumed power as chief executive at Apple, to focus on marketing and advertising).

Product promotion is equally critical for competitors who enter the market later. See Gary Lilien & Eunsang Yoon, *The Timing of Competitive Market Entry: An Exploratory*

B. The Means of Market Hying

High-tech companies utilize many forms of product promotion and marketing, several of which involve making representations about their products' availability and qualities.³⁵

The *Apple* case itself involved popular forms of promotion. Plaintiffs predicated their claims upon alleged misstatements or omissions contained in, among other communications, product press releases issued at a trade show. Conventions and trade shows have been particularly important forms of product promotion in the computer business.³⁶ Whether made at conventions and trade shows or in some other venue, product press releases are an inexpensive and relatively efficient method of promoting a new product.³⁷ Apple is far from the only company to have made

Study of New Industrial Products, 36 MGMT. SCI. 568, 570-72 (1990) ("[L]ater entrants may be able to leapfrog earlier entrants by introducing superior products if those products are backed by heavy marketing investment.").

35. Making claims for one's product is only a small part of the science of marketing. Many important aspects of marketing do not involve such representations, including: (a) pricing strategies, see Ford S. Worthy, *Japan's Smart Secret Weapon*, FORTUNE, Aug. 12, 1991, at 72 (Japanese companies use pricing policies to shape products, gaining competitive advantage); (b) distribution strategies, see Kate Bertrand, *Apple Bites Back*, BUS. MARKETING, Aug. 1991, at 12 (Apple Computer switching to mass distribution in attempt to gain market share); (c) product-life cycle management, see Rajendra K. Srivastava, *Strategic Issues in Life-Cycle Management*, in CONCURRENT LIFE CYCLE MANAGEMENT 79, 80 (Fred Y. Phillips ed., 1991) (illustrating with example of Motorola's commitment to its 68000 series microchip that "[t]he concept of product life-cycles is one of the most pervasive constructs in the marketing discipline"); (d) scientific timing of market entry, see Lilien & Yoon, *supra* note 34, at 568 ("choice of market-entry time is one of the major reasons for new product success or failure"); (e) market segmenting, see BENSON P. SHAPIRO & THOMAS V. BONOMA, SEGMENTING THE INDUSTRIAL MARKET (1983) (addressing, *inter alia*, differences between segmenting industrial markets and segmenting consumer markets); (f) inducement of the support of other stakeholders, such as vendors, government and regulatory agencies, independent testing and evaluation groups, and financial analysts when launching a new product, see Vijay Mahajan & Jerry Wind, *Marketing Hype: A New Perspective for New Product Research and Introduction*, 4 J. PRODUCT INNOVATION MGMT. 43, 44 (1987) (suggesting a comprehensive model of "marketing hype" for establishing conditions conducive to acceptance of a new product); and (g) sales force motivation, see Ira Sager, *IBM Leans on Its Sales Force*, BUS. WK., Feb. 7, 1994, at 110 (IBM restructures incentives to reward sales representatives for profitability and customer satisfaction rather than for gross sales levels.).

36. See, e.g., SHANKLIN & RYANS, *supra* note 23, at 211 ("[A]n important point of interaction between the high-technology company and outsiders is often the trade show or fair."); MICHAEL S. TOMCZYK, THE HOME COMPUTER WARS 92-93, 113, 280 (1984) (noting importance of consumer electronics conventions to development of Commodore Business Machines.).

Comdex/Fall 1993 drew 170,000 attendees to Las Vegas and Comdex/Spring 1994 drew 90,000 in Atlanta. Lori Hawkins, *Comdex*, AUSTIN AMERICAN-STATESMAN, May 23, 1994, at C1.

37. JORDAN GOLDMAN, PUBLIC RELATIONS IN THE MARKETING MIX 225 (1984); ROMAN

overly optimistic claims for its products in press releases issued at trade shows.³⁸

Another popular form of product promotion involves company officers speaking to reporters willing to write articles about the product for publication in trade magazines and newspapers.³⁹ Several such statements were at issue in the *Apple* litigation.⁴⁰ In the computer industry, employees of hardware and software makers themselves often write articles that appear in the trade press.⁴¹ Indeed, some high-tech companies have "publish or perish" policies for marketing managers.⁴²

Hyping is also conducted through direct mail⁴³ as well as print and electronic media advertising.⁴⁴ A well-conceived advertising campaign can be quite important to the marketing of many high-tech products.⁴⁵

HIEBING & SCOTT COOPER, *HOW TO WRITE A SUCCESSFUL MARKETING PLAN* 15 (1990).

38. See, e.g., Michael R. Leibowitz, *The Microprocessor Marketing Wars*, *ELECTRONIC BUS.*, July 10, 1989, at 28, 34 (When Intel introduced its 860 microprocessor at the 1989 International Solid State Circuit Conference, it likely overstated its performance, but nonetheless accomplished Intel's goal of establishing itself as a major player in the RISC [Reduced Instruction-Set Computing] field.); TOMCZYK, *supra* note 36, at 280 (Commodore Business Machines officer promised at a June convention to deliver 70 software programs by August 31 even though they could not be manufactured that quickly and many were still not delivered by Christmas of that year).

39. Computer magazines played an integral role in launching the computer industry. See Stan Veit, *Stan Veit's History: Computer Magazines Created the Channels*, *COMPUTER SHOPPER*, Oct. 1991, at 693 ("Personal computer magazines existed before the start of the computer revolution. . . . [Hobbyists' newsletters] planted the seeds of personal computing.").

40. For example, in introducing Lisa, the new computer that was the focus of much of the *Apple* litigation, Apple Computer officials flew from California to New York in order to demonstrate the machine to influential members of the press and investment community. FRANK ROSE, *WEST OF EDEN: THE END OF INNOCENCE AT APPLE COMPUTER 9* (1989).

41. When Intel launched the model 8086 microprocessor, its employees wrote many articles for the trade press, and even induced customers to write articles. DAVIDOW, *supra* note 23, at 8 ("In all, more than fifty articles were published in the trade press.").

42. Dan T. Dunn, Claude A. Thomas & Samuel Rabino, *Additional Perspectives: Marketing High-Tech Services: Target Your Sales*, in *ESSENTIALS OF MARKETING HIGH TECHNOLOGY* 105 (William L. Shanklin & John K. Ryans, Jr. eds., 1987).

43. See Joyce Lane, *Promotion Peddlers Tug on the Reins*, *BUS. J.-SAN JOSE*, Apr. 28, 1986, § 1, at 6 (noting rise in use of direct mail by computer companies). The most convincing evidence of the use of direct mail may simply be the number of catalogs and other promotional mailings that likely fill the reader's own mailbox.

44. Jan Jaben, *Marketing's New Fast Lane Emerges*, *BUS. MARKETING*, Oct. 1993, at 20 (In 1992, America's top 100 business-to-business computer marketers alone spent nearly \$1 billion on advertising in specialty publications, \$1 billion in consumer magazines, \$231 million in national newspapers, nearly \$2 billion on network TV, \$211 million on cable TV, and more than \$80 million on network radio.).

45. E.g., DANIEL ICHBIAH & SUSAN L. KNEPPER, *THE MAKING OF MICROSOFT* 166-167 (1991) (describing ads used by Microsoft to launch Excel software); Robert D. Hof, *Inside Intel*, *BUS. WK.*, June 1, 1992, at 86, 92 ("Intel scored a coup with a 1988 ad campaign promoting its low-cost, SX version of the 386. That previously obscure product took off to

All of these various types of marketing communications regularly contain promises regarding the availability, innovativeness, durability, reliability, efficiency, speed, and other qualities of the companies' high-tech products. Because these representations carry the potential for misleading investors as well as consumers, all of these avenues of communication are of concern in this article. In the high-tech field, one particular form of product promotion deserves special attention.

C. "Vaporware": High-Tech Marketing's Dark Side

In order to be successful in highly competitive high-tech industries, companies must publicize not only their current products, but also their soon-to-be-available products.⁴⁶ High-tech companies often use a wide assortment of the previously described promotional tools in a coordinated effort to launch new products. "Market hyping," defined as "a set of predominantly pre-launch activities leading to the creation of a market environment most conducive to the acceptance of a new product," has been touted as a key to successful marketing of new products.⁴⁷ Indeed, pre-launch hyping has almost become a ritualized process in the computer industry.⁴⁸ The actual introduction of the product itself may be an ambitious, hoopla-filled event.⁴⁹ Several factors necessitate this pre-

become the company's all-time best seller.").

46. The computer industry is not the only high-tech industry steeped in vaporware. See Laurie P. Cohen, *Some Biotech Firms Excel at State-of-the-Art Hype*, WALL ST. J., Mar. 13, 1992, at C1 ("Many biotechnology companies have few, if any, products and no earnings. What they do have are lots of press releases.").

47. Mahajan & Wind, *supra* note 35, at 44.

48. Samuel Rabino & Thomas Moore, *Managing New-Product Announcements in the Computer Industry*, 18 INDUS. MARKETING MGMT. 35 (1989); Sam Whitmore, *Buyers Beware Perils of Product Preannouncement* (Editorial), PC WK., June 24, 1991, at 62 ("It's hard to find a major hardware or software firm that isn't preannouncing its future products these days.").

Although ultimately unsuccessful, the introduction of Apple's Lisa computer (which played such a central role in the *Apple* litigation) has been described as "the high-water mark for Silicon Valley flackery." MICHAEL S. MALONE, *THE BIG SCORE: THE BILLION DOLLAR STORY OF SILICON VALLEY* 383 (1985). Apple's launching of the Macintosh was equally exuberant. The company helped at least fourteen trade magazines prepare covers, printed 10 million copies of a twenty-page magazine ad, budgeted \$15 million for advertising during the computer's first 100 days of formal existence, and gave more than 60 interviews by Sculley and Jobs. MICHAEL MORITZ, *THE LITTLE KINGDOM: THE PRIVATE STORY OF APPLE COMPUTER* 324-325 (1984).

49. For example, Intel spent six months planning the unveiling of its 860 chip at the 1989 International Solid State Circuit Conference. Leibowitz, *supra* note 38, at 34. Two years of planning went into Apple's launch of its Macintosh computer. ROSE, *supra* note 40, at 150.

introduction build-up of a new product:

(1) It simply takes more in the way of advertising and public relations to launch a new product than to sustain an old one.⁵⁰ This is true, in part, because in the early days of high-tech product introduction, the actual attributes and performance of competing products may be unclear. This ambiguity creates a situation where the company with the most effective marketing pitch will win the day.⁵¹

(2) Product preannouncements may be needed to gain the attention of retailers, suppliers, and related entities such as makers of software whose role in the success of a computer product can be critical.⁵² For instance, consumers do not want to buy hardware that does not offer sufficient software. Vaporware announcements serve to inform software makers as to which direction they need to go to develop software for the new machine.⁵³

(3) Vaporware announcements can enhance consumer acceptance of a new product by diminishing consumer resistance to change.⁵⁴ This allows a company to capture a "mindshare" of the market before the product is even produced.⁵⁵ This is particularly important, for example, if a hardware maker is attempting the ambitious task of moving customers to

50. S. WATSON DUNN & ARNOLD M. BARBAN, ADVERTISING: ITS ROLE IN MODERN MARKETING 319 (1986) ("[I]t takes substantially more advertising money to launch a new product than it does to keep an old one going.").

51. See, e.g., Leibowitz, *supra* note 38, at 31 ("Customers are trying to predict the future, yet with the RISC market in its infancy, they have very little hard information to go on. 'There's enough ambiguity that it is really a marketing pitch that will win or lose this war,' declares Cypress' [T.J.] Rogers.").

52. To illustrate the necessity of software support, in the late 1980s, Sun Microsystems, Inc. invited other computer makers to clone Sun's machines. The notion was that the clones would increase the volume of machines based on Sun's chip so that software developers would write programs for Sun's workstation. This would, in turn, help Sun sell more machines. See Jonathan B. Levine, *High Noon for Sun*, BUS. WK., July 24, 1989, at 70.

53. At a 1986 trade show, Atari announced 138 software programs being developed for its new ST machine, although only 44 were then available. Philip Elmer-DeWitt, *Hardware, Software, Vaporware: Tardy Technology Bedevils an Adolescent Industry*, TIME, Feb. 3, 1986, at 51.

54. See, e.g., LEO BOGART, STRATEGY IN ADVERTISING 72 (1967); Vijay Mahajan, Eitan Muller & Subhash Sharma, *An Empirical Comparison Awareness of Forecasting Models of New Product Introduction*, 3 MARKETING SCI. 179 (1984).

55. Avery Jenkins, *Long Overdue: The Reasons Behind Vaporware*, COMPUTERWORLD FOCUS, Oct. 5, 1988, at 10. A "mindshare" is acceptance by some consumers of a product that is nonexistent, or has yet to be introduced.

a new "architecture."⁵⁶ Some believe that vaporware announcements are the only way firms can break into the computer market with innovative new technological standards.⁵⁷ Without vaporware announcements, it is possible that even if their product is superior, these latecomers will not be able to capture a large enough user base, and will therefore have to conform their specs to those of the first arriver.⁵⁸

(4) Vaporware announcements can also slow down the buying of competitors' products.⁵⁹ For example, in early 1994, as anticipation built over Microsoft's unfinished Chicago operating-system software, Apple announced its System 7 upgrade of Macintosh software in order "to blunt Chicago's momentum," even though Apple's promised improvements were not due to hit the market in some cases until 1996.⁶⁰ On the same day, several personal computer makers announced plans to soon begin marketing machines incorporating Intel's Pentium Chip "in hopes of stealing some fire" from Apple Computer's launch of its new Macintosh line using a speedy PowerPC chip.⁶¹

For these reasons, the preannouncement of the imminent (or not so imminent) availability and attributes of products not yet ready for market is standard operating procedure for most hardware and software makers and many other high-tech companies. In addition to creating advantages

56. See, e.g., Kathy Rebello, *A Juicy New Apple?*, BUS. WK., Mar. 7, 1994, at 88 (explaining the difficult task facing Apple as it attempts to lure customers to its new PowerPC chips).

57. See, e.g., Stephane St-Onge, *General Magic Aims to Set Standard for Tiny Computers*, FINANCIAL POST, July 10, 1993, at C16 (The "strategy of announcing vaporware and creating alliances with large computer and telecommunications firms is the only way a firm can break into the computer market and set standards.").

58. *Id.*

59. Grace Casselman, *Vaporware: Vile or Valid? The Downside of Product Pre-Announcements*, COMPUTING CANADA, Dec. 19, 1991, at 1 (quoting marketing executive Ian Fraser).

For example, in 1990, AST Research announced at the huge Comdex computer show that it would be shipping a powerful notebook computer for under \$4,000. At the time, AST did not even have a working model, though neither did most of the other 130 or so companies that preannounced a similar product. Due to the \$4,000 price tag, which was very attractive at the time, many customers waited to buy until early 1991 when AST's product finally hit the market. Dean Takahashi, *Computer Show Features Wares That Don't Exist*, L.A. TIMES, Oct. 22, 1991, at D8.

60. G. Pascal Sachary & Jim Carlton, *Software Rivals Vying to Define How PCs Work*, WALL ST. J., Mar. 7, 1994, at B1.

61. Jim Carlton & Don Clark, *PC Makers to Launch Machines Using New Version of Intel's Pentium Chip*, WALL ST. J., Mar. 7, 1994, at B6.

for the announcing companies, the practice has various benefits to other parties, including: (a) reassuring major customers that their computer company is on the cutting edge of technology;⁶² (b) informing customers as to the direction a hardware or software supplier is taking so that the customer can plot its own purchasing and implementation strategies;⁶³ (c) giving customer companies time to study various options in order to make an informed decision, especially if they have sufficient flexibility to cope with the fact that vaporware deadlines often go unmet;⁶⁴ (d) enabling customers to budget money for purchases of next-generation hardware and software; and (e) demonstrating to the financial and business communities that a manufacturer knows where technology is heading and plans to lead the charge.⁶⁵

If preannounced products were expeditiously delivered with all of their promised features, the term "vaporware" would not carry the negative connotation that it does. Unfortunately, the pressure to hype often causes overhyping. Companies often announce non-existent products or greatly exaggerate the progress they are making in developing new products solely to discourage customers from buying from competitors.⁶⁶ Frequently, the products exist only in the minds of their developers.⁶⁷ Because of these practices, the term "vaporware" has come to include not only products that are not yet available, but also, and more pejoratively, products that probably will not be available when promised (or any time soon thereafter) and will not have the features that have been warranted.

The practice of announcing especially evanescent vaporware has been around since the beginning of the computer revolution.⁶⁸ Over the years,

62. Casselman, *supra* note 59, at 1.

63. See Linda Bridges, *The Sweet Smell of Vaporware Starts to Turn Sour for Many Micro Managers*, PC Wk., Nov. 17, 1987, at 19 (quoting manager of sales and information planning for Nabisco Brands: "We need to know if the developer is going in the same direction as we are—to know if the same product features that are important to us are important to them.")

64. *Id.* (quoting one commercial customer who likes product preannouncement because it aids in his planning even though deadlines are seldom met).

65. Casselman, *supra* note 59, at 1 (quoting market analyst Brad Casemore).

66. The ethics of this practice have been challenged. Whitmore, *supra* note 48, at 62. Indeed, this practice is roughly analogous to part of the "FUD" (Fear, Uncertainty, Doubt) tactics allegedly used by IBM over the years to retain customers. See REGIS MCKENNA, WHO'S AFRAID OF BIG BLUE 23 (1989) ("If a customer was about to shift to another brand, perhaps for cost reasons, an IBM salesperson might hint that IBM was about to introduce a breakthrough product that would make the competitor's product obsolete."). IBM insiders deny the existence of FUD. See F.G. "BUCK" RODGERS, THE IBM WAY 225 (1986).

67. See generally Takahashi, *supra* note 59, at D8 (noting that 30 companies were preannouncing pen-based computers at the 1991 Comdex computer convention).

68. Elmer-DeWitt, *supra* note 53, at 51 ("Delays and broken promises have bedeviled the

there have been innumerable examples of hardware and software products announced with great fanfare which either (a) never saw the light of day, or (b) had few of the features originally promised when finally brought to market.⁶⁹

The ever-increasing competitiveness of the computer industry has led the practice to become more widespread over time,⁷⁰ and also more exaggerated. Companies not only announce products that are not yet ready to ship, but they also call press conferences to announce that they will at some point in the future announce a future shipping date.⁷¹ Sometimes manufacturers get so carried away with hype that their imagined products do not "even qualify as vapor."⁷² Of more than 130 companies that preannounced notebook computers at the 1990 Comdex convention, fewer than 50 actually delivered a product.⁷³ "This has become a vaporware industry," in the words of one computer executive.⁷⁴

In spite of its obvious advantages for high-tech manufacturers, vaporware also causes significant problems. Consumers may be unable to differentiate real products from imaginary products.⁷⁵ Vaporware announcements place consumers in an unenviable dilemma: buy a lesser product available today or rely on companies to actually produce as promised when promised.⁷⁶ For significant industries with a broad impact on the economy, the problems caused by vaporware are more serious than a hobbyist's simple disappointment at the delay of a new high-tech toy. For example, many aerospace companies often do design work based on preannounced product specifications; when the products do not meet their

computer business since its birth some 35 years ago.").

69. See generally Krohn, *supra* note 32, at 40 (listing several examples of vaporware). Among the more famous examples are the Osborne computer and Gavilan computer, Ovation software, and even the IBM PCjr. Only the PCjr ever made it to market; it was late and flopped badly. *Id.*

70. See, e.g., Jon Zilber, *Where Are They Now? The Vaporware Hall of Fame*, MACUSER, Jan. 1990, at 60 (listing numerous Macintosh products that were hyped but turned out to be nothing but vaporware).

71. Mark L. Paul, *Another Threat to Mail Order Credibility in the Computer Products Field: "Vaporware"*, DM NEWS, Jan. 15, 1988, at 11 (quoting a spokesman for Microsoft).

