January 27, 2016

Corporate Disclosure of Government Enforcement Developments

U.S. District Court for the Southern District of New York Holds No General Duty for Issuers to Disclose SEC Investigations or Receipt of SEC "Wells Notices"

SUMMARY

On January 22, 2016, the United States District Court for the Southern District of New York (Judge John Koeltl) dismissed *In re Lions Gate Entertainment Corp. Securities Litigation*,[1] a putative securities fraud class action lawsuit, brought under Section 10(b) of the Securities Exchange Act of 1934. The complaint alleged that the company should have disclosed publicly the pendency of a Securities and Exchange Commission ("SEC") investigation, the company's intention to settle with the SEC and the company's receipt of a so-called "Wells Notice"—*i.e.*, a letter from the SEC Enforcement Division staff informing the company that it "has decided to recommend that the Commission bring an enforcement proceeding."[2] The Court held that, given the facts alleged, the company had no independent duty to disclose any of these enforcement developments and that they were not *per se* material to investors. Judge Koeltl's decision follows and expands upon a 2012 decision by Judge Paul Crotty in *Richman* v. *Goldman Sachs Group, Inc.*[3] (a case in which S&C represented the defendants), which similarly held that the issuer had no duty to disclose its receipt of a Wells Notice.

THE COURT'S DECISION

The plaintiffs in *Lions Gate* alleged that Lions Gate—a multimedia conglomerate whose shares are traded publicly on the New York Stock Exchange—violated Section 10(b) of the Securities Exchange Act of 1934 by omitting three categories of information from its SEC filings.

- First, Plaintiffs alleged that the company failed to disclose that it was being investigated by the SEC for alleged misrepresentations relating to certain corporate transactions.[4] The company did

disclose, however, that "[f]rom time to time, the Company is involved in certain claims and legal proceedings arising in the normal course of business," and that "the Company does not believe, based on current knowledge, that the outcome of any currently pending claims or legal proceedings in which the Company is currently involved will have a material adverse effect on the Company's financial statements."[5]

- Second, Plaintiffs alleged that the company failed to disclose that it had received "several" Wells Notices concerning "certain corporate transactions allegedly structured to prevent a minority investor from gaining control of the Company."[6] A "Wells Notice" is a letter from the SEC Enforcement Division staff that generally (i) "informs the recipient that the SEC Enforcement Division staff has decided to recommend that the Commission bring an enforcement proceeding," (ii) "identifies alleged violations of securities law," and (iii) "provides potential defendants the opportunity to make a responsive submission."[7] As the Court recognized, a Wells Notice "does not necessarily indicate that charges will be filed," because "[i]t is possible that the Enforcement Division may not proceed with a recommendation to commence an action and the [Commission] may not authorize the filing of an action even if the Enforcement Division recommends it."[8] In *Lions Gate*, the SEC did not bring an enforcement action against the company or any of its employees; instead, the company settled with the SEC before any action was filed and agreed to pay a $7.5 million penalty.[9]
- Third, although the company disclosed the settlement on Form 8-K the day the settlement was reached, Plaintiffs alleged that the company should have disclosed the amount of the anticipated settlement one month earlier, when the company's CFO stated during an analyst call that an increase in the company's general and administrative expenses was due to "an accrual related to an anticipated settlement of a legal matter that goes back several years," but declined to provide further details.[10]

To plead an omissions claim, the Plaintiffs first had to demonstrate that the defendants had a legal duty to disclose that Lions Gate was being investigated by the SEC, had received the Wells Notices and should have disclosed the settlement amount earlier.[11] Judge Koeltl rejected each of the Plaintiffs' three arguments as to why the company was required to make these disclosures.

