

OUTSIDE COUNSEL

Expert Analysis

Corporate Disclosure of Government Investigations Under Securities Law

When a public company learns that it is the subject of a government investigation, the company must decide whether and when to publicly disclose the investigation. While the decision whether to disclose an ongoing investigation may implicate many different legal, public relations, and business concerns, decisions in the Southern District of New York provide comfort that a company need not disclose an ongoing investigation under federal securities laws, unless and until the company determines that the investigation is “substantially certain” to lead to a formal government enforcement action, so long as the company’s other disclosures are not rendered misleading by the

JAMES J. BEHA II is a partner in Morrison & Foerster’s New York office. JORDAN ETH is a partner in the firm’s San Francisco office. CRAIG D. MARTIN is a firmwide managing partner based in San Francisco.



James J. Beha II, Jordan Eth and Craig D. Martin

omission of information about the investigation.¹

The court’s decision in ‘Lions Gate’ provides useful guidance for companies considering whether to disclose an ongoing government investigation, including the receipt of a Wells Notice from the SEC.

Disclosure Obligations

Federal securities law mandates disclosure of information only if there is some specific legal duty to disclose.² A duty to disclose

generally will arise either (1) through an independent statutory or regulatory disclosure obligation or (2) if disclosure is necessary “to make... statements made, in the light of the circumstances under which they were made, not misleading.”³ For U.S. reporting companies, the principal affirmative disclosure requirements are contained in Regulation S-K, which governs required disclosures in a company’s periodic Form 10-K and 10-Q filings.

Among other things, under Item 103 of Regulation S-K, a company must “[d]escribe briefly any material

pending legal proceedings...[including] proceedings known to be contemplated by governmental authorities.”⁴ In addition, under SEC Rule 10b-5, a company must disclose all information necessary “to make...statements made, in the light of the circumstances under which they were made, not misleading.”⁵

Discussion

In a Jan. 22 decision, *In re Lions Gate Entertainment Co.*, a court in the Southern District of New York provided a detailed analysis of when these obligations require disclosure of a “Wells Notice”—i.e., a letter from the Securities and Exchange Commission’s Enforcement Division staff informing the recipient that the staff has decided to recommend that the commission bring an enforcement proceeding against the recipient, setting forth the contemplated claims, and providing the recipient an opportunity to respond.

In connection with an ongoing SEC investigation, Lions Gate Entertainment and several of its officers received Wells Notices from the SEC. As commonly occurs, 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 and admit wrongdoing under federal securities law in connection with events underlying the investigation and settlement.⁶ After Lions Gate disclosed the

settlement, its stock price fell and several shareholder plaintiffs sued, alleging that the company and the individual defendants had violated Section 10(b) and Rule 10b-5 of the Exchange Act—the antifraud 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 court dismissed the complaint, holding that there is no independent legal obligation to disclose the existence of an ongoing investigation and that the omission of specific information about the investigation had not rendered the company’s other statements misleading.

No Independent Legal Duty to Disclose an SEC Investigation.

While Item 103 requires disclosure of pending “legal proceedings” and governmental proceedings “known to be contemplated,” in *Lions Gate* the district court held that “a government investigation, without more, does not trigger a generalized duty to disclose.”⁷ The court explained that a government investigation is not a “pending legal proceeding” for purposes of Item 103. And “the issuances of the Wells Notices did not mark the beginning of a ‘pending legal proceeding.’”

In addition, while Item 103 requires disclosure of proceedings “known to be contemplated by governmental authorities,” the court held that this provision only requires disclosure of a legal proceeding that is “substantially

certain to occur,” and that receipt of a Wells Notice did 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 bring an action and, even if the staff does make a recommendation, the commission may not authorize the 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.

