Projections, Forward Looking Statements and Safe Harbors: A Review and Analysis of *The Valuation Treadmill* by James J. Park

*By James A. Deeken**

A privately held company has no need in most cases to worry about quarterly fluctuations in its valuation. Management can concentrate on the long term. Private companies also operate without the stress of watching whether their stock price is going up or down.

Some public companies at times have no refuge from that stress and pressure. In the view of UCLA Law Professor James J. Park, modern valuation models often put companies under extreme pressure to maintain forecasts of growth. A central thesis of Park's recent book, *The Valuation Treadmill: How Securities Fraud Threatens the Integrity of Public Companies*, which is subject to debate, is that some public companies can be incentivized to focus on the short term and at times can be steered by short term financial result concerns to adopt practices to meet short-term growth targets.

Park's work, although essentially at its heart a law book, could easily pass for business or accounting analysis. Park illustrates his points and analysis through a "case study" approach similar to the analysis used by used in business treatises. Park goes through a number of studies involving well know corporations describing how financial pressures led them astray in their compliance with federal securities law, displaying not only a deep understanding of the law but also the business context of how business decisions interplay with the practical realities of securities law.

Using a method that is similar to a "law and economics" approach, Park understands that securities regulation cannot be considered in a vacuum and demonstrates an appreciation of how in certain areas excess regulation can have negative unintended consequences, noting in particular the litigation expense and costs that can be imposed on public companies. Yet, at the same time he sees a system in need of change and puts forth proposals for addressing what he perceives as material deficiencies.

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The Nuances of Projections

One of Park's most interesting studies involves Apple and a securities settlement that it entered into in the early 1980s related to optimistic forward looking statements that it had made about its planned Lisa computer and Twiggy disk drive. Although the settlement of $16 million was small in a relative sense, Park notes that the case was significant in that it underscored that under then current law a company could be held liable under Rule 10b-5 for failing to meet a projection.[1] He then uses the case as an entry to discuss the thorny issues presented by projections and forward looking statements.

Park uses the Apple case as an example of tension in securities law regarding the use of projections and "forward looking statements". One impulse is to recognize that projections can be helpful for public company valuations, while another is that companies can be reluctant to issue projections for fear of securities fraud liabilities should it fail to meet them. That fear, prior to the adoption in 1995 of The Private Securities Litigation Reform Act of 1995, or PSLRA, inhibited the dissemination of forward looking information into the market.

Prior to Congressional action, the SEC had attempted to mitigate projections and forward looking statements litigation by adopting a rule providing a safeguard for projections unless they were made without a reasonable basis or in bad faith.[2] Park argues that protection was not that helpful to companies because plaintiffs' lawyers to draft complaints that would survive summary judgment by creating a fact issue over bad faith.[3]

The PSLRA tried to address the lingering issues presented by projections litigation by shielding companies from liability if their statements were made with meaningful cautionary language and by replacing the SEC's reasonable basis and good faith standard with an actual knowledge test.[4] Thus post PSLRA, a company could only be held liable for missing a projection if it knew that it was wrong.

Park argues that the impact of the PSLRA was to give companies more freedom to issue aggressive projections. He notes that it also created a situation where courts would often dismiss projections claims due to insufficient evidence that the company knew they were wrong when made. Park views the PSLRA as having mixed success as he notes that while the percentage of companies issuing earnings projections has increased, most public companies still do not issue them.[5]

The PSLRA safe harbor is broader than just providing protections for earning projections. It's scope also includes protection for forward looking statements that are non-financial in nature.[6]

Several companies routinely issue non-financial forward looking statements, even if they do not also routinely engage in earnings projections. While the merits of that can be debated, Park's analysis of the success of the statute seems to be narrowly confined to the statute's impact on earnings guidance.

