Client Alert

July 2020

Disclosing a Government Investigation During a Securities Offering

The COVID-19 pandemic and other recent socio-political events have been accompanied by significant volatility in the capital markets and unprecedented government intervention in the private economy. With large numbers of businesses accepting stimulus funds of one kind or another under various government-sponsored relief plans, regulatory and Congressional oversight of the private sector has begun to intensify. Even businesses that did not accept stimulus funds now face an increase in public scrutiny and regulatory oversight. This alert discusses what disclosures public companies should consider for SEC filings during the pendency of a government investigation.

Disclosure Regime

Public companies do not have a general obligation under the federal securities laws to disclose every dispute or every government investigative demand. For many businesses that routinely face litigation, the prospect of disclosing each matter—large and small—would be overwhelming to investors. Recognizing this fact, Item 103 of Regulation S-K instead focuses on material legal proceedings.

Specifically, Item 103 requires a public company briefly to describe material pending legal proceedings, other than ordinary routine litigation incidental to the company's business, to which the company or any of its subsidiaries is a party. The company must disclose the name of the court or agency in which the proceedings are pending, the date the proceedings were instituted, the principal parties involved in the proceeding, and a description of the facts underlying the proceeding.

Specific instructions to Item 103 provide additional disclosure guidance:

- Companies are not required to disclose information if its business ordinarily results in actions for negligence or other actions. However, if the action departs from standard business actions, disclosure must be made.
- No information needs to be provided for any proceeding that primarily involves a claim for damages if the amount involved, excluding interest and costs, does not exceed 10 percent of the current assets of the company and its subsidiaries on a consolidated basis. However, if any proceeding largely presents the same legal and factual issues as other pending or contemplated proceedings, the amount involved in those other proceedings will be combined and included in computing the percentage.
- Any material bankruptcy or receivership with respect to the company or any of its significant subsidiaries must be disclosed.
- Any material proceedings to which any director, officer, five-percent shareholder, or affiliate of the company is an adverse party or has a material interest adverse to the company or any of its subsidiaries must be disclosed.

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Under Item 103, certain environmental litigation is subject to an additional set of disclosure criteria. Thus, any administrative or judicial proceeding arising under any federal, state, or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment will not be deemed "ordinary routine litigation incidental to the business" and must be disclosed if:

- the proceeding is material to the business or financial condition of the registrant;
- the proceeding primarily involves a claim for damages, monetary sanctions, or charges to income, and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the company; or
- a governmental authority is a party to the proceeding, and it involves potential monetary sanctions, exclusive of interest and costs, of more than $100,000, provided, however, that proceedings which are similar may be grouped and described generically.

Additionally, public companies must always consider the applicability of the anti-fraud provisions of the federal securities laws, and, in particular for the purposes of SEC disclosure, Rule 12b-20. Rule 12b-20 provides that, in addition to the information expressly required to be included in any SEC statement or report (such as under Regulation S-K), a registrant must also disclose such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

Case Law

As one may expect, whether a particular government investigation or other legal proceeding should be disclosed under Item 103, giving effect to Rule 12b-20 and other antifraud provisions, has been the subject of wide-ranging litigation. A seminal case on this issue comes from the *Richman* case, decided in the U.S. District Court for the Southern District of New York in 2012.[1]

Richman involved a prominent investment bank whom the plaintiffs alleged made material misstatements and omissions in SEC disclosure documents regarding the bank's role in the offering of several structured financial products. Of particular relevance to this alert, the plaintiffs claimed that the bank violated the anti-fraud provisions of the federal securities laws by failing to disclose the receipt of a Wells Notice[2] from the SEC regarding the bank's participation in the offering of one particular financial product.

In rejecting the plaintiff's claim, the court reasoned that there is nothing in Item 103 that mandates disclosure of Wells Notices. The court concluded that Item 103 does not explicitly require disclosure of a Wells Notice, and observed that no court has ever held that this regulation creates an implicit duty to disclose receipt of a Wells Notice. To the contrary, the court determined that when the regulatory investigation "matures to the point where litigation is apparent and substantially certain to occur," then disclosure under anti-fraud standards is mandated.

Since the decision of this case, courts have consistently instructed that the mere existence of a government investigation, without more, does not trigger a duty to disclose under the federal securities laws.[3] Instead, as the *Richman* court concluded, SEC disclosure obligations are triggered when the investigation matures to the point where litigation is "substantially certain."[4] It follows that a company's receipt of a Wells Notice—which does not signify litigation, or even guarantee an enforcement action, but

[1] *Richman v. Goldman Sachs Group, Inc.,* 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

[2] A Wells Notice is the final step in the SEC enforcement staff's investigative process whereby the staff informs a potential defendant that it intends to recommend an enforcement action for approval by the SEC commissioners, and permits the defendant one final opportunity to present its defenses and other arguments against such a recommendation.

[3] *Id.* at 273–75; *see also, e.g.*, *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 184 (2d Cir. 2014); *Ontario Teachers' Pension Plan Bd. v. Teva Pharm. Indus. Ltd*., 2019 WL 4674839, at *20 (D. Conn. Sept. 25, 2019); *In re Lions Gate Entm't Corp. Sec. Litig.*, 165 F. Supp. 3d 1, 12 (S.D.N.Y. 2016).

[4] *Richman*, 868 F. Supp. 2d at 275; *see also Lions Gate*, 165 F. Supp. 3d at 12.

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merely notifies the recipient that the SEC intends to recommend enforcement proceedings—does not itself give rise to a duty of disclosure.