72. John Schwartz, *The Next Revolution*, NEWSWEEK, Apr. 6, 1992, at 42, 45 (complaining of John Sculley appearing on the cover of Fortune magazine holding a molded plastic prop from a product that did not yet exist).

73. Takahashi, *supra* note 59, at D8.

74. Thomas Yuen, co-chairman of AST Research, Inc., *quoted in* Takahashi, *supra* note 59, at D18. See also Lindsay Van Gelder, *Vaporware for Sale*, LOTUS, Feb. 1988, at 140 ("This marketing technique [of vaporware] is rampant in the computer industry.").

75. Takahashi, *supra* note 59, at D8.

76. See *Users Want Network Vendors to Stop Using "Vaporware" Tactics*, NETWORK WORLD, July 10, 1989, at 4.

deadlines or their preannounced specifications, the aerospace companies are forced to redesign their projects and seek other vendors.⁷⁷

Even when a company delivers on its vaporware, the product preannouncement may have allowed competitors to learn where the company was going with its product development and to incorporate key features into their own competing products.⁷⁸ Announcement of an upcoming product can also substantially slow the sales of the announcing company's currently available products.⁷⁹

When, as is more often the case, preannounced products turn out to be heavily vapor-laden, problems for the announcing company are even more pronounced. For example, vaporware representations to specific customers will likely create an express warranty and the concomitant potential for damages assessed in a breach of warranty action brought under the Uniform Commercial Code or in a common law fraud suit.⁸⁰

Failure to fulfill product promises can seriously, and perhaps irreparably, injure a company's reputation among consumers as well.⁸¹ The fall of Wang Laboratories may well be traced in substantial part to a vaporware announcement of 14 new products in October 1993. Every single one of the products was ultimately delivered later than promised (or not at all), leading Wang customers to switch to competitors in droves.⁸² Vaporware problems can also create bad relations with dealers who are inconvenienced when consumers ask for products they have seen

77. See, e.g., David Hughes, *Computer Infrastructure Critical To Success in Aerospace Industry*, AVIATION WK. AND SPACE TECH., June 22, 1992, at 46 ("[C]omputer hardware and software firms do not always deliver on their promises, and aerospace executives complain about 'vaporware,' or software that is a figment of a salesman's imagination.").

78. Casselman, *supra* note 59, at 1 (quoting computer consultant Amy Wohl).

79. *Id.* (giving as an example Osborne Computer, Inc.; when it announced its next generation computer, the public almost immediately stopped buying Osborne's available computers, throwing the company into bankruptcy from which it did not return because the new generation was never delivered). This problem is particularly nettlesome for hardware manufacturers; software manufacturers often use low-cost upgrades to keep vaporware from "chilling the market." *Id.*

80. See generally Dennis S. Deutsch, *The "Demo" as the Basis of the Fraud and Breach of Contract Claim*, COMPUTER LAW., May 1991, at 22 (describing general UCC warranty rules and their applicability to marketing of software vaporware); Bob Violino, *Take This Disk and Shove It—Users are Fed Up with Vendors' Broken Promises*, INFORMATIONWEEK, July 15, 1991, at 43 (noting that computer hardware and software "vendors who don't deliver on promises [to consumers] can eventually expect to be sued").

81. Even IBM, which long disdained vaporware announcements, has recently damaged its own reputation by not living up to its own product preannouncements. Martin Garvey & John Soat, *Users Blue About IBM Blitz*, INFORMATIONWEEK, Sept. 23, 1991, at 14 (noting consumers are "fed up" with vaporware announcements from IBM).

82. See CHARLES C. KEENEY, RIDING THE RUNAWAY HORSE: THE RISE AND DECLINE OF WANG LABORATORIES 125, 146 (1992).

advertised but do not yet exist, or when consumers stop purchasing products currently on the dealer's shelves in anticipation of the availability of vaporware that may or may not ever arrive.⁸³ Indeed, widespread vaporware announcements can injure the reputation of an entire industry, perhaps causing consumers to avoid making purchases they otherwise would have made.⁸⁴

Financial analysts can also be fooled by vaporware,⁸⁵ potentially creating a backlash in the form of overly skeptical assessments of high-tech companies and their industry. Investors who have purchased small companies have been similarly fooled,⁸⁶ and those wishing to invest in high-tech companies through the stock market have been spooked by vaporware practices.⁸⁷

The problems caused by vaporware announcements have led to various efforts to curb this seemingly ubiquitous practice,⁸⁸ but vaporware remains endemic in the high-tech industries.⁸⁹

83. Lane, *supra* note 43, § 2 at 1 ("Vaporware and otherwise late products have created disappointed and angered customers, dealers and editors, and hurt the reputations of companies with histories of on-time delivery as much as the tardy ones.") (emphasis added).

84. See Jeffrey P. Papows, *A Call for Ethics; The Need for Computer Software Industry Standards for Business Practices*, COMPUTER GRAPHICS WORLD, Mar. 1991, at 116 (noting that "frustration, disappointment, and mistrust" by consumers inevitably ensue from widespread vaporware marketing in the computer graphics industry); Lane, *supra* note 43, § 2 at 6 (suggesting that vaporware "tactics came back to haunt the industry last year," leading projections for 20% growth in the computer industry to go "up in smoke").

85. See, e.g., David Churbuck, *Vapordisk*, FORBES, Oct. 28, 1991, at 188 (giving as an example a First Boston analyst who "gushed" to potential investors that Tandy Corporation's THOR [Tandy High-intensity Optical Recorder] could "remake" the audio market, the video market, and the computer mass-storage market; 42 months later the product was still vaporware).

86. Efreem Mallach, *Avoiding Risk Business: Software Buyer, Know Thy Needs*, COMPUTERWORLD, Oct. 20, 1986, at 17 (giving an example of two investors who bought a small software firm with 50 customers lined up, only to discover that the firm's product existed only in the imagination of its managers).

87. Elmer-DeWitt, *supra* note 53, at 51 ("Vaporware has dented the credibility of the technology [and] frightened investors . . .").

88. For example, some computer societies have begun to refuse to allow companies to demonstrate products that are not already being shipped. Jenkins, *supra* note 55, at 10 (e.g., Philadelphia Area Computer Society).

Certain elements of the computer industry have formed groups dedicated to promoting ethical marketing practices by limiting vaporware announcements. See *Ready for the Chase*, COMPUTERWORLD, Sept. 16, 1991, at 105 (describing efforts of Adapso's Software Business Practices Committee). This group recommends, essentially, that computer companies not preannounce products until (a) planning, designing, coding, and preliminary testing have occurred and beta testing has begun, and (b) the product will be available within a "normal" period of time. See Papows, *supra* note 84, at 116.

89. See, e.g., Marc Dodge, *The Sky Isn't Falling—Yet*, CORP. COMPUTING, June 1993, at 145 (complaining that integrated network management marketers have taken marketing of vaporware to new heights); Ric Ford, *Riding the Wave of New Computing*, MACWEEK, Jan.

Because technological evolution and revolution constantly change performance standards, computer companies must always have products in development in order to remain competitive. The above noted advantages and disadvantages of vaporware announcements make the decision whether to "preannounce" products a difficult one.⁹⁰ Companies must realize that when they overpromise, they risk not only alienating customers and dealers but also investors. They risk not only customers' breach of warranty suits under the UCC, but also shareholders' multi-million dollar securities fraud claims because product preannouncements and other promotional activity affect the company's stock price.

D. Product Marketing's Impact on the Stock Market

Both success and failure of a company's products affect the current and projected financial status of the company and, thereby, the company's stock price. If a company's product is a success, profits rise and stock prices will likely follow. If a company's product fails, profits shrink and stock prices drop.⁹¹ In a well-developed stock market, future developments are anticipated. Thus, vaporware preannouncements and other favorable projections about a company's products will also cause stock prices to rise; unfavorable projections will have the reverse effect.

The purpose of vaporware announcements and other product hype is usually to sell the product with no thought of affecting the company's stock price. Nonetheless, some effect often occurs and is foreseeable to the company making the announcement.⁹²

Furthermore, in some situations, a product announcement is made with

24, 1994, at 46 (complaining of Apple Computer's continuing promotion of vaporware).

90. Casselman, *supra* note 59, at 1.

91. *See, e.g.*, Ron Winslow, *Synergen's Data on Sepsis Drug Dismays Market*, WALL ST. J., Feb. 23, 1993, at A3 (Announcement of adverse test results on company's flagship drug caused share price to drop from \$28-5/8 per share to \$13-1/2 per share in one day; rumors as to these test results had caused the share price to decline from around \$60/share during the preceding month.).

92. *See, e.g.*, Janet Day, *Iceberg Gives Investors Chill*, DENVER POST, Jan. 25, 1992, at C1 (Anticipation of new product announcement drove up stock price of Storage Technology Corporation); Michael Unger, *Enzo Takes Investors on Wild Ride*, NEWSDAY, Jan. 29, 1992, at 35 (Product announcements by small drug company caused a six-fold rise in stock price in three-day period.).

A logical correlate of this effect is that a positive product announcement by Company A can depress the stock price of its competitor, Company B. *See, e.g.*, Joanne Kelley, *Computer Workstation Battle Heats Up, Prices Fall*, REUTER BUS. REP., Jan. 13, 1992 (noting that stock price of Sun Microsystems, Inc. fell as competitors announced new products).

the specific purpose of influencing investors, as opposed to consumers.⁹³ For instance, it is becoming increasingly popular for companies to meet with potential investors at industry conferences simply to expand visibility in order to raise capital.⁹⁴ Companies also tout vaporware at meetings with *securities analysts*.⁹⁵ More flagrantly, companies sometimes make product announcements for the specific purpose of buoying their stock's market price. In 1986, for example, Apple Computer counterbalanced an anticipated negative stock market response to its announcement that dividends would not be paid by simultaneously announcing that it would soon begin selling a new product.⁹⁶

In situations where the primary purpose of the product remarks is to entice investors rather than sway customers, it is more likely that securities lawyers will have input and exercise a restraining influence on a speaker's hyperbole.⁹⁷ Nonetheless, as cases later in this article indicate, even in these contexts, overly enthusiastic product descriptions often lead to litigation.

E. "Danger! Danger, Will Robinson!"

During the 1986 Christmas season, Ann Arbor Softworks advertised software called FullWrite Professional as a new product "expected to obsolete all existing text-based products." When, in 1987, Microsoft Word's Version 3.0 for the Macintosh had begun to ship, Ann Arbor published a two-page ad saying: "DON'T BUY IT," urging consumers to wait just a bit longer for FullWrite, "a superior word processor, at a better price . . . at your store within 60 days."⁹⁸ Several months later, FullWrite had still not been released. This situation, although not at all uncommon in the computer industry today, has been analogized to Ford Motor Co. taking out a big ad in *Newsweek* announcing that in 60 days

93. Pamela Bayless, *The Art of the Product Launch*, INST. INVESTOR, June 1984, at 183.

94. Udayan Gupta, *Financing Small Business: Entrepreneurial Forums Draw Crowds in Unlikely Places*, WALL ST. J., Jan. 31, 1994, at B2 (Technology conferences sponsored by the American Electronics Association near Silicon Valley began a trend of matching high-tech companies with venture capitalists, but the trend has now spread across the country.).

95. E.g., Don Clark, *Intel to Ship Its Next-Generation Chip in 1995, Boosts Outlays for Production*, WALL ST. J., Jan. 28, 1994, at B5 (Intel CEO, at a meeting with securities analysts, announced an aggressive schedule for the availability of a new computer chip.).

96. Rabino & Moore, *supra* note 48, at 39.

97. ICHBIAH & KNEPPER, *supra* note 45, at 218 (describing lawyers' instructions to Bill Gates to "adopt a conservative tone" regarding products' virtues when speaking to institutional investors during Microsoft's initial public offering).

98. Van Gelder, *supra* note 74, at 140.

it would be coming out with a car with all the features of a BMW at half the price, and then producing nothing.⁹⁹ Investors would slap Ford with a bevy of securities fraud class action lawsuits in a hurry. Not surprisingly, real vaporware preannouncements in the computer industry that are comparable to this Ford hypothetical also generate securities fraud litigation.

Given the potentially huge verdicts in class action securities litigation that were noted above, it is particularly worrisome that leading handbooks on the law of marketing totally ignore the potential liability for securities fraud.¹⁰⁰ Marketing journals keep those in the field abreast of developments in the law of false advertising, antitrust, products liability, and other legal areas of obvious importance.¹⁰¹ However, these sources have done nothing—and until recently, reasonably so—to educate marketing professionals as to the basics of federal securities laws. For that reason, these professionals may not be sufficiently aware that in making public statements about their products that are clearly aimed at *consumers*, they may also influence *investors*, thereby courting federal securities law liability.

Corporate attorneys are accustomed to screening registration statements, prospectuses, 10-Ks, 10-Qs, proxy statements, and the like for inaccurate or overly optimistic statements that might create securities fraud liability. However, it appears that product promotions—whether in the form of press releases, interviews, presentations at trade shows, and other product promotions—are often not so carefully scrutinized. Yet, the SEC has specifically reminded public companies that provisions such as Section 10(b) and Rule 10b-5 “apply to all statements that can reasonably be expected to reach investors and the trading markets, *whoever the intended primary audience.*”¹⁰² The failure of products to live up to marketing hype will disappoint consumers and other corporate constituents and may lead to breach of contract or warranty litigation. But it may also lead to a “double whammy” in the form of a securities fraud lawsuit filed

99. *Id.*

100. *E.g.*, RICHARD M. STEUER, A GUIDE TO MARKETING LAW: WHAT EVERY SELLER SHOULD KNOW (1986); DAVID C. HJELMFELT, EXECUTIVE'S GUIDE TO MARKETING, SALES, AND ADVERTISING LAW (1990); JOHN LICHTENBERGER, ADVERTISING COMPLIANCE LAW (1986); ROBERT J. PORSCH, THE COMPLETE GUIDE TO MARKETING AND THE LAW (1988); JOE L. WELCH, MARKETING LAW (1980).

101. *See, e.g.*, J. MARKETING, J. MARKETING RES., J. PRODUCT INNOVATION AND MGMT.

102. SEC, Securities Act Release No. 6504, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,120B, at 17,095-3 (Jan. 13, 1984) (emphasis added).

by the company's own investors, as Apple Computer has learned.¹⁰³

F. A Case History: Apple Computer

1. Facts and District Court Rulings

The Apple case arose out of the company's marketing through press releases, interviews with the press, and other communications of a novel office computer system. The system consisted of a computer called Lisa and its compatible disk drive known as Twiggy. Twiggy was promoted by Apple as a disk-drive that stored far more data than existing drives.

Various boastful statements made by Apple officials (including Apple's product marketing manager) belied Twiggy's known problems. Internal tests being conducted concurrently with the positive public statements indicated not that Twiggy and Lisa were to be a great success, but that Twiggy had "a very high out of box failure rate"¹⁰⁴ and that reliability issues would "delay the introduction of Lisa by many months."¹⁰⁵ Furthermore, Apple co-founder Steven Jobs expressed within the company "virtually zero confidence" in the division responsible for the design of Twiggy.¹⁰⁶ Lisa and Twiggy turned out to be little more than vaporware.¹⁰⁷ Although Apple finally began to ship the Lisa computer in 1983, Apple announced publicly on September 22, 1983 that it intended

103. The *Apple* defendants are not the first corporate officers to learn that decisions seemingly unrelated to securities law may lead to the potential for massive securities law liability. See, e.g., *Levine v. NL Indus.*, 926 F.2d 199 (2d Cir. 1991) (The company was spanked by the EPA for environmental law violations and was also sued by shareholders under 10b-5 for not revealing the violation to investors.); *Morse v. Abbott Lab.*, 756 F. Supp. 1108 (N.D. Ill. 1991) (The company was fined by the FDA for sanitary rule violations, and was also sued under 10b-5 for not disclosing violations and potential fines to investors.); *In re Union Carbide Class Action Sec. Litig.*, 648 F. Supp. 1322 (S.D.N.Y. 1986) (The company sued for the Bhopal disaster was also sued under 10b-5 for not disclosing to investors the potential for such accidents and their attendant lawsuits to occur.). See also *Goldsmith v. Rawl*, 755 F. Supp. 96 (S.D.N.Y. 1991) (*Exxon* was sued not only for environmental damage arising out of the *Exxon Valdez* shipwreck and under 10b-5 for not disclosing the danger that such accidents would occur, but also in a third-tier suit for a proxy law violation based on allegedly inadequate disclosure of the second-tier 10b-5 suits.).

104. *In re Apple Computer Sec. Litig.*, 672 F. Supp. 1552, 1565 (N.D. Cal. 1987), *aff'd in part, rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).

105. 886 F.2d at 1115.

106. *Id.*

107. This statement, generally speaking, may be a little unfair. Lisa did contain several technological innovations, such as a "mouse" and screen icons to graphically display the computer's functions that were later incorporated into the successful "Macintosh" home computer. *Id.* at 1111. Nonetheless, Twiggy never amounted to more than vaporware and Lisa was a commercial debacle.

to discontinue its efforts in designing and manufacturing Twiggy. The next day, Apple stock dropped \$8/share.¹⁰⁸ Soon thereafter, sales of Lisa ceased.

Although Apple's marketing of Lisa and Twiggy has been characterized as "merely following a time-honored Silicon Valley tradition of flogging a new gadget before the product is in marketable form,"¹⁰⁹ shareholders filed suit alleging that Apple had violated Section 10(b) and Rule 10b-5. Plaintiffs alleged that a total of 18 public statements by Apple had artificially inflated the market price of Apple stock. Apple thrice moved for summary judgment and in a series of three orders, the trial judge eventually ruled for Apple on all 18 statements, finding them not actionable because they were (a) true, (b) merely statements of opinion truly held and reasonably believed, (c) immaterial, (d) made without bad intent, or (e) some combination of the above.¹¹⁰ Plaintiffs appealed to the Ninth Circuit.

2. *The Ninth Circuit's Ruling*

For reasons that will be discussed in more detail in later sections of this article, the Ninth Circuit affirmed the trial court's granting of summary judgment to defendants on 16 of the 18 alleged misstatements. However, with respect to challenged statements 4 and 5, the court held that genuine issues of material fact existed, necessitating a trial. Statement 4 appeared in a November, 1982 trade show press release in which Apple stated that Twiggy "ensures greater integrity of data than other high density drives by way of a unique, double-sided mechanism designed and manufactured by Apple."¹¹¹ Challenged statement 5 appeared in the same press release and claimed that Twiggy "represents three years of research and development and has undergone extensive testing and design verification during the past year."¹¹² Ruling on these public statements, the

108. During the class period, Apple stock reached a high of approximately \$63/share and reached a low of \$24/share. When Apple announced negative quarterly earnings along with its decision to discontinue Twiggy, Apple stock fell from \$32/share to \$24/share in a single day. 672 F. Supp. at 1557.

109. Stephen Kreider Yoder, *Verdict in Apple Computer Fraud Case May Bring Restraint to Product Hype*, WALL ST. J., June 3, 1991, at B4.

110. These district court orders were reported at 672 F. Supp. 1552, *In re Apple Computer Sec. Litig.*, 690 F. Supp. 872 (N.D. Cal. 1987), and *In re Apple Computer Sec. Litig.*, 696 F. Supp. 490 (N.D. Cal. 1987).

111. *In re Apple Computer Sec. Litig.*, 886 F.2d at 1115.

112. *Id.*

court found that in light of Apple's internal pessimism concerning the performance of Twiggy, a trier of fact could find that these statements were materially misleading. The Ninth Circuit accordingly remanded the case for trial on those two public statements.¹¹³

3. *Jury Verdict and Ultimate Denouement*

At trial, the jury found Apple officers John Vennard and A.C. Markkula guilty of violating Section 10(b) and Rule 10b-5, but exonerated all other defendants, including Apple itself. The trial court, in ruling on defendant's motion for a judgment notwithstanding the verdict, held that no reasonable jury could have found the two individual defendants liable and that such a finding by the jury was internally inconsistent with the finding of nonliability for Apple.¹¹⁴ The court ordered a new trial. Apple dodged a bullet,¹¹⁵ and eventually settled the case out of court for less than \$20 million.¹¹⁶

The implications of the *Apple* litigation and the multitude of Section 10(b)/Rule 10b-5 cases, many of which arise from product marketing, that continue to be filed against high-tech companies, warrant an examination of the current state of doctrinal law in this area.

