

Second Circuit Sets Standard for Disclosure of Interim Financial Results in Offering Documents

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On June 21, 2017, the U.S. Court of Appeals for the Second Circuit issued a decision of first impression that sets the standard for determining whether to disclose interim financial documents in a prospectus. In addition, the court made clear that risk warnings can satisfy an issuer's affirmative obligation to disclose a negative trend under Item 303 of Regulation S-K (Item 303).

The Second Circuit affirmed the dismissal of the putative securities class action *Stadnick v. Vivint Solar, Inc., et al.*, No. 16-65. The complaint asserted violations of Sections 11 and 15 of the Securities Act of 1933 against Vivint Solar, Inc. (Vivint), its underwriters and its private equity sponsor in connection with Vivint's initial public offering, made pursuant to a registration statement that became effective on the last day of the company's third quarter for 2014. Plaintiff alleged that Vivint's registration statement misled investors by omitting third quarter financial information and failing to disclose the potential impact of regulatory changes in Hawaii on the company's revenue and operations.

Upon the issuance of the third quarter financial information following the offering, plaintiff argued that Vivint was required to have disclosed such information in its prospectus because the results purportedly constituted an "extreme departure" from prior quarters. Although plaintiff conceded that Vivint was in compliance with SEC regulation S-X because the registration statement included financial statements that were less than 135 days old, he relied upon the First Circuit test set forth in *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194 (1st Cir. 1996), to argue that interim results were required to be disclosed if they constitute an "extreme departure" from prior disclosed results.

The Second Circuit declined to adopt *Shaw's* "extreme departure" standard, adhering instead to the materiality test it articulated in *DeMaria v. Andersen*, 318 F.3d 170 (2d Cir. 2003). Under *DeMaria*, a duty to disclose interim financial information arises "if a reasonable investor would view the omission as 'significantly alter[ing] the 'total mix' of information made available.'" The Second Circuit found *Shaw's* standard to be "unsound" because too many elements of its application were open questions, creating situations in which the test is "analytically counterproductive." Offering the case at hand as an example, the Second Circuit faulted plaintiff's view that the third quarter was an "extreme departure" based on changes in two metrics that are "not fair indicators of performance" for Vivint's business model.

Instead, the Second Circuit analyzed the omissions holistically in light of the total mix of available information. The Second Circuit concluded that when viewed in the context of the registration statement's extensive disclosures on Vivint's six prior quarters and unique business, Vivint's third quarter results were consistent with past performance and "the successful implementation of its business model." Moreover, the Second Circuit determined that Vivint's third quarter performance on the metrics plaintiff identified as extreme departures was actually in line with a "pattern of fluctuation" that was evident from a broader examination of the company's disclosed financial data. Therefore, the Second Circuit concluded in affirming the decision granting the motion to dismiss that the challenged omission was not material or misleading.

The Second Circuit also rejected plaintiff's argument on appeal that Vivint failed to adequately disclose risks relating to the Hawaiian regulatory environment in violation of Item 303. Item 303 requires the disclosure of trends that are (1) known to management and (2) reasonably expected to have a material impact on financial results. The Second Circuit concluded that Vivint's ample warnings to investors that regulatory changes in

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Hawaii posed a threat to future growth constituted an adequate defense to plaintiff's Item 303 claim. Moreover, the Second Circuit found that plaintiff failed to allege that the regulatory regime in Hawaii negatively impacted Vivint's business.

On a practical level, when assessing whether to disclose interim financial results in offering documents — especially if the offering is at the end or near the end of a quarter — this decision reinforces the need to assess such results holistically, taking into account the various financial metrics (including GAAP and

non-GAAP numbers) that reflect the unique circumstances of the issuer. It is also important to ensure that those metrics are consistent with those that are used and highlighted in connection with the disclosure of prior financial results. This decision also emphasizes the importance of robust and pointed risk disclosures. In this case, the court considered such disclosures both in determining that the interim results were not material and in concluding that the company satisfied any affirmative duties under Item 303.