

Client Alert

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In re Lions Gate Entertainment Securities Litigation: Court Rejects Securities Claims Based on Company's Decision Not to Disclose Ongoing SEC Investigation

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In a January 22, 2016 decision, a federal court in New York dismissed federal securities law claims against Lions Gate Entertainment and several of its senior executives based on the company's decision not to disclose that it was being investigated by the SEC or that it received Wells notices from the SEC in connection with the investigation.¹ The *Lions Gate* decision finds that there is no general obligation under the federal securities laws to disclose to investors an ongoing SEC investigation or the receipt of a Wells notice, and provides important disclosure guidance to companies facing SEC inquiries.

I. BACKGROUND

When the staff of the SEC's Enforcement Division decides to recommend that the Commission assert claims against the subject of an investigation, the Enforcement Division generally sends a "Wells notice" setting forth the contemplated claims and providing the recipient an opportunity to respond.

In *Lions Gate*, the company and several of its officers received Wells notices relating to defensive measures the company took in response to a tender offer by activist investor Carl Icahn. As is not uncommon, the Wells notices triggered settlement discussions between Lions Gate and the SEC, ultimately resulting in Lions Gate's agreement to pay a \$7.5 million civil penalty, admit wrongdoing under federal securities law, and admit that it had made misleading statements in connection with its defensive strategy against Icahn.

After Lions Gate disclosed the settlement, its stock price fell and several shareholder plaintiffs sued, alleging that the company and the individual defendants violated Section 10(b) and Rule 10b-5 of the Exchange Act—the anti-fraud provisions of the federal securities laws—by failing to disclose the existence of the SEC investigation and, in particular, the receipt of Wells notices. The plaintiffs argued (i) Lions Gate had an affirmative duty to disclose the receipt of the Wells notices and (ii) Lions Gate had a duty to disclose the receipt of the Wells notices to prevent its prior disclosures from being misleading. The Court rejected both arguments.

¹ The case is *In re Lions Gate Entertainment Corp. Sec. Litig.*, 14-cv-5197 (JGK), 14-cv-5477 (JGK) (S.D.N.Y.). The decision can be found [here](#).

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II. DISCUSSION

A. No Generalized Duty to Disclose Receipt of a Wells Notice

First, the Court held that “a government investigation, without more, does not trigger a generalized duty to disclose.” While the securities laws require disclosure of material litigation that is “substantially certain to occur,” the Court held that receipt of a Wells notice does not trigger this obligation. As the Court explained, after issuing a Wells notice, the Enforcement Division staff may choose not to proceed with a recommendation that the Commission initiate an action and, even if the staff does make a recommendation, the Commission may not authorize filing of an action. Because “the securities laws do not impose an obligation on a company to predict the outcome of investigations,” the Court held that the receipt of a Wells notice standing alone does not trigger a duty to disclose.

Second, the Court rejected plaintiffs’ argument that Lions Gate was obligated to disclose the existence of the SEC investigation because the investigation “could have” resulted in a material penalty to the company. As the Court explained, “the possibility of materiality” is not enough to support a securities fraud claim. The Court also noted that the small size of the penalty ultimately imposed—representing less than one percent of Lions Gate’s annual consolidated revenue—and the absence of any “qualitative” factors suggesting the materiality of the ultimate settlement undermined any inference that the investigation itself was material under the securities laws.

Third, the plaintiffs argued that the company was required to disclose the existence of the SEC investigation under Regulation S-K, Item 103, which requires reporting companies to disclose “any material legal proceedings . . . known to be contemplated by governmental authorities.” The Court rejected this argument, as well, holding that an SEC investigation is not a “pending legal proceeding” for purposes of Item 103. And, as the Court explained, “the issuances of the Wells Notices did not mark the beginning of a ‘pending legal proceeding.’”

B. Failure to Disclose a Wells Notice Does Not Necessarily Make Other Statements About Ongoing Government Actions Misleading

Even in the absence of an affirmative duty to disclose, a company may not omit material information—including the existence of an ongoing investigation—if doing so makes the company’s other statements misleading.

Plaintiffs argued that the company had a duty to disclose the ongoing SEC investigation and the Wells notices because the company previously disclosed it did not believe that “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.” The Court rejected this argument, as well. As the Court explained, based on the allegations in the complaint, the challenged disclosure accurately described the company’s assessment of the legal proceedings then pending against it. Moreover, the challenged disclosure did not selectively disclose details about some proceedings but not others. Rather, the company acknowledged the existence of ongoing proceedings without providing further details. As a result, the Court concluded that the company’s disclosure would not mislead a reasonable investor about the existence of an ongoing SEC investigation.

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C. Companies Should Carefully Consider Whether to Disclose Receipt of a Wells Notice

The Court's decision in *Lions Gate* provides useful guidance for companies considering whether to disclose the receipt of a Wells notice. Companies should review their previous disclosures to make sure that failing to disclose the Wells notice would not make them misleading. Companies should also consider whether the particular circumstances suggest that litigation is "substantially certain to occur," and whether the receipt of a Wells notice could, in and of itself, be deemed material to the company. Even if the company determines disclosure is not legally required under the circumstances, there may be other reasons voluntarily to disclose the investigation, as well, ranging from concerns about rumors or contemplated stock sales to investor relations issues.

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