Published on *The National Law Review* https://natlawreview.com

Half a Loaf Is Not Enough: Second Circuit Sustains Fraud Claim for Failure to Disclose SEC Investigation

Article By:

Eric Orsic

Eugene I. Goldman

Companies under US Securities and Exchange Commission (SEC) investigation focus on marshaling the facts, defenses and related strategies during the course of the investigation and making presentations to the enforcement staff. However, there is also a parallel issue that companies often grapple with: whether the investigation should be publicly disclosed. In general, public companies under investigation are not required to disclose the existence of the investigation to the public. However, even without an independent duty to disclose, case law dictates that if a company speaks on an issue, it has a duty to tell the whole truth.[1]

The US Court of Appeals for the Second Circuit's recent decision in *Noto v. 22nd Century Group, Inc*. is a wake-up call for companies to consider disclosing an SEC investigation when they have disclosed the transactions or activities that are the subject of the investigation where there has otherwise been no disclosure of the investigation itself. Failure to do so may result in the sustaining of fraud claims in private litigation for not disclosing an SEC investigation.

IN DEPTH

In *Noto*, the complaint against a public company and two executives alleged that the defendants failed to disclose an SEC investigation into the company's internal control over financial reporting. The company disclosed in SEC filings that management had concluded that material weaknesses existed in its internal control over financial reporting and that it had undertaken remediation efforts. Ultimately, in the Form 10-Q for the second quarter of 2018, the company disclosed that it completed its remediation plan that was targeted at eliminating the previously reported material weaknesses. Throughout the period of these disclosures, the company was aware that the SEC was investigating its internal controls. After online commentators revealed the SEC investigation and an alleged paid stock promotion scheme, the company's price fell, and the plaintiffs alleged they were harmed.

The district court dismissed the complaint, ruling that the company had no duty to disclose the investigation. The Second Circuit reversed, finding that the complaint adequately alleged that the defendants violated Rule 10b-5(b) by not mentioning the SEC investigation, thus making the disclosure of the internal control deficiencies misleading:

Defendants had a duty to disclose the SEC investigation in light of specific statements they made about the Company's accounting weaknesses… Because defendants here specifically noted the deficiencies and that they were working on the problem, and then stated that they had solved the issue, "the failure to disclose [the investigation] would cause a reasonable investor to make an overly optimistic assessment of the risk"… Indeed, the nondisclosure remained a material omission even after the Company represented that it had rectified the problem because the SEC investigation was ongoing.[2]

Noto appears to be the first decision tying the duty to disclose an investigation to concurrent disclosures that the company has deficiencies and weaknesses in its internal control over financial reporting. A logical extension of the Second Circuit's reasoning would apply to disclosures made about an issuer conducting an internal investigation. If, in addition to conducting an internal investigation, the SEC were investigating the matter, disclosing such an internal investigation without disclosing the SEC investigation would appear to run counter to the Court's rationale for sustaining the fraud complaint.

Disclosure issues related to governmental investigations are not likely to abate but are expected to grow as the Biden Administration ratchets up enforcement actions across many fronts, including financial reporting, antitrust, the Foreign Corrupt Practices Act (FCPA), false claims and consumer protection. That is certainly anticipated to be the case with SEC enforcement activity, with tough pronouncements emanating from the SEC Division of Enforcement's leadership and the White House boosting the SEC's proposed budget by more than 11% from fiscal year 2021 and boosting the Enforcement Division's budget by $53 million.

We can identify several measures to consider in assessing the disclosure issues, including:

- Ensuring that individuals who would have information about an investigation participate in the company's regular disclosure review process

- Close collaboration between disclosure counsel and defense counsel to advise the company on whether there is a duty to disclose an investigation and/or strategic reasons for making a voluntary public disclosure. This collaboration would include advising on the requirements of Accounting Standard Codification 450 to determine whether disclosure of a loss contingency from a lawsuit or government investigation when the loss is required and an assessment of the disclosure requirements under items 103 and 303 of Regulation S-K.

- Regular evaluation of the disclosure position and reassessment of materiality as the course of the investigation unfolds.

FOOTNOTES

[1] *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d. Cir. 2002); *Meyer v. JinkoSolar Holdings Co.*, 761 F.3d 245, 250 (2d Cir. 2014); *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 258 (2d 2016).

[2] *Noto v. 22nd Century Grp., Inc.*, No. 21-0347-cv, 2022 U.S. App. LEXIS 13935, at *17-18 (2nd Cir. May 24, 2022).

Mary Ryan, a summer associate in the Washington, DC, office, also contributed to this article.

© 2024 McDermott Will & Emery

National Law Review, Volumess XII, Number 157

Source URL:https://natlawreview.com/article/half-loaf-not-enough-second-circuit-sustains-fraud-claim-failure-to-disclose-sec