Park's Proposals Regarding Projections

Two of Park's proposals set forth in *The Valuation Treadmill* address projections. His first proposal along those lines is that public companies should be obligated to issue periodic disclosures of earnings and revenue projections, accompanied by the information supporting the basis of those projections. He even goes further and suggests that the projections be audited. The main benefit he sees is that the disclosure of such information would allow correction of analyst expectations that otherwise may result in a company being valued incorrectly, while also reducing speculation about a company's long term prospects, speculation that he views as often putting companies under stress to meet unrealistic growth expectations.

In review, Park's proposal puts forth as many questions and issues as it does potential benefits. How often and for what duration would companies be required to put forth projections? Would they be required to do it every year for two years out? Three or five years out? Shorter term projections would might have less impact on reducing speculation as they would be just a little longer than regularly reported earnings. However, longer term projections might be more unreliable given the increased degree of risk in projecting something over a longer period of time.

Then there is the nature of earnings and revenue projections themselves. Any financial projection rests upon assumptions about future events and circumstances, a large number of which are even outside the realm or control of a company. No company to any large degree knows prospectively what its labor costs will be, what it costs of materials or supplies will be, how macroeconomic events may impact the demand for its goods and services, what legal liabilities it may face, what its competitors will do or even what new competitors may emerge. The necessity of making a vast number of assumptions might be the reason so many companies avoid earnings and revenue projections all together. In addition, a mandated use of projections seems to run against the restrictions and conditions on their use that the SEC has advanced in other areas of securities law, partly due to the nature of assumptions needed.[7]

Thirdly, would auditors being willing to audit "projections"? Are the assumptions that underlying projections even "auditable"? In an era of already rising audit costs, how expensive would that be? Concerned about their potential liability, the fees might be crippling for smaller companies. In fairness, Parks suggests that some of the audit costs could be offset by reducing other regulatory mandates, such reducing the frequency of auditor reviews of internal controls that are required by Sarbanes-Oxley.

Lastly, with mandatory projections being put into the market place by every company, would companies be under pressure to issue increasingly aggressive projections to match some of their peers? Park points out that the PSLRA in some cases would protect companies if their projections turn out to be incorrect. However, would that encourage some unscrupulous companies to issue speculative projections especially when they might be under pressure to keep their near-term stock price up in relation to their competitors?

His second proposal is that public companies be required to update projections in light of major new developments, noting that courts have been reluctant to impose such a duty. Would companies face increased litigation over failure to update claims? Park's answer is the law should provide that for such litigation to succeed plaintiffs would need to show that the projection has become "false." That only raises the question of when exactly a projection in fact becomes "false." Because a number of projections are long-term it might not necessarily be clear when it becomes impossible to meet them. For example, if a company provides a one-year projection, then has a bad month does it need to update the projection if it believes that it will recover over the next eleven months to meet the full year target? Also, since any projection would be based on assumptions, likely a multitude of them, would there resultantly be a duty to update each time one of those assumptions changed? Could a company even keep track of that on a continual basis?

Those and many related items might be subjective items that could be challenged in court through endless litigation. Although to Park's credit, he does suggest that the law may need to provide that litigation over a duty to update could only be brought by the SEC.

However, it might seem "unfair" to force a company to do something that is inherently speculative to begin with and then punish them for failing to meet a somewhat subjective standard related thereto. In essence companies could be hit with a "double hammer." They would be first hammered into doing something that they either don't want to do or find too risky. Then they could be hammered again when someone later alleges that they were not meritorious in doing in what they didn't want to do to begin with. Any consideration of imposing a duty to update on companies would need to be viewed with beady eyes.[8]

Other Case Studies of Note

Park also takes the readers through a case study involving Xerox where the SEC alleged that Xerox had moved profits that normally would have been booked in a later quarter to an earlier quarter to create the appearance of growth. In analyzing the case Park reminds readers that the primary rule that prevents securities fraud, Rule 10b-5 adopted under the Securities Exchange Act of 1934, requires that a misstatement was not only wrong but that it was made with the intent to deceive investors and that in the Xerox case the SEC based its intent argument on alleged recklessness. In this case, Park lays out how in the SEC's view Xerox exploited the gray areas in accounting assumptions in a manner that it alleged was not in good faith.

