Duties of Public Companies To Disclose SEC Investigations

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BASIC PRINCIPLES: IMMINENT GOVERNMENT ACTION

No U.S. statute, rule, or regulation imposes a per se duty on a registrant to disclose that the registrant or a director is the subject of a government investigation.

Reg. S-K, Items 103 (the Company) and 401(f) (Directors) require disclosure when a formal proceeding is filed or is known to be imminent. An investigation is not a proceeding, whether voluntary, by subpoena, search warrant or CID.[1]

- A proceeding is imminent when the Government makes clear that it is will be filing a regulatory proceeding or bringing criminal charges in the near term.
- The classic guidance is that the issuance of a Wells Notice is the triggering event that makes disclosure necessary, but no court has ever made that ruling.
- Richman v. Goldman Sachs Group, Inc., 10 Civ. 3461 (June 21, 2012 S.D.N.Y.), most recently holds a Wells Notice is not a triggering event.
  - "At best [for Plaintiffs], a Wells Notice indicates not litigation but only the desire of the Enforcement staff to move forward, which it has no power to effectuate. This contingency need not be disclosed."

BASIC PRINCIPLES: A MATERIAL PRIOR STATEMENT IS MISLEADING

When an Investigation Renders a Prior Material Public Statement Misleading the Investigation Must Be Disclosed.

- An investigation rarely renders a prior material statement misleading.
  - Certainty of investigation costs or disruption can render projections or other prior statements misleading
  - Prior statements that the Company is not subject to any investigation would have to be updated.

- Prior statements about the subject under investigation or a related investigation are those most likely to be rendered misleading.

Most often it is the key interaction between the investigation and the conduct under investigation that gives rise to the duty to correct a prior material statement.

- The investigation is most often the triggering event for disclosure required when the underlying conduct renders prior statements misleading.
- Disclosure of the investigation becomes a proxy for disclosure of the underlying conduct without admitting that conduct occurred.

DISCLOSURE CALCULUS: PROBABILITY AND CONSEQUENCES IN CONTEXT

Disclosing investigations is largely a function of:

- the probability of government or company action and
- the consequences of such action. [2]

The Company's probability assessment and the consequences will be judged by the entire context, including the Company's actions.[3]

- RMED International, Inc. v. Sloan 's Supermarkets Inc., the defendants breached their duty to disclose an FTC investigation months prior to an FTC filing. Key was their settlement offer to divest acquired stores and to forego acquisitions made at the same time their public statements touted their acquisition strategy.[4]
- Acito v. IMCERA Group, IMCERA's annual report didn't disclose two failed FDA inspections of an acquired plant. The annual report expressed optimism and the touted the acquisition's benefits. Later public earnings guidance expressed optimism. The Second Circuit ruled the failure to disclose the failed inspections was not actionable because in the FDA regulatory context such failures and consequent warning letters were not unusual, so the Company couldn't necessarily predict the FDA would order manufacturing suspended when the plant failed a third inspection.[5]

DISCLOSURE: SOFT INFORMATION AND HARD INFORMATION

The federal circuits have analyzed the questions of

- (i) whether an investigation is material, and, if so,
- (ii) whether there is a duty to disclose, under a variety of rubrics, but the foundational principles are roughly equivalent across the circuits.

The Most Useful Heuristic: Soft Information and Hard Information.

- "'Soft' information includes predictions and matters of opinion"[6]
  - materiality of an investigation almost invariably requires prediction of the outcome and the impact of government action, hence the mere fact of the investigation is soft information
  - Prediction of government action requires a forecast
  - Government's deliberations are generally secret.
  - No duty to disclose arises absent a clear signal from the government.

"'Hard information' is typically historical information or other factual information that is objectively verifiable"... any prediction must be substantially certain to hold...as hard as fact.[7]

BASIC PRINCIPLES IN FLUX: TO CONFESS… OR NOT?