II. THE ELEMENTS OF A SECTION 10(b)/RULE 10b-5 SUIT

Section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regu-

113. *Id.*

114. *In re Apple Computer Sec. Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. ¶ 96,252, at 91,341 (N.D. Cal. Sept. 6, 1991).

115. Despite its narrow escape from a \$100 million jury verdict in 1991 and 1992 while promoting the palm-sized Newton computer, Apple's then-CEO John Sculley greatly overpromised what his design team was able to produce and opened another window of potential liability. See John Markoff, *Marketer's Dream, Engineer's Nightmare*, N.Y. TIMES, Dec. 12, 1993, at F1 ("While Mr. Sculley was proclaiming an era of 'Newton Intelligence,' the team designing the computer was floundering The completion of the Newton, originally scheduled for April 1992, would ultimately be postponed until August 1993. And the computer would be far less ambitious than the one Mr. Sculley was describing.").

116. See *Apple Computer Settles Shareholder Actions for Nearly \$20 Million*, M&A AND CORP. GOVERNANCE L. REP., Feb. 1992, at 1066 (Two cases settled simultaneously for \$19.8 million.).

lations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5, of course, is the most significant of those rules and regulations promulgated by the SEC over the years.¹¹⁷

A. *False Statement or Omission*

The first element that must be established by a plaintiff alleging a violation of Section 10(b) and Rule 10b-5 is that the defendant engaged in some form of fraudulent, deceptive or manipulative conduct. The actionability of an outright false statement is fairly easy to understand, but many cases involve more difficult questions. This subsection addresses three of those more difficult issues: (1) What does "misleading" mean? (2) What about inaccurate projections and forecasts? (3) What about misleading omissions rather than positive misstatements?

1. *What Does "Misleading" Mean?*

The simplest corporate misstatement cases involve obviously false statements, such as "Our new computer responds to voice-activated commands," when it does no such thing. Just as apparent are patently misleading omissions, such as neglecting to disclose that a high percentage of units sold have burst into flame. Both consumers and investors are misled in such instances.

More difficult questions are presented when the information is "soft"—subjective and perhaps forward-looking. When marketing hype is repeated in SEC-mandated disclosures, securities lawyers are typically alert enough to include various disclaimers regarding the risks that vaporware will not be promptly actualized in order to avoid misleading readers. However, securities liability can flow from any public statement and marketing efforts too often go unscrutinized by attorneys.

In the *Apple* litigation, Apple Computer produced affidavits from

117. Rule 10b-5 makes it unlawful "[t]o make any untrue statement . . . or to omit to state a material fact . . . or . . . [t]o engage in any . . . course of business which operates . . . as a fraud or deceit upon any person." 17 C.F.R. § 240.10b-5 (1993). As is well known, the SEC promulgated Rule 10b-5 without full knowledge of its implications. *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-923 (1967) (statements of Milton V. Freeman). The Supreme Court has called Rule 10b-5 a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

several market experts indicating that the vaporware phenomenon is well known, that "when a computer industry product is announced for future availability, the market fully understands that the product is still in the development stage."¹¹⁸ In other words, Apple was arguing that a preannounced product is merely vaporware, and everyone knows it, and therefore no one could be misled.

However, as the Ninth Circuit stated in response to this argument, "[t]here is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay."¹¹⁹ A statement that production is progressing smoothly when significant problems have already arisen is obviously misleading.¹²⁰ In other words, disclosure of the potential complications that all hardware and software manufacturers may encounter is not required. Disclosure of problems that have already been encountered and undermine previous expressions of optimism is required.

Additionally, statements, although literally true, may be misleading if they make up part of a "mosaic" of information that conveys a misleading impression.¹²¹ Thus, a statement which discloses most relevant facts might still be misleading if it is presented in such a manner that reasonable investors (or consumers) cannot assemble an accurate picture of the whole. This is often termed the "buried facts" doctrine. For example, a company might disclose a good deal of information regarding the features of its new computer and the speed with which the computer performs its tasks, failing to mention the total lack of reliability the computer has demonstrated in internal testing.

In a related vein, half-truths may also be considered misleading. For

118. 886 F.2d at 1115.

119. *Id.*

120. See *Huddleston v. Herman & MacLean*, 640 F.2d 434, 543 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983) ("To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit.").

121. *E.g.*, *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 512 (9th Cir. 1991) ("Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors." (quoting *McMahan & Co. v. Warehouse Entertainment, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990) ("[T]he disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers."), *cert. denied*, 501 U.S. 1249 (1991)); *but see* *Steiner v. Tektronix, Inc.*, 817 F. Supp. 867, 879 (D. Or. 1992) (noting that the "flip side of this principle" is that overly optimistic statements may, when read in context, be surrounded by sufficiently cautionary revelations to blunt any misleading impact).

this reason, as noted above, Rule 10b-5 prohibits companies from “omitt[ing] to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” Thus, if a product press release announced that a company’s new line of computers was on schedule to be released on January 1, 1996, but failed to mention that development of the new software needed to operate the computers was behind schedule and would not be ready until July 1, 1996, a misleading half-truth has been told. The hardware is little more than vaporware if there is no software with which to operate it. Disclosure must generally be complete with respect to material facts.

At the same time, the law does not mean that by revealing one fact about a product, one must reveal all other facts that might be interesting to the stock market. One need reveal only such additional facts, if any, that are needed to ensure that what was revealed would not be “so incomplete as to mislead.”¹²² Thus, a product press release touting a new printer’s speed of operation would not necessarily be misleading if it failed to mention that the printer did not have color capacity.

2. *What About False and Misleading Projections?*

A projection or forecast is not a statement of historical fact. Persons who hear or read a forward-looking statement, perhaps regarding a new computer that is in development, can generally understand that predictions do not always come true. No company must, or could, guarantee the accuracy of its predictions.¹²³ Therefore, no one expects all vaporware

122. *Backman v. Polaroid Corp.*, 910 F.2d 10, 16 (1st Cir. 1990) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1969)).

123. In *Raab v. General Physics Corp.*, 4 F.3d 286 (4th Cir. 1993), the court cautioned:

Predictions of future growth stand on a different footing [than statements of current fact], however, because they will almost always prove to be wrong in hindsight. If a company predicts twenty-five percent growth, that is simply the company’s best guess as to how the future will play out. As a statistical matter, twenty percent and thirty percent growth are both nearly as likely as twenty-five percent. If growth proves less than predicted, buyers will sue; if growth proves greater, sellers will sue. Imposing liability would put companies in a whipsaw, with a lawsuit almost a certainty. Such liability would deter companies from discussing their prospects, and the securities markets would be deprived of the information those predictions offer.

announcements to be realized on schedule.

However, that does not mean that vaporware announcements are never actionable. In the *Apple* case, Apple officers made statements such as "Lisa is going to be phenomenally successful." In fact, Lisa turned out to be a nearly unmitigated flop. The key issue in terms of liability is the good faith and reasonable basis of the prediction, not its ultimate accuracy.¹²⁴ As the Ninth Circuit noted in *Apple*:

A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate.¹²⁵

Thus, when companies make vaporware announcements about the future availability and projected features of their products, just as when they make financial forecasts regarding gross income or profit margin, securities fraud liability may attach if the statements are not genuinely believed or have no reasonable basis.¹²⁶

In *Apple*, the court found that the company's statements that it had "unequaled strength, experience and expertise," that its new product was "a significant breakthrough," that "success should continue," and that its forecasting process had been "refined," were generally accurate and certainly believed in good faith. Apple, indeed, was a successful company with a good track record and for a time it believed in its Lisa and Twiggy products, even though they ultimately did not pan out as hoped. There-

124. *Arazie v. Mullane*, 2 F.3d 1456, 1466 (7th Cir. 1993) ("A company's predictions of future performance are protected so long as they have a reasonable basis in fact—a poor prediction will not automatically subject a company to suits under the securities laws."); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 513-14 (7th Cir. 1989).

125. 886 F.2d at 1113 (citing *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 490 (9th Cir. 1974)).

126. This rule is consistent with the SEC "safe harbor" for forward-looking information contained in Rule 175 of the 1933 Securities Act and Rule 3b-6 of the 1934 Securities Exchange Act. Safe Harbor Rule for Projections, Securities Act Release No. 6084 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979) (adopting Securities Act Rule 175, 17 C.F.R. § 230.175 (1993) and Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (1993)). The SEC is considering expansion of these safe harbors. Christi Harlan, *SEC Seeks to Beef Up "Safe Harbor" Provision*, WALL ST. J., May 17, 1994, at C1.

fore, the trial court held, and its holding was affirmed on appeal, that these statements were not actionable.¹²⁷

Courts generally have been careful to prevent plaintiffs from alleging "fraud by hindsight,"¹²⁸ a phrase used by the District Court of Massachusetts in dismissing claims arising from a series of infamous vaporware announcements by Lotus Development Corp.¹²⁹ In that case, the court held that plaintiffs' claims that the software was not released as scheduled was only a claim of *fraud by hindsight*: "Especially where, as here, a product is understood to be in development, plaintiffs may not assert merely that, because the product did not come out when projected, plans for an earlier release were false."¹³⁰ Again, the true test is the good faith and reasonableness of the company's previous public projections.

On the other hand, if a company predicts an important release date for particular vaporware, and does not publicly revise that date in light of *known problems*, then the prediction may become actionable.¹³¹ The Apple facts discussed above regarding Twiggy's development problems are an obvious example. Another example occurred in *Bharucha v. Reuters Holdings PLC*.¹³² When Reuters touted the release of a new product, "Dealing 2000," which was to provide automatic matching facilities for foreign exchange transactions, and predicted that the new product would provide a major new source of revenue in 1990 and 1991, Reuters' ADRs rose from \$25-3/4 to \$70-5/8. However, when Reuters' announced in October, 1990 that problems had occurred and Dealing 2000 would not be introduced for at least six months, Reuters' ADR price dropped to \$32-5/8. A subsequent shareholders' complaint alleged that defendant officers knew or should have known that the predicted release date was misleading because the product had experienced development problems as early as May 1, 1989, and had not even reached the point where it could be released for beta testing.¹³³ These allegations that the forward-looking statements had not been made in good faith enabled the complaint to

127. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116-17 (9th Cir. 1989).

128. *E.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir. 1990) ("[T]here is no 'fraud by hindsight.'").

129. *Berliner v. Lotus Dev. Corp.*, 783 F. Supp. 708 (D. Mass. 1992).

130. 783 F. Supp. at 710.

131. Another way to look at this situation is that the duty to update is violated. The duty to update is discussed *infra* notes 159-181 and accompanying text.

132. 810 F. Supp. 37 (E.D.N.Y. 1993).

133. Beta testing is the testing of products by potential customers "in the field" as opposed to alpha testing—testing in the plant by the manufacturer.

survive a motion to dismiss.¹³⁴

As noted earlier, the actionability of a disclosed prediction does not turn on whether or not the prediction in fact proves to be inaccurate.¹³⁵ This is particularly the case where a projection "bespeaks caution." Under the "bespeaks caution" doctrine, a properly qualified vaporware announcement will not be actionable.¹³⁶ However, the adequacy of the caution given will be decided on a case-by-case basis.¹³⁷ The caution must be precise rather than broad boilerplate and, obviously, will not immunize forward-looking statements known to be false when made.¹³⁸

For example, the plaintiffs in *In re Storage Technology Corp. Securities Litigation*,¹³⁹ alleged that defendant company had made unduly optimistic claims for its new advanced storage and retrieval computer (the "Iceberg"). Company officers and directors represented that Iceberg had a two- to three-year technological advantage over the competition. These

134. 810 F. Supp. at 41 (quoting *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103, 137 (S.D.N.Y. 1989) ("[F]orecasts contain implicit representations that they were made in good faith and were based upon a reasonable method of preparation, and those representations constitute 'facts' actionable under Rule 10b-5.")). See also *Schwartz v. System Software Assocs., Inc.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,621, at 96,843 (N.D. Ill. Feb. 12, 1993) (holding actionable earnings forecast announcements that were contradicted by existing internal profit forecasts).

135. To hold otherwise would unduly discourage the free flow of information to the public. *E.g.*, *In re Adobe Systems, Inc. Sec. Litig.*, 787 F. Supp. 912, 917 (N.D. Cal. 1992) (attempting to strike a balance between encouraging the free flow of information and discouraging the making of misleading projections).

136. Several circuit courts and numerous district courts have adopted the "bespeaks caution" doctrine, most often to protect good-faith, qualified projections as to a company's financial performance. *E.g.*, *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 364 (3d Cir. 1993) (holding that the doctrine is "essentially shorthand for the well-established principle that a statement or omission must be considered in context"), *aff'g* 793 F. Supp. 543 (D. N.J. 1992), *cert. denied*, 114 S. Ct. 1219 (1994); *Moorhead v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245 (8th Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991) ("Economic projections are not actionable if they bespeak caution."). See also *Donald C. Langevoort, Disclosures That "Bespeak Caution"*, 49 Bus. Law. 481 (1994) (evaluating "bespeaks caution" doctrine).

137. For example, plaintiffs in *In re Donald J. Trump Sec. Litig.*, 793 F. Supp. 543, 553-59 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994), claimed that "The Donald" and others had no reasonable basis for their projection that funds generated from operation of the Taj Mahal would be sufficient to cover all debt service. The court dismissed the claim, stressing that liability cannot be imposed upon a single statement taken out of context, that the prospectus in this case "scream[ed] caution," that repeated, specific warnings of risk factors (rather than general warnings) had been made, that the debt/equity ratio of the enterprise was clearly disclosed, and that any alleged risk factors that were omitted from the prospectus were compensated by other warnings.

138. *Anderson v. Clow*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,990-91 (S.D. Cal. Sept. 17, 1993) (applying doctrine to claim brought under Section 11 of the 1933 Securities Act).

139. 804 F. Supp. 1368 (D. Colo. 1992).

statements naturally excited consumers and investors alike. When problems with Iceberg's production were eventually disclosed, the stock price plunged and plaintiff investors sued under, *inter alia*, Section 10(b) and Rule 10b-5. Storage Technology defended by claiming that its overly optimistic predictions were mixed with statements of caution. The court denied Storage Technology's motion to dismiss, concluding that its vaporware announcements had not been sufficiently qualified to avoid misleading investors:

[T]he unmistakable message conveyed by defendants' pre-April 20, 1992 public statements was that Iceberg would be in production by 1992, Storage Technology would enjoy a competitive advantage because it would be the first to reach the market with this new product and Storage Technology would earn large profits in 1992 as a result of Iceberg. Although some of the comments were tempered with caution, I cannot say as a matter of law at this juncture that they are too cautious to be actionable. "Not every mixture with the true will neutralize the deceptive."¹⁴⁰

In the case *In re Marion Merrell Dow, Inc. Securities Litigation*,¹⁴¹ plaintiffs evaded a motion to dismiss based on the "bespeaks caution" doctrine because the challenged statements and omissions (relating to adverse effects of defendants' drug) did not contain "repeated specific warnings of significant risk factors." Broad, generic warnings were deemed inadequate to "bespeak caution."¹⁴²

Still, when risk factors are clearly disclosed in a detailed fashion, investors will not be allowed to argue that they were misled when projections known to be contingent fail to materialize. For example, in *In re Convergent Technologies Securities Litigation*,¹⁴³ plaintiff investors complained that Convergent and its officers misled them by concealing from the market certain cost and production problems regarding the company's next generation ("NGEN") workstation product line. Product life cycle decisions are among the most difficult marketers have to make,

140. *Id.* at 1373 (quoting *Virginia Bankshares v. Sandberg*, 111 S. Ct. 2749, 2760 (1991)).

141. [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,776 (W.D. Mo. Oct. 4, 1993).

142. *Id.* at 97,768.

143. *Morris v. Newman*, 948 F.2d 507 (9th Cir. 1991).

because in the high technology field new products must continually be developed, but their development always poses technical problems and their marketing often diminishes the sales of the company's predecessor products.

The Ninth Circuit held, *inter alia*, that the market was not misled regarding the diminished sales of Convergent's earlier workstation product line because "[a]s a general matter, investors know of the risk of obsolescence posed by older products forced to compete with more advanced rivals,"¹⁴⁴ and that the risks regarding the development and marketing of NGEN had been particularized and emphasized.¹⁴⁵

3. What About Mere Omissions of Fact?

Suppose that while a company is in the process of developing a new line of software, its engineers run into several technical roadblocks and it becomes unlikely that they will be able to meet the company's stated performance goals. This is certainly a common if not universal occurrence in high-tech product development, but must the company voluntarily disclose to the market whenever such roadblocks are encountered? In other words, *when does a company have the duty to disclose news (usually bad news) to the market?*

Of course, if the news is already known to the public or to the plaintiffs, there is no duty to disclose.¹⁴⁶ Further, the general rule is that the simple fact that a company possesses *nonpublic*, material information does not mean that it automatically has a duty to disclose that information.¹⁴⁷

144. *Id.* at 513.

145. *Id.* at 515. In one of its prospectuses, Convergent had disclosed the following risk factors:

(1) The Company is undertaking substantial development, manufacturing, and marketing risks; (2) There can be no assurance that the Company will successfully complete the development of its new products or that it will be successful in manufacturing the new products in high volume or marketing the products in the face of intense competition; (3) Lack of availability of components from sole or limited sources would have a temporary adverse affect [sic] on the Company by delaying shipments; (4) While the Company believes that the technical risks in the development of NGEN are well controlled, the product cost objectives are very aggressive and there is no assurance they can be achieved.

Id.

146. *Jensen v. Kimble*, 1 F.3d 1073, 1079 n.11 (10th Cir. 1993); *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317, 1323 (7th Cir. 1988).

147. *E.g.*, *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("[A]

Absent a duty to disclose, an omission is generally not deemed misleading or deceptive.¹⁴⁸

According to several recent court decisions, there are three basic situations giving rise to a duty to disclose: (a) when insider trading is occurring, (b) when specific statutes or regulations require disclosure, and (c) when a company should correct "inaccurate, incomplete, or misleading prior disclosures."¹⁴⁹ Each of these will be discussed in turn.

a. Duty to Disclose Arising Because of Insider Trading

The insider trading cases are fairly clear-cut, although they are properly viewed as the major component of a larger subset of cases—those where a fiduciary relationship exists.¹⁵⁰ Assume, for example, that officers of a small computer company that has recently gone public learn that their only product has developed so many technical glitches that it will probably never be anything more than vaporware. If those officers begin unloading their stock in the company without disclosing the technical glitches, an insider trading violation of Section 10(b), actionable by contemporaneous purchasers of the stock, occurs.¹⁵¹

corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact."); *Holstein v. Armstrong*, 751 F. Supp. 746, 747-48 (N.D. Ill. 1990) (failure to make public a takeover proposal is not misleading absent a duty to disclose; that the information was material did not in itself give rise to such a duty).

148. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *Chiarella v. United States*, 445 U.S. 222, 228-33 (1980) (insider trading case).

149. *E.g.*, *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26-27 (1st Cir. 1987).

150. *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7th Cir. 1989) ("[E]ven absent any misleading statements, an independent duty to disclose material facts may be triggered by a fiduciary-type relationship.").

Some courts stress other factors. For example, in determining the existence of a duty to speak the Fifth Circuit considers:

- (1) [T]he relationship between the plaintiff and defendant;
- (2) the defendant's access to the information to be disclosed;
- (3) the benefit derived by the defendant from the purchase or sale;
- (4) defendant's awareness of plaintiff's reliance on defendant in making its investment decisions; and
- (5) the defendant's role in initiating the purchase or sale.

Kaplan v. Utilicorp United, Inc., 9 F.3d 405, 407-08 (5th Cir. 1993).