First, Judge Koeltl followed Judge Crotty's decision in *Richman*, and rejected Plaintiffs' argument that there is "a general duty to disclose the SEC investigation," or "the Wells Notices."[12] The Court noted that "when a company speaks on a subject, it cannot omit material facts about that subject, and cannot make a material misrepresentation about the existence of an investigation,"[13] but here the company had made no statements about the SEC investigation. On that basis, the Court distinguished this case from others where a company made allegedly materially incomplete or inaccurate public statements about government investigations. Judge Koeltl explained that "[t]he securities laws do not require a company to hypothesize the worst results of an investigation when those results do not materialize and when the company chooses not to speak about the investigation."[14] Judge Koeltl held in the alternative that the Plaintiffs have failed to allege that the SEC's investigation and Wells Notices were material because the $7.5 million civil penalty amounted to less than 1% of the company's consolidated revenues during the quarter when the settlement was announced, which is far below the 5% threshold that the Second Circuit uses as a "good starting place for assessing materiality."[15] Judge Koeltl rejected the Plaintiffs' argument that the mere possibility that a regulatory investigation could have materially affected Lions Gate's financial condition was sufficient to satisfy their burden to plead materiality: "The materiality analysis thus

requires a showing of actual materiality; the possibility that the information may be material does not suffice if a reasonable investor would not view the information as significantly altering the total mix of information available."[16] Judge Koeltl did not hold that the pendency of a regulatory investigation or receipt of a Wells Notice could never be material; instead, he observed that, although the Plaintiffs had not pled "qualitative" materiality factors, there remained the possibility that disclosure of SEC investigations and Wells Notices might be material to investors in other circumstances where the penalty was facially insignificant from a quantitative perspective, such as where "the penalty imperiled an important line of business or a significant revenue stream."[17]

Second, Plaintiffs argued that the company's disclosure that it was "involved in certain claims and legal proceedings arising in the normal course of business" was a misleading "half-truth" because the disclosure omitted that the SEC staff had issued Wells Notices to the company.[18] Judge Koeltl rejected that argument, holding that "[t]here was in fact nothing false or misleading about Lions Gate's statements," which "accurately describe[d] that there were currently pending claims or legal proceedings."[19] Judge Koeltl also rejected Plaintiffs' claim that the company's CFO made misleading statements during an analyst call by stating that an increase in the company's general and administrative expenses was due to "an accrual related to an anticipated settlement of a legal matter that goes back several years" but "declined to provide more information about the size of the settlement" when asked.[20] As Judge Koeltl explained, the refusal to elaborate did not render the statement misleading: "At most, the Plaintiffs argue that the defendants should have provided more details, but do not argue that the lack of detail rendered the statements in their original form misleading."[21]

Third, Judge Koeltl rejected Plaintiffs' claim that a trio of disclosure items in SEC Regulation S-K (Item 103, Item 303 and Item 503)[22] compelled disclosure of the SEC Investigation and Wells Notices:

- ***Item 103.*** Item 103 requires companies to describe "any material pending legal proceeding" or any material legal proceeding "known to be contemplated by governmental authorities."[23] Judge Koeltl held that Item 103 did not mandate disclosure of the investigation or Wells Notices, explaining that investigations are not pending legal proceedings, and that "the issuances of the Wells Notices did not mark the beginning of a 'pending legal proceeding'" because a Wells Notice does no more than "inform[] an individual or company that the SEC Enforcement Division staff is considering recommending that the SEC file an action, but the SEC itself has not yet determined whether or not to bring a case."[24]
- ***Item 303.*** Item 303 requires companies to disclose any "known trends" or "uncertainties" that "are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."[25] Judge Koeltl held that "the plaintiffs do not point to any set of facts that remotely create a 'trend[,]' [n]or do they point to any 'uncertainty' that is linked to the company's liquidity."[26] The Court noted that Lions Gate's setting reserves for "legal matters" at less than $18 million indicated that the company was not "anticipating a very large settlement that would have a material effect on revenues."[27]
- ***Item 503.*** Item 503 requires companies to discuss "the most significant factors that make the offering speculative or risky," such as the company's "lack of an operating history," "lack of profitable operations in recent periods," and "financial position."[28] Judge Koeltl held that the SEC investigation did not bear on any of the enumerated risk factors, and that the "the complaint does