Classic Guidance is there is No Duty to Confess Wrong doing When Disclosing an Investigation.[8]

- The logic for the Classic Guidance is:
  - SEC disclosure rules should not compromise the Company's defense.
  - The Company cannot predict the outcome of the proceeding, including liability or conviction

The Classic Guidance has always been an overstatement.[9]

- If the Company speaks about the reasons for its success, it must disclose all material reasons, including wrongdoing.
- Recent decisions finding misconduct by senior management or pervasive misconduct in business practices have held companies to account for failure to disclose.
- Disclosure is material to evaluating management and the business.
- The investigation becomes part of the

analysis as the triggering event for analyzing who knew what when.

THE IMPACT OF THE FINANCIAL CRISIS

General statements about the business are more likely to give rise to a duty to disclose misconduct affecting the business sooner:

In re Marsh & McLennan Cos. Sec. Litig. (2006), is a precursor: statements describing sources of revenue triggered a duty to disclose the role of illegal conduct in generating that revenue.[10]

Richman v. Goldman Sachs Group, Inc., statements about the reasons for the success of Goldman Sachs, including the statement it was committed to complying with the letter and the spirit of the law, were material and actionable in light of the company's failure to disclose alleged illegal conflicts of interest with clients throughout the company.

Rahman v. Kid Brands (2012), the statement an increase in sales was "primarily" attributable to growth is a subsidiary was actionable in light of the attributability of increased earnings to undisclosed U .S. customs violations.[11]

The key element is not the investigation per se. It is the conduct giving rise to the investigation.

THE "NEW" LEARNING IS A RENEWED EMPHASIS ON THE CLASSIC PRINCIPLES

There is no duty per se to predict the outcome of an investigation.[12]

The duty of disclosure of the conduct under investigation must be assessed separately, but in the context of, the investigation.

Where there is no duty to disclose the investigation, there may be a duty to disclose the conduct at the outset of the investigation.[13]

Disclosures minimizing the potential impact investigation are highly risky.[14]

Predicting outcomes is not required and is a minefield.15

UNDER THE NEW RIGOR YOU HAVE TIME TO DEVELOP FACTS VIA INVESTIGATION BEFORE MAKING DISCLOSURE

The Rahman court found Kid Brands met its obligations by disclosing the audit being conducted by U.S. Customs two months after it began" particularly in light of Defendants' efforts to investigate the matter through an independent law firm and because a company may not immediately be expected to identify the inaccuracy of prior disclosures relative to such newly revealed information."

Rahman holds the failure to disclose two other U.S. Customs investigations for five months was actionable in light of prior statements about the reasons for business success.

"The gap in time between the onset of the investigation and the disclosure does not, without more, provide a basis for a securities fraud claim, even assuming the materiality of the … investigation.[16]

1 Richman v. Goldman Sachs Group, Inc., 10 Civ. 3461 (June 21, 2012 S.D.N.Y.) (Crotty, J.), citing, ABA Disclosure Obligations under the Federal Securities Laws in Government Investigations—Part II.C.; Regulation S-K, Item 103: Disclosure of "Legal Proceedings," 64 Bus. Law. 973 (2009).

2 Roeder v. Alpha Industries, Inc., 814 F.2d 22 (1st Cir. 1987).

3 Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321; 179 L. Ed. 2d 398, 412 (2011) (assessing the materiality of adverse event reports is a "fact-specific" inquiry, that requires consideration of the source, content, and context of the reports.)

4 185 F. Supp. 2d 389 (S.D.N.Y.), motion for reconsideration denied, 202 F. Supp. 2d 292 (S.D.N.Y. 2002).