151. Obviously, if officers make affirmative misstatements (rather than mere omissions) while trading in their company's stock, the insider trading case of contemporaneous traders brought under Section 10(b) and, perhaps, Section 20A, 15 U.S.C. § 78t-1 (1988), is just that much stronger. *See, e.g.*, *In re Storage Technology Corp. Sec. Litig.*, 804 F. Supp. 1368, 1374 (D. Colo. 1992) (contemporaneous traders allowed to maintain corporate misstatement and insider trading claims, in the alternative, against officer-directors who

Insider trading is often alleged in securities fraud cases arising out of high-tech industries, because many such companies in their formative years reward officers and other employees with stock options. When stock prices drop, plaintiff shareholders often claim that the defendants had been making overly optimistic statements about the company's products or financial prospects in order to buoy the company's stock price for their own personal trading profit. Therefore, for purposes of the corporate disclosure cases discussed in this article, insider trading serves primarily as the wellspring for a duty to disclose by the company and as evidence of scienter, indicating a possible motivation behind misleading statements and omissions.¹⁵²

b. Duty to Disclose Arising from Statute or Regulation

A duty to speak out also arises when SEC rules and regulations require disclosure, as in the filing of annual or quarterly reports.¹⁵³ One category of relevant cases deals with projections, forward-looking statements, and other "soft information." A pressing concern for public companies centers on the imposition of liability for not disclosing soft information. What if, for example, a company has a practice of making formal but internal projections as to the date its new products will be issued, and updates these internal projections every quarter? Certainly investors (as well as consumers) would be interested in such projections. Although, as noted earlier, such matters receive certain "safe harbor" protection if they are disclosed, SEC rules and regulations typically do not require that they be disclosed.¹⁵⁴

On the other hand, despite recent judicial reluctance to widen the corporate duty to disclose, the SEC's 1989 Interpretive Release on Management Discussion and Analysis ("MD&A") seemingly requires disclosure of some forward-looking information,¹⁵⁵ complicating the

allegedly made misstatements about company products and performance and traded while in possession of material nonpublic information).

152. Insider trading as evidence of scienter is discussed *infra* notes 202-227 and accompanying text.

153. For a general discussion of these reporting requirements, see BROWN, *supra* note 8, at 3-27.

154. *In re Verifone Sec. Litig.*, 11 F.3d 865, 869 (9th Cir. 1993) (failure to make and disclose forecast of future events not actionable); *In re Lyondell Petrochem. Co. Sec. Litig.*, 984 F.2d 1050, 1052 (9th Cir. 1993) (also holding that disclosure of internal projection to lender did not require public disclosure of that projection).

155. Sec. Act Rel. No. 6835, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,436, at 62,143 (May 18,

disclosure picture. Thus, the MD&A disclosure provisions arguably require a company to disclose, for example, major development problems regarding a key product it hopes to produce. SEC action in the MD&A area certainly merits close monitoring by corporate counsel,¹⁵⁶ for the SEC seems to be requiring more in the way of predictive information from companies than are the courts.¹⁵⁷

Similarly, NYSE-listed companies must consider Exchange Manual Rule ¶ 202.05 which provides that listed companies are "expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."¹⁵⁸ Good and bad information about major products (not mere vaporware) would seem to meet these criteria.

c. *Duty to Disclose in Order to Correct Prior Disclosures*

An understanding of this third category of duty initially requires that a distinction be drawn between historical information and forward-looking information, and between the *duty to correct* and the *duty to update*. An examination of three hypothetical scenarios will illustrate the key distinctions drawn by most courts.

Scenario #1: Assume, first, that the McCoy Computer Co. product manager announces at a trade fair that McCoy's engineers have just completed a technological breakthrough enabling McCoy's soon-to-be-released computer to be equally compatible with both IBM-style PCs and Apple-style Macs. Assume that McCoy's officers truly believe this to be true, but six weeks later McCoy's engineers learn that they had over-

1989).

156. Only twice has the SEC brought actions based solely on MD&A disclosures. *In re Caterpillar, Inc.*, Exchange Act Release No. 30,532, 51 SEC Docket (CCH) 147 (Mar. 31, 1992); *In re Shared Medical Sys. Corp.*, Exchange Act Release No. 33,632, 56 SEC Docket (CCH) 199 (Feb. 17, 1994).

See generally Suzanne J. Romajas, *The Duty to Disclose Forward-Looking Information: A Look at the Future of MD&A*, 61 FORDHAM L. REV. S245 (1993) (noting need for clarification of management's duties in this area); Harvey L. Pitt & Matt T. Morley, *Through a Glass Starkly: A Practical Guide for Management's Forward-Looking Disclosures*, INSIGHTS, June 1993, at 3 [hereinafter Pitt & Morley, *Starkly*].

157. John C. Coffee, *Companies' Projections Pose Problems*, NAT'L L.J., Feb. 8, 1993, at 22 ("The courts and the SEC appear to be moving in diverging directions.").

158. THE NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL ¶ 202.05 (1983). The American Stock Exchange (AMEX) in its Company Guide, § 401 (Mar. 31, 1983) and the National Association of Securities Dealers (NASD) in ¶ 1754 of the NASD Manual impose similar requirements. See generally BROWN, *supra* note 8, at 96-98.

looked a serious technical problem which will prevent the promised compatibility from occurring. This development means that the trade fair announcement contained an *inaccurate statement of historical fact*. The misstatement is actionable.¹⁵⁹ Furthermore, McCoy would have an affirmative duty to correct this inaccuracy.

The seminal duty to correct case is perhaps *Ross v. A.H. Robins Co., Inc.*,¹⁶⁰ in which A.H. Robins made optimistic statements in 1970 and 1971 about the safety, efficacy, and marketability of its intrauterine contraceptive devices. In 1972, an unpublished research report demonstrated that the device was not as safe as previously represented, and Robins was found potentially liable under Section 10(b) and Rule 10b-5 for neither correcting nor modifying its previous statements which had been revealed to be inaccurate statements of historical fact.¹⁶¹

Another case involving product marketing is *In re Pfizer, Inc. Securities Litigation*,¹⁶² wherein plaintiffs alleged that Pfizer had been aggressively marketing its Shiley heart valve without disclosing its internal corporate knowledge of serious problems in manufacturing and quality assurance procedures. Pfizer alleged that it had no obligation to disclose its conjecture about these problems or about the tremendous legal liability to which they might give rise as the heart valves failed. The court disagreed, holding that plaintiffs' assertions that Pfizer had known as far back as 1980 that the Shiley heart valve had design flaws but had nonetheless continued to aggressively market and positively describe the valve, adequately stated a claim.¹⁶³ Pfizer's marketing claims constituted inaccurate statements of historical fact crying out for correction.

To complicate our first hypothetical scenario slightly, assume that the inaccurate statement of historical fact was contained in a computer magazine article written by an analyst who regularly follows McCoy. Would McCoy have a duty to correct that statement? Inaccurate state-

159. See *Massaro v. Vernitron Corp.*, 559 F. Supp. 1068, 1075-77 (D. Mass. 1984) (company's statement that its revolutionary device eliminating the need for pilot lights on gas ranges would soon be ready for market held actionable in light of fact that the company was having major difficulty designing a device that would fit all models of stoves and expected great difficulty obtaining regulatory approval).

160. 465 F. Supp. 904 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

161. 465 F. Supp. at 908 ("It is now clear that there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events. This duty exists so long as the prior statements remain 'alive.'")

162. [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,710 (S.D.N.Y. Dec. 21, 1990).

163. *Id.* at 98,349.

ments in such sources can affect market price and possibly lead to securities law liability. Companies should not, of course, be generally liable for the statements of third parties and have no duty to police the trade magazines to find inaccuracies that are not attributable to the companies.¹⁶⁴ However, companies are liable for misstatements of their own employees appearing in the trade press¹⁶⁵ and for third parties' misstatements if they have somehow placed their imprimatur upon those misstatements.¹⁶⁶

Scenario #2: Assume that McCoy's product manager had announced at a January 1993 trade fair that McCoy had sold 10,000 personal computers in 1992, and announced at a January 1994 trade fair that McCoy had sold 20,000 personal computers in 1993. If McCoy really sold these computers, these are *accurate statements of historical fact*. Assume further than on February 15, 1994, McCoy learns that due to competitive pressures it will probably sell no more than 3,000 personal computers in 1994. No statement needs correction, and most courts would hold that there is no free-standing duty to update an accurate statement of historical fact. In this case, there is no duty to speak, even though the situation, once accurately reported, has changed.¹⁶⁷

Scenario #3: Assume, finally, that McCoy's product manager states at the January 1994 trade fair that McCoy had sold 10,000 computers in 1992, 20,000 in 1993, *and expects to sell* 30,000 in 1994. Assume further

164. Raab v. General Physics Corp., 4 F.3d 286, 288 (4th Cir. 1993) ("The securities laws require General Physics to speak truthfully to investors; they do not require the company to police statements made by third parties for inaccuracies, even if the third party attributes the statement to General Physics.").

165. E.g., Fischer v. Tynan, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,672 (S.D.N.Y. 1993) (acknowledging possibility of 10b-5 liability for misstatements made by corporate officers to the trade press, although dismissing complaint due to lack of evidence of materiality and scienter). However, the Second Circuit recently held that if a newspaper or magazine does not identify a source within a company, and plaintiffs cannot discover that source, a motion to dismiss will be properly granted, even though this might enable a company to perpetrate a fraud by whispering unfounded rumors to the press. *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 265 (2d Cir. 1993).

166. See *In re RasterOps Corp. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,790, at 97,849 (N.D. Cal. Aug. 13, 1993) ("Defendants may be liable for statements made in securities analysts' reports if they sufficiently entangle themselves with the reports as to render the reports attributable to the defendants.").

167. See *Capri Optics Profit Sharing v. Digital Equip. Corp.*, 760 F. Supp. 227, 233 (D. Mass.) (accurate disclosure of historical earnings data did not give rise to duty to disclose internal company worries about revenues in light of "Black Monday" stock market crash of October, 1987), *aff'd*, 950 F.2d 5 (1st Cir. 1991).

that this *forward-looking* statement was made in good faith and with reasonable belief, but on February 15, 1994, McCoy learns that due to competitive pressures it is unlikely that it will sell more than 10,000 units in 1994. Here there is no duty to correct a historical inaccuracy, but a duty to update does exist. A statement, correct at the time, may have a forward connotation upon which readers or listeners may be expected to rely. If it becomes clear that the forward-looking statement was the product of a defective crystal ball, further disclosure may be called for.¹⁶⁸ Thus, companies must update opinions and projections if they have become misleading as a result of intervening events.¹⁶⁹

*In re Convergent Technologies Securities Litigation*¹⁷⁰ involved several claims of misstatement and omission. One objection was to Convergent's statement that "[o]ur growth in the [first] quarter [of 1983] was the result of increases in shipments to our large OEM customers." Despite plaintiffs' claim that this statement misled investors by implying that the upward trend would continue, the court concluded that no duty to correct arose when Convergent learned that the upward tick in shipments was only temporary because the statement was an accurate statement of historical fact. Nor was there a duty to update, because the statement was not forward-looking.¹⁷¹

On the other hand, in *Alfus v. Pyramid Technology Corp.*,¹⁷² plaintiffs alleged that defendant corporation fed information to financial analysts for inclusion of the analysts' reports. Those reports were optimistic regarding Pyramid's financial prospects and its MIServer product line, which would purportedly become available in February 1989 and contribute to revenues in the quarter ending in March. These forward-looking statements allegedly were rendered misleading by the fact that the manufacture and initial marketing of the MIServer family of products were plagued by serious and persistent problems causing at least a seven-month delay in their introduction. The court held that because these omissions rendered the previous forward-looking vaporware announcements inaccurate, those

168. See *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

169. *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993); *In re Gulf Oil/Cities Service Tender Offer Litig.*, 725 F. Supp. 712, 745-49 (S.D.N.Y. 1989).

170. 948 F.2d 507 (9th Cir. 1991).

171. *Id.* at 514; see also *Backman*, 910 F.2d at 17 (statement that substantial expenses had rendered a product's earnings negative was an accurate statement of historical fact that required neither correction nor update).

172. 764 F. Supp. 598 (N.D. Cal. 1991).

announcements should have been updated.¹⁷³

Unfortunately, the duty to update is one of the murkiest areas of federal securities law.¹⁷⁴ Such a duty generally seems to arise when a development occurs that renders a prior forward-looking statement no longer accurate. In other words, a duty to update exists if such a prior statement would be a misstatement or half-truth if it were republished currently.¹⁷⁵ Because a duty to update exists only if forward-looking statements, accurate when made, remain alive and have become false or misleading as a result of subsequent events, it is arguably just a variation of the "duty to correct."¹⁷⁶

One difficulty often lies in knowing how long a prior statement remains "alive," i.e., how long investors could reasonably rely on the statement.¹⁷⁷ Courts have not set forth clear guidelines regarding the "shelf life" of forward-looking statements. If, for example, on January 1, 1995, the ABC Computer Co. announces that its engineers are working hard on developing software to perform a particular task, may investors reasonably rely on that statement on January 1, 1996? How about January 1, 1997? Because there are no firm answers to these questions, forward-looking statements regarding vaporware (as well as regarding financial conditions) should be made with caution and only with respect to products in the advanced stages of development. To do otherwise, while not necessarily creating Section 10(b)/Rule 10b-5 liability, may create a continuing duty to update.¹⁷⁸

173. *Id.* at 603-04.

174. Dennis J. Block, Stephen A. Radin & Michael B. Carlinsky, *A Post-Polaroid Snapshot of the Duty to Correct Disclosure*, 1991 COLUM. BUS. L. REV. 139, 140 ("The law has always been less than completely clear regarding the duty to correct and/or update disclosure.").

175. Carl W. Schneider, *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?*, REV. SEC. & COMMOD. REG., May 9, 1990, at 83, 84.

176. See Block, Radin & Carlinsky, *supra* note 174, at 159-60 ("No decision that we are aware of other than the now reversed panel opinion in *Polaroid I* has ever imposed liability for not updating a disclosure which has not become materially false or misleading, absent an independent duty (such as insider trading or a statute or regulation) requiring such disclosure."). This dispute seems to be simply a matter of characterization. As noted above, there exists no general free-floating duty to update accurate historical statements.

177. 3 ALAN R. BROMBERG, SECURITIES FRAUD & COMMODITIES FRAUD § 6.11(543) (1977).

178. See generally Paul P. Brontas, Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1527 (1992) ("These legal puzzles create a considerable disincentive for corporations voluntarily to disclose soft information for fear of initiating a burdensome cycle of updating.").

Fortunately for defendant manufacturers, some rulings in analogous factual situations support the argument that a company's announcement that it has embarked upon development

Another difficulty involves the question of timing. If a company begins to suspect that one of its vaporware products is going to be very late, when must it inform the market? The courts have held that material information may be withheld from the market if there is a good business reason to do so. However, while courts often find good business reasons for the delay of disclosure of "good" information, such as a favorable mineral strike¹⁷⁹ or the obtaining of a major contract,¹⁸⁰ they rarely find a good business reason for the delay of "bad" information, such as the fact that a new product line will not be released on the date previously announced. About the most that can be claimed is a good faith delay sufficient for the company to verify the accuracy of the bad news.¹⁸¹

B. Materiality

A second basic element of a Section 10(b)/Rule 10b-5 claim is materiality. The false or misleading statement or omission must be as to a "material" fact in order to be actionable. Matters of only niggling consequence do not affect investment decisions and should not give rise to liability. Classic examples of material facts include major mineral strikes,¹⁸² a substantial dividend reduction,¹⁸³ and a large decline in earnings.¹⁸⁴ As discussed earlier, vaporware announcements touting new products aimed at consumers can also influence investors and thereby be material.¹⁸⁵

of a specific product does not give rise to a continuing duty to make "play-by-play" announcements as to the project's progress. See *Sailor v. Northern States Power Co.*, 4 F.3d 610, 612 (8th Cir. 1993).

179. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 850 n.12 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (company had a good business reason to delay announcing giant mineral strike—so that it could lease surrounding areas before competitors—but should not have allowed insider trading).

180. *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981) (delay in disclosure justified by contractual provision).

181. See *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 518-22 (10th Cir.) (allowing company to delay announcement of bad news about earnings long enough to dispatch 50 accountants to verify preliminary reports), cert. denied, 414 U.S. 874 (1973).

182. E.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

183. E.g., *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

184. E.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

185. See generally Barbara Rudolph, Note, *Subjective Evaluations of Technology as Bases for Rule 10b-5 Securities Law Violations: Liability for Scientific Consultants*, 61 GEO. WASH. L. REV. 1856, 1869 (1993) ("technological breakthroughs that further the objective

Of course, not all product-related misstatements are material. Thus, if a product manager stated that the company's next generation computer would be on the market by July 1 of the following year, when, in fact, she believed that it would not be on the market until July 5 of that year, the inaccuracy would probably be immaterial. Misstatements regarding a line of products accounting for only a small fraction of a company's sales and profits would also most likely not be material.

The difficulty, of course, is drawing the line in that gray area between the obviously material and the obviously immaterial. The Supreme Court has established a test of materiality keyed to whether there is a "substantial likelihood" that a misstated fact had, or disclosure of an omitted fact would have, "significantly altered the 'total mix' of information made available" in the eyes of a reasonable investor.¹⁸⁶ A fact can be material, however, even if it would not have changed the plaintiff's decision on whether to consummate the transaction in question so long as it would have assumed actual significance in a reasonable investor's deliberations.¹⁸⁷

The Supreme Court has also stated that in some instances materiality is gauged by multiplying the probability that an event will occur by the magnitude of the event.¹⁸⁸ The Supreme Court made its pronouncement in the context of a takeover that was being negotiated but had not yet been consummated, holding that the magnitude of the deal multiplied by the likelihood that it would be consummated might well make it material *before* negotiations had advanced to the point that the "price and structure" of the transaction had been fixed. It is easy to see the analogy to product development. Information about the development of a

of commercialization or otherwise affect security values are 'material' when an investor who knows about and can understand both the new technology and its ramifications would consider the information important in making an investment decision").

186. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Although *TSC Industries* was a proxy case decided under Section 14 of the 1934 Securities Exchange Act, this definition of materiality has been widely accepted and is undoubtedly the proper standard for Section 10(b)/Rule 10b-5 cases. *E.g.*, *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 280 n.11 (3d Cir. 1992) (applying *TSC Industries* test in 10b-5 case to hold representations and omissions regarding bank's loan loss reserves potentially material); *Berkowitz v. Baron*, 428 F. Supp. 1190, 1195 (S.D.N.Y. 1977) (applying *TSC Industries* test in 10b-5 case to hold that failure to comply with Generally Accepted Accounting Principles in compiling financial statements was materially misleading).

187. *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1534 (2d Cir.), *cert. denied*, 112 S. Ct. 587 (1991) (using this test to hold that deliberately concealed earnings projections were potentially material).

188. *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (involving materiality of merger announcement).

particularly significant product could be deemed material before that product was ready for market if there was a reasonable likelihood that it would become ready. Deciding when in the long evolution of a high-tech product the "probability times magnitude" formula provides a conclusion regarding materiality is obviously problematic.¹⁸⁹

In one case involving a product representation, *Pommer v. Medtest Corp.*,¹⁹⁰ evidence indicated that the sellers of a company with but a single asset—the intellectual property in a self-administered cervico-vaginal cytology testing process—sold the company's stock to a buyer and, in so doing, represented that the process was patented. In fact, it was not patented. Even though the process was ultimately patented two years later, the court concluded that the misstatement was material¹⁹¹ by applying the Supreme Court's formula:

West [an attorney owning 26% of Medtest stock] told [buyers] that Medtest *had* a patent, doubtless recognizing that in selling stock as in other endeavors a bird in the hand is worth two in the bush. Counsel's belief that the process is patentable is a fair distance from a patent. The examiner may disagree or insist that the applicant limit the claims in a way that affects the commercial value of the invention. If we take counsel's belief as signifying an 80% chance that Medtest will obtain a patent on the central claims, still the difference is material. *Even a small probability of a bad event may be material, if that event is grave enough.*¹⁹²

A more concrete indication of materiality than the Supreme Court's "probability times magnitude" formula is, where applicable, actual market response. Given the premise that American securities markets are essentially efficient and respond accurately to new information, a large movement (up or down) of the market in response to a company's news

189. The *Basic* holding has been criticized for just this reason. See *Disclosing the Court's Confusion*, Editorial, WALL. ST. J., Mar. 9, 1988, at 24 ("the justices endorsed ambiguity"). Fortunately, as noted above, although the fact of a new product almost ready for market might be material, the company is under no duty to disclose it unless the criteria discussed in Section II(A) (1) of this article are present.

