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Eighth Circuit Rules Safe Harbor Does Not Protect CEO's Statements Because He Had Actual Knowledge They Were Misleading, in Rand-Heart of New York, Inc. v. Dolan (February 10, 2016)

Securities Litigation Legal Update

In *Rand-Heart of New York, Inc. v. Dolan*, 812 F.3d 1172 (8th Cir. 2016), the Eighth Circuit Court of Appeals found that the Reform Act's Safe Harbor did not protect comments made by a CEO during an earnings call, finding that he had actual knowledge that his comments would be misleading when he did not disclose a significant decline in future revenue from a major customer.

The Eighth Circuit reversed a district court's dismissal of the claims against James Dolan, the CEO of Dolan Company, finding that plaintiffs had adequately alleged that Dolan acted with scienter during an earnings call with analysts, and that he was not protected by the Reform Act's Safe Harbor, because the company's cautionary language was not sufficiently meaningful and Dolan had actual knowledge that his statements were misleading. However, the Court ruled in Dolan's favor on a loss causation issue, holding that the company's first corrective disclosure was complete, and that plaintiffs therefore could not claim damages from a second large stock price decline two months later.

Factual Background

The litigation relates to Dolan Company's subsidiary DiscoverReady, a company that performed litigation support services primarily for Bank of America. In spring 2013, Bank of America expressed concern to Dolan and DiscoverReady management regarding Dolan Company's financial health, suspended discussions of a pending colocation agreement with DiscoverReady, and indicated it would cease sending new work to DiscoverReady until the financial concerns were resolved. Dolan reported this news to Dolan Company's board, which then authorized the sale of DiscoverReady. *Id.* at 1174-75.

Approximately two months later, on August 1, 2013, Dolan Company announced its second quarter financial results. Among other things, it reported 18% revenue growth for DiscoverReady. It also reported on certain cash flow and borrowing issues that could impact its profitability, but nothing specific to DiscoverReady. The same day, James Dolan spoke with stock analysts. He said that Dolan Company expected double-digit growth from DiscoverReady for 2013, but that third quarter revenue would be lower than the previous year. He added: "We make this comment not to dampen enthusiasm about our growth prospects for DiscoverReady, but to set proper expectations for a business that may experience lumpiness on a quarter-to-quarter basis." When asked to elaborate on the "lumpiness," Dolan added some additional vague commentary, but refused to elaborate on any specifics. *Id*. at 1175.

On November 12, 2013, Dolan Company filed its third quarter Form 10-Q, which reported that revenue decline "exceeded our expectations," largely due to "a reduction in new work from [DiscoverReady's] largest customer, a reduction that we identified towards the end of the quarter." Dolan Company's stock price traded at $2.08 on November 11, and fell to $1.05 on November 12, and to $0.90 on November 13. On January 2, 2014, Dolan

Company issued a final press release announcing the appointment of a Chief Restructuring Officer and a Continuing Listing Standards Notice from the NYSE. On that news the company's stock fell an additional 20%. In March, the company filed for Chapter 11 bankruptcy protection. *Id*. at 1175-76.

Eighth Circuit's Scienter Analysis

In analyzing the complaint's scienter allegations, the Court agreed with the district court that there was no allegation of Dolan's motive. However, plaintiffs could still survive the motion to dismiss by alleging that Dolan was "severely reckless," which, under Eighth Circuit precedent, is defined as "highly unreasonable omissions or misrepresentations involving an extreme departure from the standards of ordinary care, and presenting the danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Id*. at 1177 (quoting *In re K-Tel Intern.*, 300 F.3d 881, 893 (8th Cir. 2002)).

Applying the "severely reckless" standard, the Court held that plaintiffs had not adequately pleaded that Dolan possessed scienter in failing to disclose that Bank of America had suspended discussions of a co-location agreement with Dolan Company, and had demanded that Dolan Company restructure, finding that the inference of scienter was negated by Dolan's warnings regarding the company's precarious financial state during the August 1 analyst call. *Id.* However, the Court concluded that Dolan was severely reckless in failing to disclose that Bank of America had stopped sending new work to DiscoverReady; the company's financial instability was, at the least, "so obvious that [Dolan] must have been aware of it." *Id*. at 1178. As a result, the Court ruled that plaintiffs had met their burden of pleading Dolan's scienter.

Court's Findings on Safe Harbor

Dolan asserted that his August 1 statements about "double-digit" growth and "lumpiness" were protected by the Reform Act's Safe Harbor, which provides that a forward-looking statement is not actionable if it is accompanied by meaningful cautionary language or the defendant does not have actual knowledge of the statement's falsity. *See* 15 U.S. C. 78u-5(c)(1). The Court found that Dolan's Safe Harbor defense failed on both grounds. First, the court held that Dolan had actual knowledge that his statements about DiscoverReady's expected performance were misleading. *Rand-Heart of New York, Inc.*, 812 F.3d at 1178. Second, the cautionary language was not meaningful because it consisted of boilerplate, generally applicable risk factors. For example, one excerpt of cautionary language on which Dolan relied stated: "Our failure to comply with the covenants in our debt instruments could result in an event of default that could adversely affect our financial condition and ability to operate our business as planned if we are not successful in obtaining a waiver of our failure to comply with our covenants." *Id.*

Eighth Circuit Opinion on Loss Causation

Finally, the Court addressed plaintiffs' assertion that the fraud was not fully revealed until the January 2 press release announcing the new restructuring officer, which disclosure was followed by a 20% stock price decline. But the Court found that the January 2 press release merely elaborated on the previous corrective disclosures, and did not serve as a separate corrective disclosure. *Id.* at 1180. The fact that this disclosure was followed by an additional stock price decline does not necessarily mean that decline was caused by the previous misrepresentation. The 20% stock price decline in January could have been caused by any number of other market forces. As the Court concluded, "not every bit of bad news that has a negative effect on the price of a security necessarily has a corrective effect for purposes of loss causation." *Id*. (quoting *Meyer v. Greene*, 710 F.3d 1189, 1202 (11th Cir. 2013)).