> not plausibly allege that th[e] civil penalty put Lions Gate's profits at risk or made the stock 'risky' as a result of Lions Gate's ongoing operations."[29]

IMPLICATIONS

Judge Koeltl joins Judge Crotty, also of the Southern District of New York, perhaps the Nation's leading trial court for securities claims, in holding that the receipt of a Wells Notice does not create an independent duty to disclose potential SEC claims, and provides further guidance on this issue. For example, *Lions Gate*'s ruling that the company had no independent duty to disclose ongoing investigations or anticipated settlements addresses issues not presented in the earlier *Richman* decision. Judge Koeltl's decision does not hold that a company is never obligated to disclose ongoing investigations or receipt of a Wells Notice; rather, courts will be guided by established principles of quantitative and qualitative materiality. Accordingly, issuers and their advisors will need to continue to assess their own unique facts and circumstances to reach a judgment as to their disclosure obligations. The scope of disclosure obligations in this context has not been directly addressed by a federal appeals court and thus there may be further development in the law, including if the *Lions Gate* plaintiffs appeal the dismissal decision. Nonetheless, companies that are subject to regulatory proceedings or that have received Wells Notices would be well advised to consider the surrounding context in determining whether it is necessary or appropriate to disclose those developments publicly.

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ENDNOTES

1 *In re Lions Gate Entertainment Corp. Securities Litigation*, No. 14-cv-5197 (JGK), 2016 WL 297722, at *6 (S.D.N.Y. Jan. 22, 2016).

2 *Id.* at *4.

3 868 F. Supp. 2d 261, 272-75 (S.D.N.Y. 2012).

4 *Lions Gate*, 2016 WL 297722, at *6.

5 *Id.* at *10.

6 *Id.* at *1, *6.

7 *Id.* at *4.

8 *Id.* at *7.

9 *Id.* at *5.

10 *Id.* at *4-5, 10.

11 It is well established that sellers of securities do not have "an affirmative duty to disclose any and all material information." *Matrixx Initiatives, Inc.* v. *Siracusano*, 563 U.S. 27, 44 (2011). Instead, a duty to disclose "may arise when there is a corporate insider trading on confidential information, a statute or regulation requiring disclosure, or a corporate statement that would otherwise be inaccurate, incomplete, or misleading." *Stratte-McClure* v. *Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015) (internal quotation marks and alterations omitted).

12 *Lions Gate*, 2016 WL 297722, at *10.

13 *Id.* at *8.

14 *Id.* at *9.

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.* at *10.

19 *Id.* at *11.

20 *Id.* at *5.

21 *Id.* at *11 n.5.

22 Regulation S-K imposes disclosure requirements on certain SEC filings, including annual Form 10-K and quarterly Form 10-Q reports. *See* 17 C.F.R. § 229.10.

23 17 C.F.R. § 229.103.

24 *Lions Gate*, 2016 WL 297722, at *13. Judge Koeltl also held that disclosure of the Wells Notices would not be required under Item 103's "distinct materiality test," *id.*, which states that "[n]o information need be given with respect to any proceeding that involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis." 17 C.F.R. § 229.103(2).

25 17 C.F.R. § 229.303(a)(1).

26 *Lions Gate*, 2016 WL 297722, at *14.

ENDNOTES (Continued)

[27] *Id.*

[28] 17 C.F.R. § 229.503(c).

[29] *Lions Gate*, 2016 WL 297722, at *15.

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CONTACTS

New York		
David H. Braff	+1-212-558-4705	braffd@sullcrom.com
Jay Clayton	+1-212-558-3445	claytonwj@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
Theodore Edelman	+1-212-558-3436	edelmant@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
Richard H. Klapper	+1-212-558-3555	klapperr@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Richard C. Pepperman II	+1-212-558-3493	peppermanr@sullcrom.com
David M.J. Rein	+1-212-558-3035	reind@sullcrom.com
Benjamin R. Walker	+1-212-558-7393	walkerb@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Los Angeles		
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Robert A. Sacks	+1-310-712-6640	sacksr@sullcrom.com