190. 961 F.2d 620 (7th Cir. 1992).

191. *Id.* at 623 ("[J]ust as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true.").

192. *Id.* (emphasis added).

(good or bad) is strong evidence of the materiality of the information.¹⁹³ As noted earlier, the announcement that Apple Computer intended to discontinue the development and production of its Twiggy vaporware precipitated a 25% drop in the price of Apple's stock in a single day. This drop indicates that the information was clearly material, although the announcement was made concurrently with public disclosure of a negative report on quarterly earnings.¹⁹⁴

Similarly, in *In re U.S. Bioscience Securities Litigation*,¹⁹⁵ plaintiffs alleged that the company treasurer made a claim that a drug produced by the company might be marketed during the latter half of a specified year, pending FDA approval, knowing that getting the drug to market so quickly was not realistic. When securities analysts learned the truth, they concluded that the news "severely undermined the credibility of both the drug and [Bioscience]."¹⁹⁶ This response by analysts, whose role is critical to providing information upon which investors in public companies make their pricing decisions, was deemed by the trial judge to be evidence of materiality.¹⁹⁷

"Puffing," the defensive concept that renders overly favorable descriptions of products immaterial in a consumer's fraud suit,¹⁹⁸ is also occasionally successful in an investor's Section 10(b)/Rule 10b-5 suit.¹⁹⁹

193. See Mark L. Mitchell & Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545, 549 (1994) ("Information allegedly used in fraudulent activity that is important enough to affect security prices when publicly released provides compelling evidence that a reasonable investor would consider the information important in making an investment decision.").

194. This confluence of factors emphasizes the difficulty of determining materiality and gives rise to the argument that it is beyond the expertise of a jury to distinguish, for example, what portion of Apple's stock price drop was caused by the Twiggy disclosure and what portion was caused by the negative earnings announcement made on the same day. A finder of fact must, however, be allowed to decide such issues; to hold otherwise would permit defendants to escape liability by simply announcing more than one item of bad news at a time.

195. 806 F. Supp. 1197 (E.D. Pa. 1992).

196. *Id.* at 1206.

197. *Id.* (refusing to strike analysts' statements from complaint). On the other hand, in *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977), the court applied the probability times magnitude test in determining that a company's announcement of new products to analysts was not material because none of the analysts thought it important and one could not even remember it. *Id.* at 18.

198. W. PAGE KEETON ET. AL., PROSSER AND KEETON ON TORTS 757 (5th ed. 1984) ("The 'puffing' rule amounts to a seller's privilege to lie his head off, so long as he says nothing specific, on the theory that no reasonable man would believe him, or that no reasonable man would be influenced by such talk.").

199. *E.g.*, *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (advertising slogan "When E.F. Hutton Talks, People Listen" held to be inactionable puffing); *In re Software*

For example, an investor sued Commodore International claiming, *inter alia*, that in press releases Commodore promised that its new product—CDTV (a new interactive compact disc television system for the home)—would do far more than it ultimately did.²⁰⁰ The trial court dismissed the investor's lawsuit on the same grounds that it might have dismissed a disappointed consumer's fraud suit:

All of Commodore's statements about CDTV either constitute unactionable "puffing" (CDTV is "revolutionary," it can "change the world," could "be what VCR's . . . were to the 1980's"), or they are not misleading. Commodore promised only that it would have 50 titles "in (its) introductory phase," not that it would have them immediately. Mr. Gould announced that CDTV represented a "major potential opportunity"—which could only be taken as a doubly qualified advertisement, not any kind of promise at all.²⁰¹

C. *Scienter*

Although many lower courts once held that mere negligence was sufficient to create a violation of Section 10(b) and Rule 10b-5, the Supreme Court in *Ernst & Ernst v. Hochfelder*,²⁰² held that in a private cause of action a "mental state embracing intent to deceive, manipulate or defraud" is a necessary element to establishing liability under Section

Publishing Sec. Litig., [Current Binder] Fed. Sec. L. Rep. ¶ 98,094, at 98,757 (N.D. Cal. 1994) (statement that "[o]ver the next twelve months we will be introducing a number of new products that will strengthen our position in our current business" held inactionable puffing). *But see* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3434 (3d ed. 1991) ("the puffing concept in the securities context has all but gone the way of the dodo").

200. *Vosgerichian v. Commodore Int'l*, 832 F. Supp. 909 (E.D. Pa. 1993). In evaluating Section 10(b)/Rule 10b-5 liability, it is obviously necessary to ask how significantly a product must differ from the company's public comments before it creates a basis for liability. If a company promises that it is about to market a product that contains a great technological breakthrough yet never brings the product to market, a material misstatement has probably occurred. But what if the product is brought to market, yet represents only a slight technological advantage, attracting little consumer interest? Or, what if the product represents such a great leap ahead that consumers are not ready for it and refuse to buy it? If these disappointing customer reactions caused a drop in the price of the company's stock price, would the statements be actionable? These represent some of the difficult questions that may arise in determining materiality under the *TSC Industries* standard.

201. *Id.* at 916.

202. 425 U.S. 185 (1976).

10(b) and Rule 10b-5.²⁰³ The scienter requirement need not entail a desire to deceive; it may mean only that defendant knowingly made a false statement and appreciated that it would likely mislead investors.²⁰⁴ As in other areas of the law, securities class action defendants are presumed to intend the natural consequences of their actions.²⁰⁵

Although the Supreme Court has never spoken on the issue, most lower courts have held that "recklessness" may be sufficiently condemnable conduct to satisfy the scienter standard.²⁰⁶ Although courts have not been completely consistent in defining recklessness, one court recently described the concept as:

[A] highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standard of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.²⁰⁷

Scienter is a convoluted doctrine that raises difficult problems of both a legal²⁰⁸ and factual nature. Because plaintiffs cannot read defendants'

203. *Id.* at 193 & n.12. The Supreme Court later held the SEC to this same standard in Section 10(b)/Rule 10b-5 actions for injunctive relief. *Aaron v. SEC*, 446 U.S. 680 (1980).

204. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir.) (noting that the law rarely "demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of those actions suffices."), *cert. denied*, 449 U.S. 1012 (1980); *accord Duckworth v. Duckworth*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,537, at 92,460 (S.D. Ga. Oct. 17, 1991).

205. *E.g.*, *Fleischmann Distilling Corp. v. Distillers Co. Ltd.*, 395 F. Supp. 221, 227 (S.D.N.Y. 1975).

206. *E.g.*, *In re Glenfed, Inc. Sec. Litig.*, 11 F.3d 843, 847 (9th Cir. 1993); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46-47 (2d Cir.), *cert. denied*, 455 U.S. 1039 (1978); *Magna Inv. Corp. v. John Does One Through Two Hundred*, 931 F.2d 38, 39 (11th Cir. 1991) ("severe recklessness" satisfies scienter requirement).

Note, however, that at least one commentator believes that the Supreme Court's 10b-5 aiding and abetting decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994), "hinted at the possibility that 'recklessness . . . [as opposed to] intentional wrongdoing' would not be an acceptable basis for imposing liability." Harvey L. Pitt, *Of Deep Pockets, Frivolous Premises and Statutory Makeweights: The Demise of Implied Federal Securities Law Aiding and Abetting Liability* 6 (Apr. 29, 1994) (unpublished manuscript, on file with authors).

207. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990).

208. This article has already discussed applications of the scienter requirement. For instance, a prediction that, say, a new computer product will be available for sale upon a certain date, will not be grounds for liability simply because it does not turn out to be accurate, so long as it was made in good faith and upon a reasonable basis. *E.g.*, *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 930-31 (9th Cir. 1993); *In re Westinghouse Sec. Litig.*,

minds,²⁰⁹ plaintiffs are typically allowed to establish scienter by inference.²¹⁰ But plaintiffs must allege *particular facts* that give rise to an inference that defendants actually knew (or were reckless in their ignorance) of fraudulent conduct.²¹¹ The Second Circuit, for example, recognizes two primary means for plaintiffs to adequately plead scienter. First, plaintiffs "may allege facts establishing a motive to commit fraud and an opportunity to do so."²¹² Second, plaintiffs "may allege facts constituting circumstantial evidence of either reckless or conscious behavior."²¹³

In applying these concepts to product hyping, the first means of pleading scienter could be fulfilled by alleging that defendants' motive in prematurely announcing vaporware, as is commonly the case, was to discourage customers from buying competitors' products. It could also be fulfilled by alleging that defendant company officers sought to buoy the company's stock price with overly optimistic product announcements in order to profit personally by the exercise of stock options or other trading in the company's shares. Given the common practice of compensating officers and directors with share ownership, stock options, stock appreciation rights, and the like,²¹⁴ plaintiffs often seize upon this "motive and opportunity" to fulfill the scienter requirement. As the Ninth Circuit noted in *Apple*, "[i]nsider trading in suspicious amounts or at suspicious

[1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,750, at 97,590 (W.D. Pa. July 27, 1993). Also, the "bespeaks caution" doctrine that was noted earlier includes, in part, the notion that an inference of scienter should not be drawn if defendants include adequate cautionary language with any forward-looking statement. *E.g.*, *Haberkamp v. Steele*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,606, at 92,855 (S.D.N.Y. Apr. 15, 1992).

209. See *King v. Shipley*, 99 Eng. Rep. 744, 828, 4 Doug. 73, 177 (1784) (Ashurst, L.J.) ("What passes in the mind of man is not scrutable by any human tribunal; it is only to be collected from his acts.").

210. *O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991) (noting that permission to establish scienter by inference must not be mistaken for license to base claims on speculative and conclusory allegations).

211. *In re Network Equip. Technologies, Inc. Litig.*, 762 F. Supp. 1359, 1362 (N.D. Cal. 1991).

212. *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993).

213. *Id.*; see also *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) (recognizing Second Circuit's approach to establishing scienter in context of 10b-5 case involving some product representations).

214. *ICHBIAH & KNEPPER, supra* note 45, at 213 (Microsoft, for example, has used generous stock options to lure employees). See also Sen. Joseph I. Lieberman, . . . *But They Do Create Good Jobs*, L.A. TIMES, Apr. 8, 1994, at B7 (arguing that stock options "enable small companies to stretch scarce venture capital dollars and attract skilled and motivated employees.").

times is probative of bad faith and scienter."²¹⁵

For example, in *In re RasterOps Corp. Securities Litigation*,²¹⁶ plaintiffs claimed that the defendant company made misleadingly optimistic vaporware announcements. Plaintiffs survived a motion to dismiss on scienter grounds vis-à-vis individual officer defendants by alleging that defendants suppressed adverse information:

[S]o that they could (1) protect and enhance their executive positions and the substantial compensation and prestige they obtained thereby; (2) enhance the value of their RasterOps stock holdings and their options to buy RasterOps stock; (3) sell shares of RasterOps stock they owned at inflated prices to obtain large profits; and (4) inflate the reported profits of the Company in order to obtain larger payments under RasterOps' incentive bonus compensation plan and/or via discretionary individual performance bonuses.²¹⁷

A second means of adequately establishing scienter in the vaporware context is by use of circumstantial evidence in the form of internal memoranda or the like indicating so many problems in product development that defendants could not have reasonably believed their optimistic product announcements. In *Apple*, for example, the product press release containing challenged Statements #4 and #5 regarding the Twiggy vaporware, was issued at a time when internal documents showed that Apple's tests indicated slowness and unreliability in Twiggy's information-processing capabilities; when the Apple division in charge of producing

215. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989) (citing *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985)). However, in *Apple* itself, the Ninth Circuit found the insider trading that occurred not to be particularly suspicious in light of (a) similar amounts of trading outside the class period, and (b) credible, uncontradicted explanations of innocent motives for the trading. *Id.*

See also *In re Cypress Semiconductor Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,060, at 94,697 (N.D. Cal., Sept. 23, 1992) (finding insufficient insider trading to give rise to inference of scienter); *Alfus v. Pyramid Technology Corp.*, 764 F. Supp. 598, 605 (N.D. Cal. 1991) (finding that sale of \$4.5 million of shares by defendants gave rise to presumption of scienter).

216. [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,790 (N.D. Cal. Aug. 13, 1993).

217. *Id.* at 97,850; see also *Fujisawa Pharmaceutical Co. Ltd. v. Kapoor*, 814 F. Supp. 720, 728 (N.D. Ill. 1993) (using "motive and opportunity" approach to conclude that plaintiff had adequately pled scienter by showing that individual defendant received \$150 million from sale of his company to plaintiffs and therefore had adequate motive to mislead plaintiff regarding company's filing of false applications and information with the FDA).

Lisa had warned top executives that its current unreliability would probably delay the introduction of Lisa by many months; and when Steven Jobs was expressing "virtually zero confidence" in the division in charge of developing Twiggy.²¹⁸ The dissonance between Apple's external optimism and internal pessimism provided sufficient circumstantial evidence of scienter to warrant a jury trial, according to the Ninth Circuit.²¹⁹

Conversely, in *Berliner v. Lotus Development Corp.*,²²⁰ plaintiffs alleged that they bought Lotus stock at an artificially inflated price because Lotus kept announcing that the "1-2-3 Release 3.0" upgrade of its famous software package was about to be released when, in fact, it was nowhere near release. Plaintiffs first attacked a February 25, 1988 announcement that Release 3.0 would be available "late" in the second quarter of 1988, but the complaint alleged no facts or circumstances indicating that the projection was false when made. Absent such facts or circumstances, plaintiffs' allegations were insufficient as mere "fraud by hindsight."²²¹

Other pleadings were similarly rejected. On March 18, 1988, Lotus announced that although its senior vice president of software development had resigned, it had not yet changed its plans for introduction of Release 3.0. However, four days later, Lotus announced that the product would be delayed until the fourth quarter of 1988. That projection was repeated on March 29, July 18, August 9, August 12, and August 24. However, on October 7, 1988, Lotus rescheduled the release for the second quarter of 1989. Plaintiffs attempted to raise their claims above the level of fraud by hindsight by pointing to three "circumstances" probative of the falsehood of the later projections. First, plaintiffs alleged that five Lotus vice presidents resigned during the relevant period, but the court found several different reasons for the resignations and deemed them insufficient evidence that Lotus knew Release 3.0 would not meet its projected release dates. Second, plaintiffs alleged that Lotus did not begin beta testing until February 1989, urging the inference that because such testing is a prerequisite to commercial distribution of software, Lotus was reckless in projecting its earlier release dates. The court responded by pointing out that when Lotus announced on August 24, for example, that it was

218. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989).

219. *Id.*

220. 783 F. Supp. 708 (D. Mass. 1992).

221. *Id.* at 710.

“aiming to” market Release 3.0 “late” in the fourth quarter, four months remained in the year, a period not alleged to be necessarily insufficient to complete beta testing. Finally, plaintiffs advanced a “motive and opportunity” type of argument that Lotus had an incentive to defraud the public in that (a) the company purportedly wished to dissuade customers from purchasing other products, and (b) Lotus insiders sold their Lotus shares during this time period. The court also rejected this third ground (and therefore dismissed the suit), stating in conclusory fashion that the insider sales, which were not alleged to have violated insider trading proscriptions, were not by themselves a sufficient basis for inferring that Lotus had repeatedly misrepresented the product’s release date.²²² However, the court never responded to plaintiffs’ argument regarding Lotus’ motive to dissuade customers from purchasing competitors’ products—a motive which, as we have seen, often underlies vaporware announcements.²²³

When, as is usually the case, *individual* defendants are included in a Section 10(b)/Rule 10b-5 complaint, many courts require very specific pleadings regarding the scienter of each.²²⁴ For example, in *In re*

222. 783 F. Supp. at 711-12.

223. For other cases involving attempts to establish scienter through circumstantial evidence see *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 507 (9th Cir. 1992) (company’s own internal records were filled with references to problems in development of new printer, contradicting positive and unqualified public statements, thereby providing evidence of scienter despite company’s asserted good faith as demonstrated by its continuing to make, sell, and invest in the product and by fact that corporate officers did not sell their stock during class period); *Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 814 F. Supp. 720, 726 (N.D. Ill. 1993) (scienter adequately pled by boilerplate allegations that defendant drug company had “knowingly and recklessly made untrue statements” supplemented with ample references to specific dates, documents, and contents clearly indicating that defendant had known of inappropriate submissions to the FDA); *In re Marion Merrell Dow, Inc. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,776 (W.D. Mo. Oct. 4, 1993) (circumstantial evidence that personnel at defendant’s research institute knew of adverse drug reactions reported in England and other adverse reports in U.S. justified an inference of scienter regarding defendant’s positive statements about its drug’s potential for over-the-counter FDA approval); *In re Storage Technology Corp. Sec. Litig.*, 804 F. Supp. 1368, 1373 (D. Colo. 1992) (allegation that defendants publicly represented that new data storage and retrieval code would be available by a certain date and would produce profits when, in fact, they knew that the product would not be ready for sale by that date, satisfied scienter requirement); *Handelsman v. Gilford Sec., Inc.*, 726 F. Supp. 673, 683 (N.D. Ill. 1989) (handwritten notes indicating that defendant’s executive knew that a chip being prepared for his company’s product was “important” but “didn’t work” provided evidence that scienter underlay company’s alleged omission regarding performance problems with its product); *but see Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994) (rejecting theory that “gross deviation” between results actually achieved and those predicted supported an inference of scienter).

224. *E.g.*, *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994). Some courts recognize the “group pleading presumption,” which

Newbridge Network Securities Litigation,²²⁵ part of the plaintiffs' complaint related to the defendants' alleged misrepresentations and omissions about problems with product quality. Regarding the scienter issue, the court held that where multiple individual defendants are sued, "the complaint must apprise each defendant of his or her participation in the fraud."²²⁶ Plaintiffs met that burden because their complaint specified the statements alleged to be misleading, adequately detailed when, where, and by whom they were made, and identified facts indicating conscious behavior by the individual defendants.²²⁷

D. Reliance

Reliance by a plaintiff is "essential to a claim under Rule 10b-5 because it 'provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.'"²²⁸ As one court put it, reliance is "the subjective counterpart to the objective element of materiality."²²⁹

entitles plaintiffs attempting to meet Federal Rule of Civil Procedure 9(b)'s requirement that fraud be pleaded with particularity to attribute group published information—such as prospectuses, registration statements, annual reports, press releases, 10-Q filings, etc.—to the individual defendants as a whole. This presumption is naturally limited to defendants who are officers and executives involved in the day-to-day management of the parts of the corporation involved in the fraud. See *Blake v. Dierdorff*, 856 F.2d 1365, 1369 (9th Cir. 1988); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987).

225. 767 F. Supp. 275 (D.D.C. 1991).

226. *Id.* at 282 (citing *DiVittorio v. Equidyn Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987)).

227. *Id.*

228. *Smith v. Ayres*, 845 F.2d 1360, 1363 (5th Cir. 1988) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988)), *cert. denied*, 113 S. Ct. 2342 (1993).

229. *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1117-18 (5th Cir. 1988) ("Whereas materiality requires the plaintiff to demonstrate how a 'reasonable' investor would have viewed the defendants' statements and omissions, reliance requires a plaintiff to prove that it actually based its decisions upon the defendants' misstatements or omissions."), *vacated on other grounds*, 492 U.S. 914, *cert. denied*, 492 U.S. 918 (1989).