5 47 F.3d 47 (2d Cir. 1995); In re Boston Scientific Corp. Sec. Litig., 708 F. Supp. 2d 110 (D. Mass. 2010), aff'd 649 F. 3d 5 (1st Cir. 2011). See also, Anderson v. Abbott Laboratories, 140 F. Supp. 2d 894, 902 (N.D. Ill. 2001)(in light of the operation of the FDA's supervisory regime, in order to establish a duty to disclose the plaintiffs had to show there was something different about this event, which should have led Abbott Labs to conclude its "prospects had genuinely changed," such as a communication from the FDA that this warning was different and serious). The same can be said about the request for information received from the regulators. Cf., In re Vimpel-Communications Securities Litigation, No. 04 Civ. 5243, 2006 U.S. Dist. LEXIS 10256 (S.D.N.Y. March 14, 2006)(plaintiffs failed to allege facts that company officers knew or should have known Russian government tax inspection would result in a large assessment or that the company's VAT strategy was "highly unreasonable.")

6 In re Sofamor Danek Group, 123 F.3d 394, 403 (6th Cir. 1997); Kushner v. Beverly Enterprises, 317 F.3d 820 (8th Cir. 2003)

7 City of Pontiac v. Stryker, No. 1:10-CV-520 (GJQ), 2012 U.S. Dist. LEXIS

45069, at *24 (W.D. Mich. Mar. 30, 2012); Zaluski v. United Am. Healthcare Corp., 527 F.3d 564 (6th Cir. 2008) (quoting City of Monroe Employees Ret. Sys., 399 F.3d at 669 (citing Starkman v. Marathon Oil Co., 772 F.2d 231, 238 (6th Cir. 1985), cert. denied, 475 U.S. 1015 (1986)).

8 United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986)(no duty to confess guilt to uncharged crimes); GAF Corp. v. Heyman, 724 F.2d 727, 740 (2d Cir. 1983)(no duty to confess to illegality); Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328, 331-32 (S.D.N.Y. 1979), vacated as moot, 638 F.2d 7 (2d Cir. 1980)(same); Crouse-Hinds Co. v. Internorth, Inc., 518 F. Supp. 416, 475 (N.D.N.Y. 1980).

9 In re Van Der Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388, 400-01 (S.D.N.Y. 2005) (quoting In re Providian Fin. Corp. Sec. Litig., 152 F. Supp. 2d 814, 824-25 (E.D. Pa. 2001) (citing Shapiro v. UJB Fin. Corp., 964 F.2d 272, 281-82 (3d Cir. 1992)).

10 In re Marsh & McLennan Cos. Sec. Litig., 501 F. Supp. 2d 452, 470 (S.D.N.Y. 2006); see also, Steiner v. MedQuist, Inc., No. 04-5487 (JBS), 2006 U.S. Dist. LEXIS 71952, at *53 (D.N.J. Sept. 29, 2006)(statements about the source of the company's revenue that did not reveal a fraudulent billing scheme; instead attributing them to legitimate factors were actionable.).

11 No.: 11-1624 (JLL), 2012 U.S. Dist. LEXIS 31406, at *28-29 (D.N.J. Mar. 8, 2012).

12 E.g., City of Pontiac v. Stryker, No. 1:10-CV-520 (GJQ), 2012 U.S. Dist. LEXIS 45069, at *32-33 (W.D. Mich. Mar. 30, 2012)(general statements that company believes processes under investigation comply with law are not actionable) (quoting In re Ford Motor Co. Sec. Litig., 381 F.3d 563, 572 (6th Cir. 2004)); Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001) (en banc))

13 Ballan v. Wilfred American Educational Corp., 720 F. Supp. 241 (E.D.N.Y. 1989); accord, Roeder, 814 F.2d 22 (conduct of management is material); see also Ind. State Dist. Council Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 583 F.3d 935, 942 (6th Cir. 2009).

