An SEC investigation: to disclose, or not disclose?

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In a recent decision, the Ninth Circuit addressed for a second time the question of whether an issuer’s disclosure of a Securities and Exchange Commission investigation can provide a sufficient basis for a plaintiff to plead “loss causation” in a securities class action.

The court’s ruling – that disclosure of an investigation combined with “a subsequent revelation” can suffice to plead loss causation in a later civil action alleging securities fraud – should lead issuers to think more carefully about disclosure of such investigations at all.

The Ninth Circuit’s new loss causation analysis for SEC investigations

“Loss causation” is one of the elements a plaintiff must plead (and prove) to prevail in a securities fraud suit: investors must demonstrate that the defendant’s deceptive conduct, not some intervening event, caused their claimed economic loss. In Lloyd v. CVB Financial Corporation (decided on February 1, 2016), the Ninth Circuit considered whether an issuer’s announcement of an SEC investigation could “form the basis for a viable loss causation theory.” The court held:

that the announcement of an SEC investigation related to an alleged misrepresentation, coupled with a subsequent revelation of the inaccuracy of that misrepresentation, can serve as a corrective disclosure for the
In reaching this conclusion, the court distinguished an earlier decision in Loos v. Immersion Corp., 762 F.3d 880, 890 n.3 (9th Cir. 2014), where the court held “the announcement of an investigation, ‘standing alone’ and without any subsequent disclosure of actual wrongdoing, does not reveal to the market the pertinent truth of anything, and therefore does not qualify as a corrective disclosure.” Loos, 762 F.3d at 890 n.3 (quoting Meyer v. Greene, 710 F.3d 1189, 1201 n.13 (11th Cir. 2013)) (emphasis added). A footnote in Loos explained that the panel “did not mean to suggest that the announcement of an investigation could never form the basis of a viable loss causation theory.” Id. Instead, an announcement that “contains an express disclosure of actual wrongdoing” “might suffice.” Id. (emphasis added).

In its recent decision in Lloyd, the Ninth Circuit said that the footnote in Loos “left open whether the announcement of an investigation can ‘form the basis for a viable loss causation theory’ if the complaint also alleges a subsequent corrective disclosure by the defendant.” The Lloyd panel found that it could.

In Lloyd, the panel explained, “much more” had been alleged than just the announcement of a government investigation. The defendant (a lender) allegedly knew that one of its borrowers was having difficulty making loan payments, yet the lender nevertheless reported in its SEC filings that “there was no basis for ‘serious doubt’ about [the borrower’s] ability to repay.” Thereafter, the SEC commenced an investigation and the lender disclosed receipt of a subpoena from the Commission.

In the court’s view, the following allegations supported an inference of loss causation: (1) one month after the defendant announced it had received an SEC subpoena, the lender disclosed that “it was charging off millions” in the borrower’s loans (i.e., writing down their values); and (2) the defendant’s stock price—which had dropped dramatically following the disclosure of the SEC subpoena—“reacted hardly at all.” The court saw the market’s failure to respond to news of the write-down as confirmation “that investors understood the SEC announcement as at least a partial disclosure of the inaccuracy of the previous ‘no serious doubts’ statements.”

What may the decision mean for future issuers?

There are at least two troubling aspects to the court’s analysis. First, the court’s decision to equate an announcement of the existence of an SEC investigation with a “disclosure of...inaccuracy” is curious, given the court’s prior analysis in Loos, which rejected this approach, holding that “[t]he announcement of an investigation reveals just that – an investigation – and nothing more.” Even if stock prices might react to that news, the Loos panel reasoned, such a reaction is more indicative of market speculation that there is “an added risk of future corrective action” than proof that disclosure of an investigation revealed fraudulent practices to the market. Loos, 762 F.3d 890 (emphasis added).

Second, while the panel in Lloyd treated the subsequent disclosure regarding the write-down as a “corrective disclosure,” nowhere in the opinion does the court describe that this subsequent write down by the lender included an admission or acknowledgement of the type of “actual wrongdoing” that the Loos court had suggested would be necessary to show “loss causation” in these circumstances. Similarly, the opinion does not suggest that the issuer’s write-downs in September 2010 were either admissions or acknowledgments that the issuer’s SEC filings from May 2010 were incorrect. (Indeed, the SEC has not instituted enforcement proceedings against the issuer, as the Lloyd panel observed.)

A new calculus for deciding whether to disclose an SEC investigation?

Perhaps the most troubling aspect of the court’s analysis is its possible unintended consequences: it may discourage issuers from disclosing the existence of SEC investigations.

There is very little authority regarding whether SEC investigations must be disclosed, but the weight of authority (including, for example, a decision from the Southern District of New York in January 2016) suggests that they need not be.

In a recent decision, Judge John G. Koetll of the Southern District of New York held that there is no general duty for issuers to disclose either SEC investigations or their receipt of “Wells Notices” (i.e., notifications from the staff of the SEC that they have decided to recommend that the SEC bring an enforcement proceeding):

[T]he defendants did not have a duty to disclose the SEC investigation and Wells Notices because the securities laws do not impose an obligation on a company to predict the outcome of investigations. There is no duty to disclose litigation that is not “substantially certain to occur.”
In addition to finding no general duty of disclosure for issuers, Judge Koeltl found that – given the facts alleged – the SEC investigation was not (1) a “pending legal proceeding” that was required to be disclosed under Item 103 of Regulation S-K; (2) a “known trend” or “uncertainty” required to be disclosed under Item 303 of Regulation S-K; or (3) a risk factor required to be disclosed under Item 503(c) of Regulation S-K.

Issuers, it would seem, are subject to two competing incentives arising from these two lines of cases. On one hand, there is authority holding that there generally is no “duty to disclose” an SEC investigation. On the other hand, the Ninth Circuit holds that such a disclosure, when coupled with subsequent disclosures, may be a loss causation event.

As a result, issuers that are subject to an SEC or other government investigation should carefully consider all the ramifications, including the potential fallout in subsequent securities class actions, of publicly disclosing the existence of such an investigation.

Find out more about this issue by contacting any of the authors.

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