Although subjective, reliance must be justifiable or reasonable. The general notion of *reasonable* reliance means that a plaintiff cannot rely upon a misrepresentation or omission when he or she knows the truth. *E.g.*, *Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025, 1030 (9th Cir. 1992) ("the investor who closes his eyes to a known risk" cannot meet reliance requirement). The "bespeaks caution" doctrine mentioned earlier in the article, *supra* notes 136-145 and accompanying text, has applicability here. Many courts hold that plaintiffs who have been extensively warned in writing regarding the risks of a particular investment cannot reasonably rely upon optimistic oral communication to the contrary. *E.g.*, *Brown v. E.F. Hutton Group, Inc.* 991 F.2d 1020, 1032-33 (2d Cir. 1993). Another way to approach this requirement is to say that a plaintiff whose reliance was not reasonable or justifiable failed to perform "due diligence" and therefore is not entitled to the protection afforded by Section 10(b) and Rule 10b-5. The standard of plaintiff's conduct in this regard is typically recklessness rather than negligence. *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511,

Common law rules required that a plaintiff prove she had *actually* based decisions upon the defendant's misstatements or omissions.²³⁰ This traditional element of a common law fraud claim requiring a plaintiff to directly read or hear a misstatement and then rely on it has by necessity been altered in causes of action under Section 10(b) and Rule 10b-5.

The first such major alteration arose in *Affiliated Ute Citizens of Utah v. United States*,²³¹ wherein the Supreme Court held that plaintiffs need not establish reliance in an omission case. In other words, it makes little sense to ask plaintiffs to plead and prove reliance on facts that were hidden from them. Therefore, traditional reliance ("I saw, I read, I relied") need not be proved in omission cases. That the omitted information was material is sufficient to give rise to a presumption of reliance.²³² Two other developments are of particular importance in recent 10b-5 cases.

1. "Fraud-on-the-Market"

In creating the "fraud-on-the-market" theory of reliance, lower courts reasoned that in cases of affirmative misrepresentation, reliance may be presumed even on the part of plaintiffs who did not see, read, or truly rely on misleading documents if they relied on the integrity of the market price. The Ninth Circuit, for example, reasoned that the purchaser of stock "relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price."²³³ This fraud-on-the-market theory equates an investor's reliance

1518 (10th Cir. 1983).

230. *Abell v. Potomac Ins. Co.*, 858 F.2d at 1118 (5th Cir. 1988).

231. 406 U.S. 128 (1972).

232. Many courts also require that plaintiffs have seen and read the documents containing the alleged omissions. *E.g.*, *Eckstein v. Balcor Film Investors*, 740 F. Supp. 572, 578 (E.D. Wis. 1990) ("To presume reliance on omissions which allegedly occurred in statements and documents which the [plaintiffs] do not claim to have listened to, read, or relied on is illogical and would eliminate the reliance requirement.").

233. *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The presumption actually has three facets, as explained by the Third Circuit:

The fraud-on-the-market theory created a threefold presumption of indirect reliance. First, this court presumes that the misrepresentation affected the market price. Second, it presumes that a purchaser did in fact rely on the price of the stock as indicative of its value. Third, it presumes the reasonableness of that reliance.

on market price with reliance upon statements made to the market.²³⁴ It changes the focus of the inquiry from whether the plaintiffs were misled to whether the market was misled.²³⁵ In *Basic, Inc. v. Levinson*,²³⁶ the Supreme Court accepted the fraud-on-the-market presumption, and the Efficient Capital Market Hypothesis (ECMH)²³⁷ upon which it is based.

Several cases involving statements about products have involved the fraud-on-the-market approach to reliance. One example²³⁸ is *DeVries v. Taylor*,²³⁹ in which Thelma June DeVries (and others) sued Chemex Pharmaceuticals (and its officers and directors) alleging that they had misrepresented numerous aspects of Chemex's business and fraudulently concealed the truth about the development problems of one of its main products, a drug called A (inex). Defendants moved to dismiss on the reliance issue because DeVries candidly admitted that she was unaware of the facts on which the lawsuit was premised, had never read any of the documents allegedly containing misstatements and omissions, and had simply followed her husband Dale's recommendations in buying Chemex stock. On the other hand, Dale had worked in the securities business for 25 years and swore that he had relied on the securities markets to establish a fair price for Chemex stock. Given these facts, the court concluded that DeVries' reliance "on the alleged misrepresentations and omissions can be established via Dale's reliance on the same and the

Zlotnick v. TIE Communications, 836 F.2d 818, 822 (3d Cir. 1988).

234. *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 512 n.2 (9th Cir. 1991); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113-14 (9th Cir. 1989), cert. denied, 496 U.S. 943 (1990).

235. *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1479 (N.D. Cal. 1992), aff'd, 11 F.3d 865 (9th Cir. 1993). Acceptance of the fraud-on-the-market doctrine is critical to the viability of class action securities litigation because without the presumption of reliance created by the doctrine, plaintiffs would arguably lack the common issues of fact required for class action certification under FED. R. CIV. P. 23.

236. 485 U.S. 224, 247 (1988).

237. In its well-recognized "semi-strong" form, the ECMH "states that, at any point in time, market prices are an unbiased forecast of future cash flows that fully reflects all publicly available information." RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 136 (1993) (emphasis in original).

238. Another product promotion case involving fraud-on-the-market issues is *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986), in which defendant Health-Chem Co. claimed its new insecticide would cause gypsy moths to soon "become a memory." The product was written up in scientific and gardening journals, and the company's stock price surged before it became clear that the product was not effective and the stock price plunged. The Third Circuit strongly supported the availability of the fraud-on-the-market theory to securities class action plaintiffs, *id.* at 1162-63, although plaintiffs lost on other grounds.

239. [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,679 (D. Colo. June 28, 1993).

integrity of the marketplace."²⁴⁰

Courts have recognized several basic rebuttals to the fraud-on-the-market presumption of reliance in a Section 10(b)/Rule 10b-5 case: (a) proof that the plaintiff did indeed know of the false statement or omission and traded in the stock anyway; (b) proof that the plaintiff would have made the purchase or sale even had she known of the false statement or omission;²⁴¹ (c) proof that the market in question was not, in fact, efficient;²⁴² (d) proof that the market price did not respond to the misrepresentation, indicating that the market was not misled;²⁴³ and (e) proof that "market makers" were privy to the truth in the case of a misrepresentation or omission, and, thus, the market price was not perversely affected by that misrepresentation or omission.²⁴⁴ This fifth

240. *Id.* at 97,144. *See also* Hanon v. Dataproducts Corp., 976 F.2d 497, 506 (9th Cir. 1992) (allowing even sophisticated investors to rely on the fraud-on-the-market presumption).

241. *E.g.*, Gianukos v. Loeb Rhoades & Co., Inc., 822 F.2d 648, 655 (7th Cir. 1987) (holding that plaintiff relied not on the market but on inside information from friends and associates); Harkavy v. Apparel Indus., Inc., 571 F.2d 737, 742 (2d Cir. 1978) (plaintiff sold not because he was misled but because he needed the funds); Helman v. Murray's Steaks, 742 F. Supp. 860 (D. Del. 1990) (reliance not established where plaintiff did not read documents, but bought as an "act of love" and would have purchased no matter what price was shown in the documents).

242. When securities of a particular company are not widely traded in an efficient market, there is no reason to presume the applicability of the ECMH underlying the fraud-on-the-market theory. For example, if, while seeking to raise capital through an initial public offering ("IPO"), a company exaggerates the features of a computer it is developing, it is unlikely that the fraud-on-the-market theory would apply. The company has not yet gone public; its market price is set by the company and its underwriters, not an efficient market. *See generally* Michael W. Prozan & Michael T. Fatale, *Revisiting Truth in Securities: The Use of the Efficient Capital Market Hypothesis*, 20 HOFSTRA L. REV. 687 (1992) (surveying court approaches to determining whether market for a particular security is efficient).

However, in this context, several courts have adopted the "fraud-created-the-market" theory to aid plaintiffs in meeting the reliance test when there is no efficient market. This test has taken several forms, but generally allows a plaintiff who cannot claim "eyeball" reliance ("I saw, I read, I relied") to nonetheless satisfy the reliance requirement by claiming that the securities could not have been marketed absent fraud. Courts are generally divided regarding the predicates for invocation of the doctrine. Some courts require plaintiffs to prove "factual unmarketability" (that the securities could not have been marketed absent the fraud), while others require a more stringent showing of "economic unmarketability" (that the security could not have been issued at any combination of price or interest rate). *See, e.g.*, Ross v. Bank South, N.A., 885 F.2d 723, 729 (11th Cir. 1989) (noting that in an undeveloped market "it is reasonable to rely on the market to screen out securities that are so tainted by fraud as to be totally unmarketable, [but] investors cannot be presumed to rely on the primary market to set a price consistent with the appropriate risk"), *cert. denied*, 495 U.S. 905 (1990); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1121 (5th Cir. 1988) (holding that fraud-created-the-market theory available to plaintiffs "only where the promoters knew the enterprise itself was patently worthless"), *vacated on other grounds*, 492 U.S. 914 (1989).

243. *E.g.*, Zlotnick v. TIE Communications, 836 F.2d 818, 822 (3d Cir. 1988).

244. *Basic, Inc. v. Levinson*, 485 U.S. 224, 248 (1988).

category has evolved into what is currently known as the "truth-on-the-market" defense.

2. "Truth-on-the-Market"

The most interesting aspect of the fraud-on-the-market theory is the "truth-on-the-market" defense that has evolved from it. The essence of this defense is a claim by defendant companies in securities fraud cases that any inaccurate public announcements that they may have made were neutralized by corrections made by other sources that permeated throughout the efficient market. Clearly, if the market knew that a statement made by a corporate defendant was false or misleading, and the market priced the shares accordingly, a plaintiff's presumed reliance on a misleadingly high or low market price is severed. In essence, the company is arguing: "Yeah, we lied, but no one believed us."²⁴⁵

Ironically, in vaporware cases the more spectacularly misleading the statement made by the company about its promised products, the more credible is its claim that the market was not defrauded because the truth was well known. This defense was used by Apple in its vaporware case involving Lisa and Twiggy. In *Apple*, the Ninth Circuit applied the truth-on-the-market defense in the following manner:

The press portrayed Lisa as a gamble, with the potential for either enormous success or enormous failure. At least twenty articles stressed the risks Apple was taking, and detailed the underlying problems producing those risks. Many of the optimistic statements challenged by plaintiffs appeared in those same articles, essentially bracketed by the facts which plaintiffs claim Apple wrongfully failed to disclose. The market could not have been made more aware of Lisa's risks.²⁴⁶

In almost the same breath that it recognized the truth-on-the-market defense, the *Apple* court stressed the limits of its holding:

245. *E.g.*, *Wieglos v. Commonwealth Edison Co.*, 892 F.2d 509, 512-16 (7th Cir. 1989) (public knew about problems in nuclear industry, and that company projections were often overly optimistic).

246. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1989).

The investing public justifiably places heavy reliance on the statements and opinions of corporate insiders. In order to avoid Rule 10b-5 liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the insiders' one-sided representations.²⁴⁷

Another product promotion case involving the truth-on-the-market defense is *Ballan v. Upjohn*,²⁴⁸ in which plaintiffs claimed that in marketing and attempting to secure FDA approval for its drug Halcion, Upjohn hid data showing Halcion's negative side effects.²⁴⁹ Upjohn also omitted this data from its annual reports, quarterly reports, and other SEC filings. Upjohn argued that the market was well aware of the side-effects of Halcion, but the court denied Upjohn's motion to dismiss, quoting the Ninth Circuit's statement in *Apple* that unqualified exuberance from corporate insiders would typically be weighed heavily by the market and would not be overcome by "information [that] has received only brief mention in a few poorly-circulated or lightly-regarded publications."²⁵⁰ To prevail with the truth-on-the-market defense, defendant companies must prove that the corrective statements from other sources "credibly entered the market."²⁵¹ The court also cited *In re Seagate Technology II Securities Litigation*,²⁵² for the proposition that where the evidence of what the market knew consists of competing volumes of contradictory analysts' reports and contradictory articles published in the popular press, the truth-on-the-market defense is not established.²⁵³ Because the *Ballan* court could not "discern whether information concerning the side-effects of Halcion

247. *Id.*

248. 814 F. Supp. 1375 (W.D. Mich. 1992).

249. This data arose both from clinical trials conducted by Upjohn and from experience marketing the drug in Europe. *Id.* at 1378-79.

250. *Id.* at 1382.

251. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1989) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 248-49 (1988)).

252. 802 F. Supp. 271 (N.D. Cal. 1992).

253. *Id.* at 275-76. In *Seagate*, defendant supplemented its summary judgment motion with over 50 documents produced and publicly distributed by third parties (in publications such as *Business Week*, *P.C. Magazine*, *Investor's Daily*, and the *New York Times*) which, defendant argued, apprised the market of information that defendant itself had not disclosed and thereby prevented the market from being "hoodwinked" by defendant's failure to disclose. However, the court found that evidence of information reported in the popular press was sufficiently contradictory that it did not establish that there was no reasonable possibility of systematic bias in the market price. *Id.* at 275-77.

was *credibly* made available to the market by other sources,"²⁵⁴ it could not summarily rule for defendants on the reliance issue.²⁵⁵

E. Causation

The causation element of a Section 10(b)/Rule 10b-5 claim is closely related to the reliance element. Indeed, for many years most courts were willing to assume that evidence of materiality plus reliance gave rise to a presumption of causation.²⁵⁶ After all, materiality is defined as the type of information which might well affect an investor's decision whether to invest. The Supreme Court itself, in *Affiliated Ute Citizens of Utah v. United States*,²⁵⁷ pronounced that the "obligation to disclose and [the] withholding of a material fact established the requisite element of causation in fact."²⁵⁸ The ease of establishing reliance in both omission cases (through the *Ute* analysis) and in most misrepresentation cases (through the fraud-on-the-market theory) largely eliminated the causation requirement in securities fraud cases for a few years.

However, in a recent development of great benefit to defendants, many courts have split the causation requirement into two distinct elements, transaction causation and loss causation,²⁵⁹ and have required plaintiffs to establish both.

"Transaction causation" is a requirement of causation in fact which is largely a restatement of the reliance element,²⁶⁰ demanding that plaintiffs show that a securities violation directly caused them to enter into the challenged transaction.²⁶¹ Plaintiffs must show that "but for" the fraud, they would not have entered into the transaction which ultimately resulted in a loss.

254. 814 F. Supp. at 1382 (emphasis added).

255. The importance of this limitation on the truth-of-the-market defense is the requirement that courts evaluate the extent to which the truth has entered the market. This fact-specific determination may preclude summary judgment. A corporate defendant faced with establishing that the truth had entered the market with a sufficient level of "intensity and credibility" may well decide that the certainty of a settlement outweighs a potential \$100 million verdict, such as the one handed down in *Apple*.

256. *E.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

257. 406 U.S. 128 (1972).

258. *Id.* at 154.

259. *E.g.*, *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988); *Kademian v. Ladish Co.*, 792 F.2d 614, 628 (7th Cir. 1986).

260. *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989).

261. *Id.*; *Fischer & Porter Co. v. Tolson*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,944, at 94,014 (E.D. Pa. June 30, 1992).

The more problematic causation aspect for plaintiffs is "loss causation," a concept that generally requires plaintiffs to show, additionally, that defendants' fraud proximately caused their economic loss.²⁶² Loss causation acts to limit the damages stemming from a securities fraud and "in effect requires that the damage claimed be one of the foreseeable consequences of the misrepresentation."²⁶³ A strict application of this approach allows defendants to concede that they misrepresented but still escape liability if plaintiffs' economic losses were caused by other factors.²⁶⁴

A leading case establishing the loss causation element is *Bastian v. Petren Resources Corp.*²⁶⁵ Plaintiffs had the misfortune of investing in an oil and gas venture in 1981, the peak year for oil prices, before a steady decline caused virtually all of the oil and gas limited partnerships formed in that year to lose money. Plaintiffs claimed that they would not have invested in defendants' particular oil and gas limited partnership had they known certain facts about defendants' honesty or lack thereof. However, plaintiffs steadfastly refused to provide the court with evidence as to the cause of their loss. Because the court was convinced that plaintiffs, had they known the truth regarding defendants, would simply have invested in a different oil and gas limited partnership and lost their money anyway, it denied recovery on grounds that plaintiffs had failed to establish loss causation:

262. A mere allegation of "but for" causation is insufficient in this connection. *E.g.*, *Bloor v. Carro, Spanbock, London, Rodman & Fass*, 754 F.2d 57 (2d Cir. 1985) (mere fact that attorneys filed documents that allowed corporation to raise funds that corporate officers later stole does not render attorneys liable under 10b-5). Rather, plaintiff must establish:

[N]ot only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value.

Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983).

263. *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 708 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

264. Some courts say that Section 10(b)/Rule 10b-5 causation has three elements: transaction causation, loss causation, and the requirement that the challenged fraud be "in connection with" the purchase or sale of a security. *E.g.*, *In re Catanella & E.F. Hutton & Co. Sec. Litig.*, 583 F. Supp. 1388, 1414 (E.D. Pa. 1984); *Haskell v. Wilson*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,543, at 92,488 (E.D. Pa. Dec. 30, 1991). For a discussion of the "in connection with" requirement, see *infra* notes 277-289 and accompanying text.

265. 892 F.2d 680 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990).

If the alternative oil and gas limited partnerships to which these plaintiffs would have turned had the defendants leveled with them were also doomed, despite competent and honest management, to become worthless, the plaintiffs were not hurt by the fraud; it affected the place but not the time or amount of their loss.

.....

... No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities.²⁶⁶

The promulgation of a high standard for establishing the separate element of loss causation has been strongly criticized as "an insuperable barrier to recovery."²⁶⁷ Fortunately for plaintiffs, some courts presume both transaction *and* loss causation if the plaintiff proves the elements of the fraud-on-the-market theory.²⁶⁸

Causation has been an issue in several product promotion cases. Demonstrating transaction causation is not too onerous because of its coextensiveness with reliance. Loss causation is often more difficult to prove because of the many factors that might affect a stock's price. For example, on May 12, 1983, Fortune Systems announced that it was having problems with its new computer product which were causing it to lose orders and customers. Fortune's stock price dropped dramatically in

266. *Id.* at 684-85.

267. Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 265 (1991) ("By this view of loss causation, even if plaintiffs can prove that the defendant's fraud caused them to pay too much for securities at the time of the transaction, they may nonetheless not recover any damages unless they can also prove that the fraud caused the postransaction [sic] decline in the value of their investments."). See also Andrew J. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469, 530-31 (1988) (criticizing the loss causation requirement as a "shield for fraud," and providing a vivid illustration based on Mel Brooks' movie *The Producers*).

268. *E.g.*, Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986) ("If plaintiffs make such a showing [that they purchased in an open and developed market], the court will presume that the misrepresentation is occasioned an increase in the stock's value that, in turn, induced the plaintiffs to purchase the stock."); *In re Phillips Petroleum Sec. Litig.*, 738 F. Supp. 825, 835 (D. Del. 1990).

wake of the announcement. Plaintiff shareholders attempted to recover for, *inter alia*, a stock price drop that had occurred in the two months preceding the announcement, claiming that the adverse product information had caused that loss. However, the court was convinced that defendant's evidence showed that other factors, including adverse stock market conditions, caused the pre-May 12 drop.²⁶⁹

Plaintiffs fared better in *Ballan v. Upjohn Company*,²⁷⁰ the case involving the drug Halcion discussed above. The following claims were deemed sufficient to allege loss causation:

[Plaintiffs] have alleged that due to defendants' intentional and reckless concealment of true test results from regulatory agencies, Halcion, during the class period, became Upjohn's second biggest sales item. Plaintiffs have further alleged that Upjohn, in the face of charges regarding adverse reactions to Halcion, falsely denied those charges. Plaintiffs have alleged that Upjohn, when faced with the withdrawal of Halcion from the United Kingdom, falsely stated that there was no scientific or medical evidence that warranted such withdrawal. Plaintiffs claim to have purchased Upjohn securities at artificially inflated prices and were damaged when the market price of Upjohn stock fell at the end of the class period Plaintiffs have alleged that the drop in the value of Upjohn's stock was not due to the approaching patent expiration date of some sleeping drugs.²⁷¹

Similarly, in *Fujisawa Pharmaceutical Co. Ltd. v. Kapoor*,²⁷² loss causation was adequately alleged when defendants sold all of the stock of Lyphomed Co. to plaintiff without disclosing that Lyphomed had filed false applications and information with the FDA in connection with Lyphomed's quest for FDA approval of new generic drugs. Defendants moved to dismiss for failure to allege loss causation, citing *Bastian* as precedent. The court denied the motion, responding:

269. *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360 (N.D. Cal. 1987) (defendants proved that forces other than misleading statements and omissions, including disastrous management of an IPO by underwriters, led to price declines).

