U.S. SUPREME COURT TO HEAR CONSEQUENTIAL SECURITIES CASE

CONCERNING PUBLIC COMPANIES' RISK-FACTOR DISCLOSURES

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WHAT HAPPENED

The U.S. Supreme Court has scheduled argument for November 6, 2024 in an important case involving risk-factor disclosures of public companies. At issue is whether a company's risk disclosures can be treated as false or misleading when they do not reveal that a warned-of risk has materialized in the past, even if that past event presents no known risk to the company's ongoing or future business. The Court's decision may have a significant impact on securities litigation and on how companies disclose risk factors.

BACKGROUND

Corporate executives and their counsel devote significant effort to preparing disclosures of "risk factors" in their public filings. Risk factors have been a required element of the Form 10K annual report since the adoption in 2005 of Item 105 of SEC Regulation S-K.

Intended to warn investors of things that could make investing in a given company risky, risk factors are not framed as statements about past developments, but rather as discussions of potential events that could affect the company. By their nature, they involve discussion of the future —i.e., "if event X were to happen, then the company could be adversely affected in the following ways . . ." Yet plaintiffs' securities lawyers often seek to use such risk-factor disclosures as the basis for securities fraud lawsuits under section 10(b) of the Securities Exchange Act of 1934, by labelling risk factors as false statements when the company does not disclose that the warned-of risk has actually materialized.

The theory of securities fraud claims based on risk factors typically involves what is sometimes called a "half-truth." That is, the claim focuses on a risk factor disclosure that something *could* happen, and then alleges that that something actually *had* happened. Such a disclosure, plaintiffs typically contend, gave a misleading impression that the relevant something had *not* happened.

The Facebook case now before the Supreme Court, *Facebook, Inc. v. Amalgamated Bank*, No. 23-980, illustrates the point. Plaintiffs sued Facebook (now known as Meta) and its executives in U.S. District Court in California for a risk-factor disclosure regarding data breaches, which warned of the risk of security breaches and improper third-party access to user data that “could harm” its business. Plaintiffs alleged that when it said this, the company was aware that another firm, Cambridge Analytica, had improperly collected and harvested Facebook user data.

The district court found that the plaintiffs had failed to state an actionable claim against the social media company for securities law violation. The U.S. Court of Appeals for the Ninth Circuit reversed the district court’s ruling, although one member of the three-judge panel dissented from the ruling with respect to risk factors.

Now, Facebook and various business groups who have filed *amicus* briefs ask the Supreme Court to reverse the Ninth Circuit decision, which they contend will encourage plaintiffs to pursue risk-factor cases.

The Ninth Circuit majority held that “a company may make a materially misleading statement when it speaks entirely of as-yet-unrealized risks when the risks have already come to fruition.” Facebook’s risk disclosure had acknowledged that “failure to prevent or mitigate improper access to or disclosure of our data or user data . . . could harm [Facebook's] business . . .,” but did not refer to past data breaches.

The Ninth Circuit majority held that Facebook’s disclosure could be read as presenting the risk of a data breach as “purely hypothetical when it had already occurred, [and that] such a statement could be misleading [to a reasonable investor] even if the magnitude of the ensuing harm was still unknown.”

Facebook argues that the Ninth Circuit risk-factor decision is wrong and conflicts with approaches of other courts to risk disclosures. The U.S. Court of Appeals for the Sixth Circuit has held that a risk disclosure is a forward-looking statement that investors should not read as a factual statement about current or past events. And, Facebook stated, while not affording issuers as much protection as the Sixth Circuit, several other circuit courts have required a showing not only that the potential risk materialized, but also that the company knew that the risk had harmed or was almost certain to harm the company’s business.

The company also urged the Court to consider a second issue in securities fraud litigation, whether the element of loss causation must be pleaded with particularity under Rule 9(b) of the Federal Rules of Civil Procedure. But the Court only agreed to hear the risk-factor issue.

AT THE SUPREME COURT

In its brief before the Supreme Court, Facebook argues that the Ninth Circuit’s approach “would require companies to chronicle past instances a risk came to fruition, even if the company has no reason to suspect those events pose any risk of business harm." It argues that a reasonable investor would not interpret "forward-looking, probabilistic statements as implicitly certifying that the triggering event identified had never occurred in the past and that the company faced no present risk of harm from such an occurrence." The Ninth Circuit's approach would incentivize companies to disclose all previous occurrences of each triggering event identified in each risk disclosure, Facebook further argues, turning risk disclosures into bloated statements that are less useful to investors, and burdensome to companies.

There is significant interest in the case. Groups like the U.S. Chamber of Commerce, the Washington Legal Foundation, and a group of former SEC officials and securities law professors have filed in support of Facebook. On the other side are the U.S. Solicitor General and groups of pension funds and other institutional investors tech industry policy advocates. Like the plaintiffs, the Solicitor General contends that Facebook overstates the potential for "over-disclosure" created by the Ninth Circuit decision. The plaintiffs and the Solicitor General also oppose the approach taken by those circuit courts that have allowed risk-disclosure-based claims but only where it is shown the materialized risk harmed or was almost certain to harm the company's business.

The Court's decision can be expected to have a significant impact on future securities litigation, and on corporate disclosure practices concerning an array of risks ranging from climate change to factory-floor accidents, pandemics to product recalls.

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