14 City of Monroe Employees Retirement System v. Bridgestone Corp., 399 F.3d 651 (6th Cir. 1990)(statements about investigation and risk of claims rendered misleading by results of investigations); In re Par Pharmaceutical, Inc. Sec. Litig., 733 F. Supp. 668, 672-73 (S.D.N.Y. 1990); Mallozzi v. Zoll Medical Corp., No. 94-11579-NG, 1996 U.S. Dist. LEXIS 22953 (D. Mass. Mar. 5, 1996)(motion to dismiss denied where defendants disclosed an FDA warning letter about the company's principal product, but thereafter failed to disclose a series of subsequent damaging FDA reports, and, during the same period, the company made public statements minimizing the scope of the ongoing FDA investigation and minimizing an FDA-prompted product recall.)

15 In re SeaChange Int'l, Inc., No. 02-12116-DPW, 2004 U.S. Dist. LEXIS 1687 (D. Mass. Feb. 6, 2004) (Even assuming the registrant knew it was infringing a patent critical to its product, it "was not obligated to predict the outcome or estimate the impact of the [] litigation." Disclosure of the litigation, the allegations, and a statement the outcome and impact could not be predicted was not misleading.) (citing, Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 517-18 (7th Cir. 1989)) Cf., Burnstein v. Applied Extrusion Tech., Inc., 150 F.R.D. 433 (D. Mass. 1993) (public statement management did not believe pending lawsuit would have a material adverse impact on the integration of business operations was actionable).

16 City of Austin Police Ret. Sys. v. ITT Educ. Servs., Inc., 388 F. Supp. 2d 932, 945 (S.D. Ind. 2005); see also, In re Dell Inc. Sec. Litig., 591 F. Supp. 877 (W.D. Tx. 2008).

About Jim McLoughlin

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In complex arbitrations, civil and criminal trials, and appeals, Jim McLoughlin's objective is to maximize the impact of the entire litigation team.

His extensive litigation and arbitration track record includes arbitrations before the NASD, the NYSE, the American Arbitration Association, and the International Chamber of Commerce; trials and appeals in numerous state and federal courts; and international matters.

Services Mr. McLoughlin regularly provides his diverse clients include:

- Complex business litigation
- Corporate investigations
- Securities litigation and arbitration
- ERISA litigation
- Class action litigation
- Healthcare litigation
- Criminal defense, including Internal investigations, White collar crime, and Grand jury matters
- Recently represented minority shareholder in the prosecution of breach of fiduciary duty and theft of corporate assets litigation.
- Recently represented a national healthcare company in the defense of an anti-trust class action in Arizona arising from alleged price-fixing by hospitals in the hiring and payment of hospital staff.
- Assists a client with the management of its litigation portfolio, including tax, civil, regulatory and labor matters in South America.
- Recently won an arbitration defending a client against multi-million dollar Sarbanes-Oxley and state law claims brought by a terminated employee who alleged he was terminated because he was a whistleblower.
- Represented the Bank of America Corporation in connection with the investigation of that corporation's merger with Merrill Lynch by the Attorney General of North Carolina and the negotiation of the settlement of that investigation.
- Represented a defendant in the first anti-terrorism trial after September 11.

Awards and Professional Recognition

- Best Lawyers 2012, Charlotte Litigation - Banking and Finance Lawyer of the Year.
- Included in Best Lawyers in America for Commercial Litigation, Bet the Company Litigation, Banking and Finance Litigation, Regulatory Enforcement Litigation and Litigation Securities 2009 - 2013
- Recognized in the 2010-2012 editions of Benchmark Litigation as a "Local Litigation Star" in the areas of Civil, Criminal, Corporate Governance, Healthcare, Internal Investigations & Securities
- Included in Chambers Partners USA in North Carolina - Litigation: General Commercial, 2006 - 2012
- Selected for inclusion to the North Carolina Super Lawyers list in 2006 - 2012. His primary areas of practice are Business Litigation, Criminal Defense, and Securities Litigation.
- Recipient of the 2012 Sally and Bill Van Allen Public Service Award.

Education

- B.A., College of the Holy Cross, cum laude;
- Phi Beta Kappa
- J.D., Duke University; Order of the Coif;
- Articles Editor, Duke Law Journal