270. 814 F. Supp. 1375 (W.D. Mich. 1992).

271. *Id.* at 1384-85 (citations omitted).

272. 814 F. Supp. 720 (N.D. Ill. 1993).

As [defendant] Kapoor's sole authority on loss causation, *Bastian* is a poor choice. The relationship between the plaintiffs' loss and the alleged fraud is much clearer in the present case. The Complaint alleged that Fujisawa would not have purchased Lyphomed had it known the truth about Lyphomed's shoddy testing and the ANDA [Abbreviated New Drug Application] filings. It can also be inferred from the Complaint that Fujisawa's loss, in the form of the FDA restrictions and recalls, is a direct result of Kapoor's fraudulent statements and omissions which artificially inflated the price of Lyphomed stock and induced Fujisawa to purchase the company.²⁷³

F. Purchase or Sale "In Connection with"

Because Section 10(b) prohibits fraud "in connection with a purchase or sale" of securities, plaintiffs must demonstrate (a) that a *purchase or sale* occurred, (b) that the alleged fraud occurred *in connection with* that purchase or sale, and (c) that the plaintiff was a *purchaser or seller*. The purchase or sale requirement derives from statutory language and is, generally speaking, broadly defined.²⁷⁴ The requirement that the plaintiff be a "purchaser or seller" is essentially a standing requirement.²⁷⁵ Unless a plaintiff bought or sold securities, he or she did not suffer the type of injury Section 10(b) and Rule 10b-5 are meant to remedy.²⁷⁶ For purposes

273. *Id.* at 727 (citations omitted).

274. *See, e.g.*, *Rubin v. United States*, 449 U.S. 424, 429-30 (1981) (holding that a pledge of stock as collateral for a loan was a "sale" for Section 10(b)/Rule 10b-5 purposes because it "unmistakably involves a 'disposition of [an] interest in a security for value'" (quoting *United States v. Gentile*, 530 F.2d 461, 466 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976)).

275. *See* *Advanced Resources Int'l, Inc. v. Tri-Star Petroleum Co.*, 4 F.3d 327, 332 (4th Cir. 1993).

Many courts recognize certain exceptions to the purchaser/seller status requirement for standing, allowing suits to be brought by (a) the SEC or U.S. Attorneys, (b) shareholder plaintiffs seeking injunctive relief rather than monetary damages, and (c) plaintiffs who can show that, but for the deceptive practices, they would have bought or sold the securities. *Id.* at 333.

There is also a "forced seller" exception for plaintiffs who have not yet sold but will inevitably be forced to sell because of defendants' alleged fraud. *See, e.g.*, *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982) ("The core issue is whether the transaction has transformed the plaintiff into the functionable equivalent of a purchaser or seller.").

276. In *Blue Chip Stamp Co. v. Manor Drug Stores*, 421 U.S. 723, 737-49 (1975), the Supreme Court stressed the wide-open and speculative nature of lawsuits that could be filed were standing granted to persons who had neither bought nor sold securities but merely

of this article, these requirements simply mean that persons who bought, say, computers and software, because they were misled by statements regarding the characteristics of those products, can sue only on grounds of breach of warranty, common law fraud, consumer protection violations, and the like. Unless the persons were moved by the misrepresentations and omissions to buy the company's securities as well as its products, they would have no standing to bring a securities fraud suit under Section 10(b)/Rule 10b-5.

The most important aspect of this area of Section 10(b)/Rule 10b-5 doctrine, insofar as this article is concerned, is the "in connection with" requirement. Proper analysis of this element requires that the topic be divided into cases primarily involving relatively private representations made by defendants to individual plaintiffs, and cases primarily involving public representations made by defendants to the market generally. Vaporware preannouncements and other forms of product marketing often involve both types of representations.

1. Private Representations

Courts traditionally construed the requirement that fraud be "in connection with" the purchase or sale of securities rather broadly in order to ease plaintiffs' pleading and proof burdens. The only Supreme Court case to address the matter, *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Co.*,²⁷⁷ announced that the requirement was satisfied by deceptive practices touching a purchase or sale of securities. A "touching" test ultimately proved too generous for the lower courts, who have searched for a more limiting principle.

Some courts have substantially equated the "in connection with" requirement to transaction causation.²⁷⁸ Other courts have examined the facts to determine whether a "nexus" existed between the defendant's fraud and plaintiff's investment decision, focusing on whether Section 10(b)'s purposes would be advanced by applying it to the particular

claimed that they *could have* done so had defendants told the truth.

277. 404 U.S. 6, 13 (1971).

278. *E.g.*, *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986) ("One factor to be considered in determining whether the 'in connection with' requirement has been met is whether a causal connection between the fraud and the transaction has been shown."). Although the "in connection with" requirement is analytically distinct from Section 10(b)/Rule 10b-5's causation requirement, the two are clearly intertwined.

transaction in question.²⁷⁹ The most restrictive view of the "in connection with" requirement demands that the fraudulent statement or omission complained of relate directly to the value of the security being sold or the consideration being offered therefor.²⁸⁰

To illustrate the potential confusion caused by this array of approaches, consider the facts of *Brown v. Ivie*.²⁸¹ Plaintiff Brown and defendants Ivie and Lightsey were each officers, directors, and one-third shareholders of a small corporation. In 1979, defendants decided to oust plaintiff from the corporation and had a vehicle by which to do so—a 1976 shareholders' "buy-sell" agreement requiring any shareholder no longer employed by the corporation to sell his shares back to the corporation at book value. Unfortunately for defendants, the 1976 agreement was unenforceable because certain statutory formalities had not been observed in its drafting. Therefore, defendants used a pretense to induce plaintiff to sign a similar, enforceable agreement in 1979. As soon as plaintiff signed the agreement, defendants fired him from his position and invoked the buy-sell agreement to force plaintiff to sell his shares back to the corporation.

There is no doubt that defendants' fraud "touched" on the sale of plaintiffs' shares. Similarly, most courts would find transaction causation and a nexus between the defendants' fraud and plaintiff's sale. However, the defendants' lies (plaintiff was told that he had to sign the new agreement in order for the company to effectuate a change in insurance companies and to increase the amount of insurance held by the corporation on each shareholder) did not relate to either the value of the securities or the consideration given therefor. For that reason, courts taking the most limited view of the "in connection with" requirement would find that it was not met in this case,²⁸² although the Fifth Circuit

279. *E.g.*, *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir.), *cert. denied*, 455 U.S. 990 (1981); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763 (5th Cir. 1974).

280. *E.g.*, *Gurwara v. LyphoMed, Inc.*, 937 F.2d 380, 383 (7th Cir. 1991) (holding that employee who was promised stock options that were later canceled did not meet "in connection with" requirement because misrepresentations did not go to the value of the stock or the value of the consideration to be given in return for it).

281. 661 F.2d 62 (5th Cir.), *cert. denied*, 455 U.S. 990 (1981).

282. Many courts taking this narrow view of the "in connection with" requirement will make exceptions when the misrepresentation, though it does not involve the merits of a particular security, nonetheless involves some aspect of the securities trading business. *E.g.*, *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 944 (3d Cir.), *cert. denied*, 474 U.S. 935 (1985) (stating that although broker-defendants' fraudulent concealment of credit terms of a margin account did not affect the investment value of a particular security, it did affect the course of dealing in securities and was sufficiently causally related to the securities

held that the "nexus" requirement applied and was met.²⁸³

There will be some obvious cases where statements made to promote products will not under any approach be "in connection with" the purchase or sale of securities about which plaintiffs later complain. Consider *Jabend, Inc. v. Four-Phase Systems, Inc.*,²⁸⁴ in which Grosenick had an idea to develop and market a computer hardware/software package for the insurance brokerage industry. Four-Phase assured Grosenick that its hardware was well-suited to Grosenick's purposes. Based on that assurance, Grosenick and Bender decided to pursue the venture. They chose the corporate form of business organization and formed Jabend, Inc. Naturally, they issued Jabend's stock to themselves in exchange for their capital investment. Four-Phase's product did not live up to representations, and Jabend ultimately went bankrupt. Grosenick sued Four-Phase under Section 10(b) and Rule 10b-5, claiming that he purchased Jabend stock in reliance on Four-Phase's representations about its computer hardware's abilities. The district court dismissed the suit for failing to meet the "in connection with" requirement because Four-Phase was trying to sell only computers and had nothing to gain by the sale of Jabend stock.²⁸⁵

Under virtually all of the various approaches discussed above, the "in connection with" element would be missing in *Jabend*. The misrepresentations were not about the particular value of Jabend stock. Nor were the misrepresentations calculated to affect the price of Jabend stock, particularly since they were made before Jabend was ever formed. Because Four-Phase was seeking to sell computers rather than stock, there was no "nexus" between its representations and the subsequent sale of Jabend stock. Only an exceedingly liberal interpretation of the out-dated "touching" test could provide even the slightest grounds for an argument

to meet "in connection with" requirement). Other courts disagree. *E.g.*, *Nevitsky v. Manufacturers of Hanover Brokerage Serv.*, 654 F. Supp. 116, 119 n.12 (S.D.N.Y. 1987) ("misrepresentation concerning the mechanics of a securities transaction, without particular regard to the nature of the securities themselves" held not actionable).

283. 661 F.2d at 65.

284. 631 F. Supp. 1339 (W.D. Wash. 1986).

285. *Id.* at 1343-44. The *Jabend* court distinguished the case from *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154 (E.D. Cal. 1976), wherein Sperry Rand promised that it could produce computer systems for a grocery delivery corporation's telephone-order marketing plan. When the corporation failed, its shareholders sued Sperry under Section 10(b) and Rule 10b-5. The "in connection with" requirement was held to be met in *Crofoot*, because under the contract Sperry's compensation would come from the sale of the corporation's stock and therefore Sperry would benefit from the sale of that stock.

that the "in connection with" test was met in *Jabend*.²⁸⁶

2. Public Representations

The "in connection with" requirement is often at issue in class action securities fraud lawsuits under Section 10(b) and Rule 10b-5 that arise out of product representations, such as vaporware announcements, reaching the investing public in general. Fortunately for class action plaintiffs, in these situations courts generally find the "in connection with" requirement to be met where the misstatements or omissions are made in a setting *reasonably calculated or reasonably expected to influence the investing public*.²⁸⁷ If this is the test applied, most cases of misleading product marketing statements will satisfy the "in connection with" test.

For example, an optimistic vaporware announcement at a trade show or in the trade press will likely have a direct impact on the market price of the company's shares. As noted earlier in this article,²⁸⁸ such an announcement can be expected to, and is often calculated to, have a direct impact on the company's stock price. If the product representations made in the *Jabend* case, for example, had been communicated not to a single potential customer, but to the public at large, the "in connection with" requirement would no doubt have been met.²⁸⁹ The product press releases complained of in *Apple* clearly reached the investing public as could reasonably have been expected. Therefore, the "in connection with" requirement will not weed out too many plaintiffs' claims in the typical class action securities fraud suit.

G. Damages

Lastly, plaintiffs in a Section 10(b)/Rule 10b-5 suit must demonstrate

286. Conversely, in a case like *Crofoot*, the "in connection with" test can be found to be satisfied if one applies a "touching" or even a "nexus" test. However, if one required that the misrepresentation relate to the value of the securities at issue, it seems unlikely that a 10b-5 claim could be stated.

287. *E.g.*, *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978) ("in connection with" requirement "is satisfied whenever it may reasonably be expected that a publicly disseminated document will cause reasonable investors to buy or sell securities in reliance thereon"), *cert. denied*, 440 U.S. 913 (1979).

288. *See supra* notes 92-97 and accompanying text.

289. In an analogous situation, a court drew a distinction between certified financial statements prepared by an accounting firm for internal use by the audited corporation, and certified financial statements prepared for use in publicly filed documents. *Braun v. Northern Ohio Bank*, 430 F. Supp. 367, 377 (N.D. Ohio 1977).

that they were damaged as a result of the fraud alleged. Because remediation is a primary goal of federal securities laws,²⁹⁰ compensatory damages provide the appropriate remedy in most 10b-5 securities fraud cases. Section 28(a) of the 1934 Act²⁹¹ limits recoveries to "actual damages," but it is not always clear how those damages are to be computed.

The courts have developed several approaches to calculating damages,²⁹² but in the vast majority of the suits brought under Section 10(b) and Rule 10b-5, courts borrow from the common law of torts,²⁹³ applying an "out of pocket" measure.²⁹⁴ In such cases, plaintiffs are entitled to recover the difference between the price paid and the actual value *at the date of the transaction*, plus interest.²⁹⁵ An important indicator of the "actual value" at the date of purchase (or sale) is the amount the market price drops (or rises) upon the public correction of a previous misleading statement or omission.²⁹⁶

Before the *Apple* verdict was overturned by the trial judge, the jury had found that the individual defendants, Markkula and Vennard, were responsible for \$2.90 of the \$8.00 stock drop because of the Twiggy vaporware announcement. Lawyers estimated that 33 million shares were traded during the class period, implying damages of at least \$96 million, plus interest.²⁹⁷

Occasionally courts have found that the investors sustained damage

290. *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

291. 15 U.S.C. § 78bb(a) (1988).

292. *Farley v. Henson*, 11 F.3d 827, 837 (8th Cir. 1993) ("out-of-pocket damages are not the only kind recoverable under Sec. 10(b)"). See also Kenneth Levine, *Damages in Fraud-on-the-Market Cases: A Price on Information*, 58 DEF. COUNS. J. 47, 50 (Jan. 1991) ("Remedies under Rule 10b-5 have included out-of-pocket, benefit-of-the-bargain, and cover damages, rescission and restitution.").

293. Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 355 (1984) ("Tort concepts have been the dominant theory shaping the measure of recovery, in large part because courts used tort theory as the primary basis for implying a private right of action.").

294. *E.g.*, *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J., concurring) (explaining advantages of out-of-pocket measure over rescissory measure).

295. *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971); *Estate Counselling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962).

296. See generally Roger R. Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99, 131 (1981); see also Kenneth R. Cone & James E. Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505 (1994) (arguing that models commonly used to determine when investors purchased and sold stock during the class period are inaccurate and generally overstate damages).

297. Yoder, *supra* note 109, at B4.

when the defendant withheld "good news," resulting in the plaintiffs selling shares at a lower price than they would have had the truth been disclosed.²⁹⁸ However, when it comes to the product marketing statements that are the focus of this article, understatement seldom occurs. Overstatement is typically the order of the day.

Courts do consider other causes that might affect a stock's price drop. For example, in the *Apple* case, disappointing quarterly earnings were announced at the same time as the decision to discontinue Twiggy and were apparently the cause of \$5.10 of the \$8.00 stock drop, at least in the jury's eyes.²⁹⁹ Such issues were discussed in the loss causation section above.³⁰⁰

III. SOME PRACTICAL GUIDELINES TO AVOIDING *APPLE*-TYPE LIABILITY

Section 10(b) and Rule 10b-5 obviously have a profound influence upon not only the formal filings that the SEC requires of public companies, but also less formal mechanisms of corporate disclosure, including product marketing activities. At times, these provisions may impose upon a company the duty to promptly disclose information such as problems in product development that the companies would wish to keep secret. At other times Section 10(b)/Rule 10b-5 may inhibit companies from conveying information (e.g., vaporware announcements) that, for marketing or other purposes, they would like to announce immediately. The specter of massive securities fraud liability inevitably shapes disclosure policies.

Although Section II's discussion provides the tools to evaluate the potential Section 10(b)/Rule 10b-5 impact arising from product hype or from other similar public disclosures (or omissions), companies must be equally concerned with avoiding litigation before it arises.³⁰¹ This is especially so because some studies show that once a Section 10(b)/Rule

298. The famous *Texas Gulf Sulphur* case is such a "good news" case; defendants misled the investing public about a tremendously rich mineral find the company had made in Canada. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

299. 672 F. Supp. 1552, 1557 (N.D. Cal. 1987), *aff'd in part, rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), cert. denied, 496 U.S. 943 (1990).

300. *Supra* notes 262-264 and accompanying text.

301. See generally Richard V. Smith, *Why Companies Must Watch What They Say*, S.F. CHRON., Mar. 9, 1992, at B7.

10b-5 class action lawsuit is filed, it has substantial settlement value *regardless of its merits*.³⁰²

Avoiding securities fraud liability in a corporation is a matter of first controlling the flow of information within the organization. A publicly-traded company must ensure that potentially material information is scrutinized by one capable of judging the information's materiality before it seeps outside the organization. Knowledge of the company's duties to disclose and timing for disclosure are also important.

Most public companies already have established mechanisms for meeting legal obligations when disclosures take the form of formal SEC filings, but increasingly companies speak to investors through less formally structured disclosures,³⁰³ including product hype. Judging from the litigation discussed in Section II, many companies do not have adequate safeguards in place to ensure that product promotional announcements are accurate, complete, and timely (but not premature).

This section outlines a program that should allow publicly-traded corporations to control the flow of product marketing information, ensure pre-disclosure evaluation of that information for potential Section 10(b)/Rule 10b-5 violations, and result in a monitored and controlled dissemination of such information to the investing public.

A. Informing Employees of Section 10(b) and Rule 10b-5 and Their Potential Impact on the Organization

Ensuring corporate compliance with Section 10(b)/Rule 10b-5 involves first informing appropriate employees of the requirements imposed by this body of law.³⁰⁴ The appropriate employees encompass all those in a position to possess "material inside information." As this article makes clear, employees engaged in product development and product marketing

302. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 596 (1991) (settlements in securities class action lawsuits are rarely influenced by expected trial outcomes).

303. See WESLEY S. WALTON & CHARLES P. BRISSMAN, CORPORATE COMMUNICATIONS HANDBOOK § 1-1 (1990) ("Speaking to the investing public through unstructured disclosure has become an integral part of managing a public company.").

304. The following discussion is designed to offer recommendations concerning corporate compliance with Section 10(b) and Rule 10b-5. Because corporations act through their officers, as so pointedly demonstrated in the *Apple* case, such recommendations also serve to protect corporate officers from certain aspects of securities fraud liability. However, the following discussion does not cover the rules of insider trading liability under Section 10(b)/Rule 10b-5. In a different forum, employees should no doubt be informed of this aspect of the law as well.

must be included in this list of employees.

After identifying this group of employees, Section 10(b) and Rule 10b-5 and their implications should be explained to the employees through a memorandum, followed by a meeting. The memorandum should set forth both the purpose and the elements of Section 10(b) and Rule 10b-5. Any description of the elements of Rule 10b-5 should be framed as broadly as possible. For instance, "material information" might be defined as "information which a reasonable investor would consider important in making an investment decision, or which would be reasonably likely to have an effect on the market price of the company's stock." Broad definitions of terms of art such as "material information" or "purchase and sale" are not only easier to comprehend, but also force those relying on such definitions to err on the side of being overinclusive. It is a safer course to have the untrained employees assume most information is material and to allow the trained attorney (via the Disclosure Compliance Committee discussed below) to assess which information is truly material. After explaining the elements of a securities fraud cause of action and the potential consequences of any violation, the memorandum should set forth common examples of corporate developments which can and cannot be discussed publicly. As this article illustrates, some examples involving product marketing should be included.