Disclosure May Be Necessary to Prevent Making Other Statements 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.⁸ Like many public companies, Lions Gate disclosed in its SEC filings in general terms that it was, from time to time, subject to government investigations. Specifically, Lions Gate disclosed that it was “involved in certain claims and legal proceedings arising in the normal course of business.”⁹ The court held that the omission of specific information about the SEC investigation did not make Lions Gate’s otherwise accurate disclosures about ongoing investigations materially misleading or incomplete.¹⁰

Plaintiffs also 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.¹¹

In this regard, the decision highlights the importance of reviewing a company’s specific disclosures to ensure they are accurate in light of the existence of a proceeding. As the court explained in *Lions Gate*, generalized disclosure that a company is the subject of government or regulatory investigations does not require specific disclosure of any particular investigation.¹² If, however, a company’s general disclosures could be read by a reasonable investor to

suggest that the company is not currently subject to any investigations, then the failure to disclose an existing investigation may be deemed misleading.

In *In re BioScrip, Inc. Securities Litigation*, for example, the Southern District held that a company’s disclosures that it received subpoenas “from time to time” and there could be “no assurance that we will not receive” subpoenas was misleading because a reasonable investor would read it to “suggest[] [the company] routinely responded to investigatory requests from the Government, but was not presently in the process of responding to such a request.”¹³ Thus, if a company chooses not to disclose an ongoing investigation, it should carefully review its other disclosures to ensure that they cannot be read to affirmatively suggest the company is not subject to any investigation.

Conclusion

The court’s decision in *Lions Gate* provides useful guidance for companies considering whether to disclose an ongoing government investigation, including the receipt of a Wells Notice from the SEC. Companies should review their previous disclosures to make sure that failing to disclose the investigation would not make their earlier disclosures misleading. Companies should also consider whether the particular circumstances suggest

litigation is “substantially certain to occur.” Even if the company determines disclosure is not legally required under the circumstances, there may be other reasons to voluntarily disclose the investigation, as well, ranging from concerns about rumors or contemplated stock sales to investor-relations issues.



1. See *In re Lions Gate Enter. Corp. Sec. Litig.*, 14 Civ. 5197 (JGK), 2016 WL 297722, *11 (S.D.N.Y. Jan. 22, 2016); *Richman v. Goldman Sachs Grp.*, 868 F.Supp.2d 261, 273-74 (S.D.N.Y. 2012).

2. See, e.g., *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 45 (2011) (“it bears emphasis that §10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information”).

3. 17 CFR §240.10b-5(b); see also *In re Lululemon Sec. Litig.*, 14 F.Supp.3d 553 (S.D.N.Y. 2014) (duty to disclose may arise either “(1) expressly pursuant to an independent statute or regulation; or (2) as a result of the ongoing duty to avoid rendering existing statements misleading by failing to disclose material facts”).

4. 17 CFR §229.103.

5. 17 CFR §240.10b-5(b).

6. The investigation related to defensive measures that Lions Gate took in response to a tender offer by activist investor Carl Icahn.

7. *In re Lions Gate*, 2016 WL 297722, *11.

8. See, e.g., *In re Bank of Am. AIG Disclosure Sec. Litig.*, 980 F.Supp.2d 564 (S.D.N.Y. 2013) (“Even though [U.S. securities law] imposes no duty to disclose all material non-public information, once a party chooses to speak, it has a ‘duty to be both accurate and complete.’” (quoting *Caiola v. Citibank, N.A., N.Y.*, 295 F.3d 312, 331 (2d Cir. 2002))); *In re Intern. Bus. Mach. Corp. Sec. Litig.*, 163 F.3d 102, 110 (2d Cir. 1998) (“A duty to update may exist when a statement, reasonable at the time it is made, becomes misleading because of a subsequent event.”).

9. *In re Lions Gate*, 2016 WL 297722, at *13.

10. *Id.*

11. See *id.*

12. See *id.*; see also *Richman*, 868 F.Supp.2d at 273-74.

13. See *In re BioScrip, Inc. Sec. Litig.*, 95 F.Supp.3d 711, 726-27 (S.D.N.Y. 2015).