Park then uses the case study of Enron to illustrate how complex financial statements have become and how pervasive estimation has become in financial reporting. While acknowledging that accounting rules were broken he cites some who have suggested that some of the manipulations had actually been disclosed but were unperceived.[9]

Park uses a later case study to attack a use of "earnings management," what Park describes as a method where companies in engage in short term financial transactions that are done with the principal motive of meeting a short term earnings target. Park questions whether when earnings management is done in accordance with GAAP whether it might allow a company to deceive its investors.[10] Park notes in one particular action partly for implementing a "deferred monetization strategy" the SEC did not cite a specific violation of any accounting rules.

Accordingly, one of Park's proposals is that the SEC preemptively target companies that engage in earnings management to meet projections even if doing so does not transgress GAAP. However, is earnings management a wide spread problem? A number of companies issue earnings guidance when market protections are too high, which seems to be the opposite of earnings management. Would the SEC be able to differentiate transactions that were done for legitimate reasons from those that were done for purposes of earnings management? Those are questions to be resolved but Park is furthering the discussion.

The Valuation Treadmill serves a dual purpose of (i) effectively educating the reader about the evolution of modern securities law and (ii) going a step beyond to provide analysis and thought provoking questions and proposals. The tightly written case studies alone make a rare nonfiction book page turner in parts.

NOTES:

[1]James J. Park, The Value Treadmill: How Securities Fraud Threatens The Integrity Of Public Companies (2022) at 58.

[2]Currently adopted as Rule 175 promulgated by the Securities and Exchange Commission under the Securities Act of 1933. 17 C.F.R § 230.175.

[3]Park, supra at 61.

[4]*The Valuation Treadmill* summarizes the PSLRA safe harbor for projections and forward looking statements. The Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67) amended by the Securities Act of 1933 by adding a Section 27A and amended the Securities Exchange Act of 1934 by adding a new Section 21A, each of which provides for the safe harbor in greater detail. The actual knowledge test for a forward-looking statement in question generally requires that a plaintiff show the statement was made with "actual knowledge" the statement was "false or misleading." Securities Act of 1933 Section 27A(c)(1)(B); Securities Exchange Act of 1934 Section 21E(c)(1)(B). There are also a number of conditions for the Acts for the applicability of the safe harbor to be triggered.

[5]Park, supra at 64–65.

[6]Securities Act of 1933 Section 27A(i)(1); Securities Exchange Act of 1934 Section 21A(i)(1) both including within the definition of "Forward-looking statement" "a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer," among other things.

[7]See recently adopted Rule 206(4)-1(d)(6) promulgated by the SEC under the Investment Advisers Act of 1940 (generally imposing requirements on registered investment advisers to provide information regarding the risks and limitations of relying upon hypothetical performance figures and sufficient information to enabled an audience to understanding the criteria used and assumptions made in calculating any hypothetical performance, as well to have policies and procedures reasonably designed to ensure hypothetical performance is relevant to the situation and objectives of the audience; SEC Release IA-5653 (Dec. 22, 2020) (adopting Rule 206(4)-1) at 213 expressing the view that requiring an investment adviser using hypothetical to consider the audience of projections may "avoid scenarios where an investment might be misled into thinking performance is guaranteed." and noting that "advisers must consider the intended audience when presentations in advertisements."

[8]A duty to update would also seem contradict the current intent of the PSLRA's safe harbor. Securities Act of 1933 Section 27A(d); Securities Exchange Act of 1934 Section 21A(d) (both providing "Nothing in this section shall impose upon any person a duty to update a forward-looking statement").

[9]Park, supra at 78 citing Malcolm Gladwell, *Open Secrets*, New Yorker (Jan. 8, 2007); Macey, A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debt Concerning the Relative Efficacy of Mandatory Versus Enabling Rules, 91 Wash. U. L. Q. 329, 331 (2003) and Langevoort, Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design or Internal Controls, 93 Geo L.J. 285, 287 (2004).

[10]Id at 124.