Finally, the explanatory memorandum should be followed by a meeting designed to explain the compliance process to employees and to offer employees the chance to ask questions regarding these liability rules and their consequences.³⁰⁵

B. The Disclosure Compliance Committee

Any effective disclosure compliance program must have at its heart not the prohibition of disclosing information to the investing public, but quite the contrary, the *disclosure* of appropriate information to the investing public. This is particularly important when that information is product-related information necessary for consumers to make important purchasing decisions. As mentioned previously, one key competitive factor in high technology industries is the ability to discuss with customers and investors

305. This meeting should be overseen by the general counsel not only for his or her insight, but also to emphasize the high level of concern over this issue. Depending on the background of the general counsel, the meeting should also be attended by a securities law expert to provide answers to difficult or unforeseen questions.

product development prior to a product's introduction to the market.³⁰⁶ Therefore, product marketing needs must always be considered and product preannouncements cannot be totally eliminated.

High-tech companies must establish centralized control over their disclosure processes.³⁰⁷ Creation of a "Disclosure Compliance Committee" ("the Committee") offers an organization the means of ensuring that relevant information enters the marketplace, allowing a company to maintain its competitive edge. Establishing such a committee, however, permits examination of information prior to its disclosure to the public, thereby preventing product hype or other unstructured corporate disclosures from translating into securities liability.

The composition of the Committee must be individually tailored to the size and structure of the particular corporation. However, all such committees should include persons with responsibilities equivalent to the general counsel, the controller, the chief financial officer and a person in charge of public affairs. The cases discussed in this article indicate that top marketing personnel should also be members. To be truly effective, the Committee should also have the demonstrated support of the chairman of the board and the CEO through either their membership on the committee or their explicitly-stated sponsorship.

The mandate of the Committee should consist of the following: (i) identifying important information as it develops, (ii) determining the materiality of such information and whether, when, and how such information is to be disclosed, (iii) providing a mechanism for coordinating public disclosure of information by the company, (iv) reducing the gap between vaporware announcements and actual results in terms of time of product availability and product features, (v) prohibiting abuse of confidential information by employees, and (vi) monitoring the trade press. These responsibilities deserve individual discussion.

1. Identifying Important Information as It Develops

The first task of the Committee is to make sure that all potentially material information is reported to the Committee. Appointing an appropriate manager within each business unit, including those devoted to marketing, to regularly report to the Committee will help ensure that

306. See *supra* notes 46-65 and accompanying text.

307. See generally WALTON & BRISSMAN, *supra* note 303, at §§ 3-1 to 3-5.

material information is received by the Committee on a timely basis. As noted above, the reporting managers should be trained to identify material information, but the Committee, not the individual manager, must ultimately be responsible for evaluating information's materiality.

Pending review of developments reported to the Committee, the managers should be advised to discuss the information only on a "need to know" basis within the organization. Operating on such a restricted basis serves the additional goals of preserving potential trade secrets and minimizing the damaging disclosure of competitive information.

2. *Determining Materiality and Appropriateness of Disclosure*

Once in receipt of information reported by the managers, the Committee can determine whether or not the information is material and whether or not disclosure is required.³⁰⁸ Material developments sometimes require almost immediate disclosure, as noted earlier in Section II. For instance, Apple, upon learning of Twiggy's shortcomings, should have promptly tempered its earlier public expressions of confidence in Twiggy. Such immediate disclosure is often the only means of avoiding liability or closing the class period if earlier disclosures or omissions are held violative of Section 10(b)/Rule 10b-5.³⁰⁹

If disclosure is not required, the Committee can address whether disclosure is nonetheless desirable, taking into account marketing as well as legal concerns. If the Committee concludes that disclosure should be deferred, it should inform the appropriate persons that until further notice is given the information is not to be discussed either outside the company, or inside the company except on a "need to know" basis.

308. In making these determinations, the Committee should take into account the following elements which, in essence, mold materiality into practical terms: (1) the possible effect of the information on individual decisions to buy, sell, or hold the company's securities and on the market value of the company's securities, and the magnitude and immediacy of that effect; (2) the specificity and reliability of the information; (3) whether the facts are in a state of flux; (4) any prior or pending public disclosures of information relating to the same subject or related matters; (5) whether the information is novel in terms of previous company experience; (6) the presence of rumors or unusual market activity in the company's securities; and (7) the existence of any proposed or pending public offering of the company's securities.

309. Immediate disclosure can be achieved by issuing press releases marked "For Immediate Release" with copies to Dow Jones and Reuters, together with copies to all stock exchanges on which the company's securities are traded. In the case of large corporations, distributions should also be made to the Associated Press, as well as to newspapers in New York City (including the *Wall Street Journal*) and other locations significant to the company.

3. *Providing a Mechanism for Coordinating Public Disclosures*

The Committee must also monitor all product marketing activity. Whether contained in advertising copy, press releases, articles written for the trade press, statements made at trade fairs, or similar releases, descriptions of product development and product performance may impact the stock market price of the company's shares. Therefore, a coordinated, comprehensive regime to ensure that overly optimistic factual statements do not occur must be in place. While execution of a broad marketing program should be left to the marketing department, all such programs must be reviewed by Committee members qualified to judge their materiality and accuracy as well as their resulting effect on the investing public.

Marketing personnel often pay close attention to the persuasive aspects of product press releases and other product communications.³¹⁰ The Committee must ensure that the same care and attention are given to the liability aspects of such releases.³¹¹ Marketing and legal concerns must be coordinated, and with potentially huge securities fraud liability looming on the horizon, sometimes the latter concerns must predominate.

Another concern must be the trade press, which, as noted earlier, plays a key role in the marketing of many high-tech products. The lines of communication must be open between the corporation and members of the press. But once again, a coordinated company approach evaluating legal concerns must be implemented because the company is always liable for statements its employees make in the press and may be liable for statements by the press that carry the company's imprimatur. Two corporate legal experts have suggested the following guidelines which may be easily applied to the product promotion activities addressed in this article:

- Limit those who deal with the press, analysts and institutional investors to one or two principal corporate spokespersons.
- Be sure that any spokesperson is fully informed about the company's activities before he or she communicates with

310. See, e.g., Christel K. Beard & H.J. Dalton, *The Power of Positive Press*, SALES & MARKETING MGMT., Jan. 1991, at 37; Sandra L. Beckwith, *Write Press Releases That Get Results*, HOME OFFICE COMPUTING, June 1991, at 24.

311. See WALTON & BRISSMAN, *supra* note 303, at §§ 3-6 to 3-8.

the press, analysts or institutional investors.

- Where practical, carefully prepare any spokesperson, in much the same manner you would prepare a witness for a deposition, before communications are had with reporters, analysts or institutional investors.
- After each conversation, debrief the corporate spokesperson, to ensure that there is no risk of a charge of selective disclosure, and that the information revealed is consistent with the facts known to the corporation at the time.
- Know the difference between statements that are "on the record," "off the record," or "for background information only," and be sure to use these appropriately in talking to the press and analysts.
- Where it is possible to communicate in a non-attributed manner, consideration should be given to doing so, since liability may be decreased as a result. The corporation should avoid maintaining records that reveal who may have been the unidentified spokesperson for specific comments.
- Company spokespersons should refrain from enmeshing themselves in, or placing the company's imprimatur on, analysts' projections.³¹²

4. Reducing the Gap Between Vaporware Announcements and Results

Certainly the discussion in Section I indicates that forward-looking product disclosures may be so competitively important that, under some circumstances, they cannot be avoided. Without totally eliminating such disclosures, the Committee must pay particular attention to their accuracy. The greater the disparity between an optimistic marketing announcement and subsequent reality, the more likely the announcement will be treated as actionably fraudulent by a court.³¹³ A company should observe

312. Harvey L. Pitt & Matt T. Morley, *Complying with Corporate Disclosure Obligations When Contemplating Strategic Planning Options 9-10* (Dec. 15, 1993) [hereinafter Pitt & Morley, *Complying*] (unpublished manuscript, on file with authors).

313. See *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974) (noting that one factor in determining actionability of a failed prediction was "the gross disparity between prediction and fact").

moderation in all things, even the hyping of products.³¹⁴ This will require the Committee to pay attention to at least four important and closely-related tasks.

First, *the Committee should establish a policy that the company will refrain from making unnecessary public projections about product development.* As noted earlier, although the SEC has provided "safe harbors" for forward-looking information and generally encourages the making of projections, too many companies have learned of the tendency of such statements to lead to securities fraud litigation.³¹⁵ Forecasting should generally be left to the financial community.³¹⁶ Similarly, companies would typically do well to leave projections regarding their upcoming products that are still in development to the trade press. While there will be times when marketing considerations of overwhelming importance require the making of projections regarding the features of a product in development and expected release dates, the potential liability if such projections are not realized must be factored into the decisional equation regarding whether such statements should be made. Without ignoring the marketing requirements of a new product, consideration must be given to foregoing the announcement of an upcoming new or improved product until its later stages of development. This is a situation where the Committee may have to overrule the desires of marketers in order to avoid securities fraud liability.

Second, *the Committee should ensure that the company avoids over-optimism in its public disclosures about product development.* When

314. Even the New York Stock Exchange recommends against over-hyping. See, e.g., THE NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL ¶ 202.06(A) (1983), which provides:

Premature announcement of new products whose commercial application cannot yet be realistically evaluated should be avoided, as should overly optimistic forecasts, exaggerated claims and unwarranted promises. Should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Id.

315. Allegations of improper financial disclosure are the largest source of lawsuits against corporate directors and officers, and overly enthusiastic projections are often the real problem. Edward Felsenthal, *Issues of Disclosure Top Survey of Suits Against Firms' Officers*, WALL ST. J., Mar. 1, 1994, at B9. This survey by consulting firm Wyatt Co. prompted Alan Bromberg to comment that lawsuits can be avoided if companies refrain from "making enthusiastic statements not only about where they are, but about where they will be in the months and weeks ahead The best advice is 'Don't hype.'" *Id.* The same advice pertains to projections about vaporware.

316. Snow, *supra* note 13, at A14.

forward-looking statements are made, the Committee must be cognizant that the stock market generally *overreacts* negatively when optimistic forecasts are not realized.³¹⁷ An announcement that earlier predicted levels of sales or earnings will not be met almost inevitably leads to the sort of drop in stock price that prompts the filing of securities fraud class actions.³¹⁸ The *Apple* case illustrates clearly that when key products fall short of performance predictions, that failure can also adversely affect the company's stock price, thereby prompting securities fraud litigation. The best way to avoid falling short of expectations is to be cautious in making projections regarding sales, revenues, and even product development.

This suggestion will no doubt significantly chafe marketing managers whose bread and butter is often the optimistic product press release. However, some lessons must be drawn from the stock prospectus, which has been called a "schizophrenic document"³¹⁹ in that it attempts to emphasize the issuer's positive features in order to interest investors in purchasing the issuer's stock, yet must also caution the investors about the issuer's weaknesses as a shield against potential lawsuits. Others have noted that this tension between the desire to be boldly optimistic to spur sales and the need to be cautious to avoid liability is even greater in statements about the company's *products* rather than its stock.³²⁰ Perhaps in response to *Apple*, some major high-tech companies have already reduced the number of public comments made by their executives.³²¹

317. Baruch Lev, *The Curse of Great Expectations*, WALL ST. J., Nov. 30, 1992, at A12 (explaining how Hewlett-Packard stock dropped a cumulative \$3 billion in value after an announcement that quarterly earnings were flat and had fallen short of analysts' expectations, although sales had risen 15% and no new product line had flopped).

318. John C. Coffee, *Disclosures to Analysts are Risky*, NAT'L L.J., Feb. 1, 1993, at 22. For example, the small computer cartridge company Exabyte received the first of a series of eight class action lawsuits within 48 hours of announcing lower-than-expected earnings, which had caused a sharp drop in its stock price. Himelstein, *supra* note 12, at 112-14.

319. ROBERT A. PRENTICE, *LAW OF BUSINESS ORGANIZATIONS AND SECURITIES REGULATION* 533 (2d ed. 1994).

320. See Pitt & Groskaufmanis, *Hyperv verdicts*, *supra* note 19, at 10 ("[T]ension exists between the two forms of corporate pronouncements. Formal filings with the SEC and/or investors tend to take on the somber tones usually associated with the legal profession, while corporate product announcements, press releases, and advertisements reflect a more free-flowing (and perhaps upbeat) form of expression.").

321. See Gupta & Bowers, *supra* note 15, at B2 (biotechnology firm Centocor, Inc. "says it no longer makes earnings projections and no longer comments on drugs that it is developing until its research results are published in academic journals."); Himelstein, *supra* note 12, at 114 ("At Intel, which isn't shy about using the courts to protect its patents, executives are now more conservative when commenting on the company. They want to steer clear of liability should those comments later prove inaccurate.").

Others have softened the praises they sing for their products still in development. Such caution is wise.

The time lag between when a product is preannounced and when it is actually marketed should be reduced to the absolute minimum that marketing considerations allow. Companies must further ensure that any predictions regarding the development and performance of products are conservative, made in good faith, and sincerely believed at the time they are made.³²² Subjective good faith belief is important, but it will not be sufficient unless the basis for the belief is adequately documented. The compiling of such a documentary basis must therefore also be a prime concern.

Third, *the Committee must establish a continuous disclosure program that will avoid surprising the market.* Nothing causes the stock market to react (and overreact)³²³ more than a surprise announcement—whether it relates to earnings and profit levels, a delay in bringing a promised product to market, or a discontinuation of efforts to develop and market a certain product. Therefore, if the market knows that a company is working to develop a particular product, perhaps because marketing constraints have induced the company to make a forward-looking product announcement, the company should do a thorough job of keeping the market abreast of major difficulties and complications regarding that product's development.³²⁴

Because the filing of securities suits usually follows precipitous stock price declines, avoiding market surprises is one of the Committee's most important tasks.³²⁵ Companies should therefore develop a regime that keeps careful track of forward-looking product development claims and provides for timely updates and/or corrections whenever it appears that the company's crystal ball has been a little cloudy.³²⁶ A series of realistic statements made pursuant to a proactive plan of thorough disclosure will

322. Pitt & Morley, *Complying*, *supra* note 312, at 11.

323. See Gupta & Bowers, *supra* note 15, at B2 (pointing out that market prices are more susceptible to news than they once were, perhaps because "big investment funds and institutional investors ignore fundamentals and dump stocks if the numbers fall short of expectations").

324. Lev, *supra* note 317, at A12 ("A consistent, proactive disclosure strategy would go a long way toward minimizing stock price volatility . . . mitigating the threat of litigation."); Snow, *supra* note 13, at A14 ("The best insurance against stock swings is to keep the markets informed, on a regular basis, of the forces affecting operating results.").

325. See Alexander, *supra* note 302, at 571 (arguing that if stock prices decline sufficiently, class action suits will be filed and "issuers cannot avoid them through compliance programs or careful scrutiny of offering materials").

326. Pitt & Groskaufmanis, *Lessons*, *supra* note 12, at 24.

keep the market informed, avoid sudden drops in the corporation's share prices, and consequently discourage the filing of securities fraud lawsuits.

Fourth, *the Committee should be alert to internal facts that contradict the company's public pronouncements.* When optimistic predictions are made and not realized by actual company performance, class action plaintiffs win over judges and juries by pointing out evidence of internal doubts that existed at the time the optimistic public pronouncements were made. The jury's award in *Apple* no doubt arose in large part from a juxtaposition of Apple's optimistic public hype about its new disk-drive with its private internal memoranda describing the product's problems as "frightening."³²⁷ Such contradictions smack of the bad intent plaintiffs must demonstrate to establish a Section 10(b)/Rule 10b-5 case.

The Committee must be alert to such contradictions.³²⁸ Vaporware typically arises out of optimism rather than malice,³²⁹ but in order to defeat claims on grounds of lack of scienter, the Committee must monitor public communications and compare them to internal corporate records *before* such communications are released in order to ensure that embarrassing discrepancies between public statements and private memos are eliminated. Careful recordkeeping will also help the company document the good faith and reasonable grounds underlying its vaporware announcements and other forward-looking statements.

5. *Prohibiting the Abuse of Confidential Information*

Part of the Committee's job should be to improve informational security. As noted earlier in this article, the trade press is extremely active in the computer field. Some part of the vaporware problem can be traced to leaks to the trade press from inside the companies.³³⁰ Rumors begin to swirl, and the company feels that it must officially respond by giving information about a product that may be in only the earliest stages of development. If leaks are minimized, vaporware preannouncements

327. 672 F. Supp. 1552, 1565 (N.D. Cal. 1987), *aff'd in part, rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).

328. See Pitt & Morley, *Starkly*, *supra* note 156, at 7; WALTON & BRISSMAN, *supra* note 303, at § 1-6 ("[A]ny particular fact in th[e] record may become the difference between liability and no liability. Thus corporate managers must think about the record they are building each time an unstructured disclosure issue is analyzed.").

329. Mallach, *supra* note 86, at 17.

330. Jenkins, *supra* note 55, at 10 ("Vendors put at least part of the blame for vaporware on the press' insatiable demand for product information.").

will be minimized as well, reducing liability exposure.

Perhaps more critical is the insider trading problem. Any company that realizes its products are not going to live up to the market's expectations should close the trading window, at least for officers and directors.³³¹ As noted earlier, insider trading in a company's stock (a) may trigger a duty to disclose information that the company does not yet wish to disclose, and (b) may provide circumstantial evidence of the scienter needed to establish a Section 10(b)/Rule 10b-5 violation.

6. *Monitoring the Trade Press*

Finally, the Committee must regularly monitor the trade press in the company's particular market (e.g., computer magazines), financial publications, and trading in the company's securities in an effort to discern unwarranted disclosures or rumors. When "plumbing control" fails and leaks occur, corrective disclosures may be required. Whether or not the company is *required* to make corrective disclosures will, as noted above, depend in large part on whether the inaccurate information had its source within the company. Only if the Committee is confident that company employees are not the source of the misinformation and have not placed the company's imprimatur upon it can the Committee comfortably avoid issuing a corrective press release.

The Committee should also keep files on all the information written about the company's products in the trade press and elsewhere.³³² At the very least, such articles may pave the way for a successful "truth-on-the-market" defense. It may be awkward for a company to take the position that its optimistic statements were not believed by anybody, but there may come a time when a clippings file containing numerous articles skeptically reviewing a company's publicized claims for its products may provide an effective and welcome defense.

CONCLUSION

This article's premise is simple. Product marketing communications often reach investors as well as product consumers. Indeed, statements about the features of a company's products are often intended to induce

331. Snow, *supra* note 13, at A14.

332. Pitt & Groskaufmanis, *Lessons*, *supra* note 12, at 26.

venture capitalists or others to invest in a company or simply to buoy the market price of actively traded shares. For that reason, misrepresentations and misleading omissions made in product marketing activities are as likely to generate securities fraud class action litigation as the more familiar statements of earnings and projections of future financial performance contained in formal filings with the SEC. Therefore, along with the other matters typically monitored for securities law purposes, product marketing must be internally policed in order to minimize potential liability.

David Packard, one of the founders of Hewlett-Packard, used to say that marketing is too important to be left to the marketing department.³³³ This article has highlighted an area where Packard's statement is undeniably true. The cautions of corporate lawyers are often needed to curb the natural optimism of product marketers so that high-tech companies may avoid the massive securities liability that a jury was willing to impose on Apple Computer because of its product hype. If, as many believe, a major cause of vaporware is a lack of communication between marketing departments and technical staff,³³⁴ it is equally true that a major cause of securities liability is a lack of communication between marketing departments and legal staff.

As the cases discussed in this article illustrate, securities fraud lawsuits arising from product marketing activities are far from rare. But such suits can be minimized and liability often averted if the suggestions set forth in Section III of this article are heeded. Fully implemented, these suggestions will not eliminate vaporware announcements. They will, however, reduce their number and do much to reduce the gap between promise and realization in high-tech product marketing. This increase in the accuracy of information provided to both investors and consumers should, in turn, increase the efficiency of both the securities markets and the economy generally.

333. Davidow, *supra* note 23, at 7.

334. See, e.g., Jenkins, *supra* note 55, at 10 (quoting David Moskowitz, president of Productivity Solutions).