Although the mere existence of an investigation alone need not be disclosed, federal courts have held that, once a company elects to speak on an issue or topic, there is a duty to be both accurate and complete.[5] Even when there is no independent duty to disclose information—as in the case of a government investigation or other uncharged wrongdoing—a company must ensure that the information it reveals to the public is not so incomplete as to mislead.[6] Companies faced with ongoing government investigations should, therefore, be cautious when disclosing pending regulatory matters or successful transactions, and when denying any improper activity.[7] If those disclosures are connected to a pending investigation such that failure to reveal the investigation would render the disclosures misleading, then a duty to disclose may arise under the federal securities laws.[8]

Suggested Practices

Public companies face a number of decisions when considering whether to disclose a government investigation in an SEC filing. In particular, companies considering a securities offering must ensure that the disclosure package of information made available to investors does not contain a misstatement or omission that would be material in the context of the offering. The disclosure package will typically include the issuer's most recently filed Form 10-K, Forms 10-Q, information filed on Form 8-K, and other information included or incorporated by reference in the offering documents, *e.g.,* prospectus, prospectus supplement, and pricing term sheet. While the mere existence of an investigation may not be required to be disclosed, if the issuer is subject to, or becomes subject to, a governmental investigation at the time of an offering, the issuer must either determine that the investigation is not material to the potential investors in the offering or disclose the investigation.

In addition to traditional quantitative and qualitative materiality factors, when assessing the materiality of a government investigation, companies should also consider the following:

- if the investigation is likely to have an impact on current or future operations or will impact the company's ability to file financial statements in a timely fashion;
- whether the company determines that there is a material error in its financial statements or that a financial restatement is otherwise required;
- whether the investigation uncovers improper conduct that is ongoing, widespread, or involving intentional conduct designed to deceive the board, auditors, investors, regulators, or other key constituencies;
- whether the investigation involves an officer, director, or member of senior management;
- whether the company learns that the government is contemplating an enforcement action, and if so, the types of remedies (including fines or other monetary penalties) likely to be sought; and
- the overall probability and magnitude of the foregoing factors.

The following are suggested practices for dealing with investigation disclosure during the securities offering process:

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[5] *See, e.g., Menaldi v. Och-Ziff Cap. Mgmt. Grp. LLC*, 164 F. Supp. 3d 568, 583 (S.D.N.Y. 2016); *Operating Local 649 Annuity Tr. Fund v. Smith Barney Fun. Mgmt., LLC*, 595 F.3d 86, 92 (2d Cir. 2010).

[6] *See Ong v. Chipotle Mexican Grill, Inc*., 294 F. Supp. 3d 199, 226 (S.D.N.Y. 2018); *Menaldi v. Och-Ziff Cap. Mgmt. Grp. LLC*, 277 F. Supp. 3d 500, 511 (S.D.N.Y. 2017).

[7] *See Menaldi*, 277 F. Supp. 3d at 511.

[8] *See* recent SEC enforcement actions for alleged disclosure and accounting failures related to government investigations, *e.g.*, *SEC v. Mylan N.V.*, Litigation Release No. 24621 (Sept. 27, 2019); *SEC v. RPM International Inc., et al.*, Litigation Release No. 23639 (Sept. 9, 2016).

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1. Time the offering to follow the filing of a Form 10-K or Form 10-Q as closely as possible, since the need for disclosure with respect to any investigation will have been determined in connection with the periodic filing.
2. Make sure that the individuals who would have information about an investigation are members of the company's regular disclosure review process and part of the offering diligence team. Such individuals should be apprised of key disclosure time periods. Updates should be solicited prior to launch, pricing, and settlement, as investigations that may not initially be determined to be material may progress and become material during the offering.
3. Be prepared to provide information to the underwriters or placement agents and their counsel concerning any investigations, whether or not previously disclosed. Underwriters and placement agents can avoid liability for inadequate disclosure if they can establish that they have conducted a reasonable investigation to support a reasonable belief that the offering disclosure did not contain a material misrepresentation or omission. In order to do so, they should fully understand the nature, status, and potential consequences of any governmental investigation and be in agreement with the determination as to whether or not disclosure is needed or existing disclosure is adequate.
4. Postpone the offering if an investigation has progressed to a stage where existing disclosure is likely to become inadequate during the offering process. While the disclosure package can be updated by the disclosure of material developments prior to launch and pricing through the filing of a Form 8-K and included in the prospectus or pricing term sheet, the news may have a negative impact on the success of the offering. Material developments that occur between pricing and settlement can give rise to investor rescission rights and result in repricing.
5. Consider and prepare for the potential impacts of disclosure. Even if a company determines that an investigation is not material, and disclosure is not required by federal securities laws, a company may decide to disclose an investigation for a number of reasons. For instance, a company may choose to disclose an investigation in the early stages to avoid possible negative reactions if the investigation is disclosed at a later stage or the investigation ultimately leads to an enforcement action or litigation. On the other hand, a company should consider the possible negative consequences associated with disclosure in the early stages of an investigation. For example, the disclosure may lead to speculation and overreaction by shareholders and analysts or may lead to other regulators opening up investigations against the company.
6. Consider the potential application of accounting standards when determining whether to disclose an investigation and discuss with the company's auditors. Pursuant to Accounting Standard Codification (ASC) 450, public companies facing possible material losses from a lawsuit or government investigation must (1) disclose the loss contingency if a loss is reasonably possible; and (2) record an accrual for the estimated loss if the loss is probable and reasonably estimable.

Contacts

Matthew S. Brooker
mbrooker@HuntonAK.com

Susan S. Failla
sfailla@HuntonAK.com

Hannah Flint
hflint@HuntonAK.com

Edward J. Fuhr
efuhr@HuntonAK.com

Scott H. Kimpel
skimpel@HuntonAK.com

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