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Do hypothetical risk disclosures give rise to securities claims?

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Risks inhere in every business. That is why Securities and Exchange Commission (SEC) rules require public companies to specify the material risks that make an investment in it speculative and risky. These required disclosures have become a prime target of securities fraud claims in recent years where already materialized risks are described in hypothetical terms.

Following the lead of the SEC in cases like *Securities and Exchange Commission v. Facebook, Inc.*, 2019 WL 3318599 (N.D. Cal. July 24, 2019), shareholder plaintiffs in securities class actions frequently allege that a risk disclosure in a company's SEC filing was misleading or inadequate to warn investors because it framed a risk as a hypothetical — warning of outcomes that "may" or "could" arise "if" certain events occurred — when, according to the plaintiffs, those events had already occurred or were occurring.

The conclusion that hypothetical risk disclosures may be insufficient if they fail to include facts showing that the risk "might" occur — rather than that the risk has already occurred or is certain to occur — is in tension with a line of cases over the last two years across multiple circuits.

Most courts have concluded that a hypothetical risk disclosure is only misleading or inadequate if the risk had "a near certainty" to cause financial harm or had already materialized. *E.g., Karth v. Keryx Biopharmaceuticals, Inc.*, 6 F.4th 123, 137-38 (1st Cir. 2021). However, in *Glazer Capital Management, L.P. v. Forescout Technologies, Inc.*, 63 F.4th 747 (9th Cir. 2023), the 9th U.S. Circuit Court of Appeals may have muddied the waters for companies drafting risk disclosures in ruling that a risk framed as a hypothetical could be insufficient if it fails to disclose a fact that suggests the risk "might" occur.

The March 2023 decision in *Forescout* addressed allegations that cybersecurity company Forescout Technologies, Inc. and its executives made misleading statements in connection with, among other topics, a merger. On Feb. 6, 2020, Forescout announced that it had entered into a merger agreement with Advent International, Inc. On May 8, 2020, an Advent representative made a phone call to Forescout stating that "Advent was considering not closing the merger." On May 11, 2020, Forescout issued a press release, stating, "[w]e look forward to completing our pending transaction with Advent," without mentioning the phone call. On May 15, 2020, Advent sent Forescout a letter purporting to terminate the merger agreement.

After Forescout sued Advent to force it to complete the merger, Advent acquired Forescout for $4 less per share than the original price. Shareholders thereafter sued under Section 10(b) and 10b-5, alleging, among other things, that the company's May 11, 2020, statement about "completing [its] pending transaction" was misleading because Advent had said it was considering not closing. The district court dismissed the complaint, concluding that the plaintiffs failed to adequately allege a misleading statement or fraudulent intent.

The 9th Circuit reversed in part. It reasoned that the plaintiff adequately alleged that the May 11, 2020, statement was a misleading opinion because the omitted phone call in which Advent informed Forescout that it was reconsidering the merger was "inconsistent" with Forescout's opinion that it expected the merger to close. The court rejected the defendants' argument that the statement was not misleading because the company had already "made 'multiple specific warnings' about the transaction, including that the timing of closing was uncertain and that closing conditions might impact the deal's course."

The court concluded that Forescout "cannot rely on boilerplate language describing *hypothetical* risks to avoid liability for the failure to disclose that the company *already* had information that the merger might not ensue." In so holding, the court, notably, cited *In re Alphabet Sec. Litig.*, 1 F.4th 687, 703-04 (9th Cir. 2021), which held — not that a company must disclose facts showing that a risk "might" occur — but that "[r]isk disclosures that 'speak[ ] entirely of yet-unrealized risks and contingencies' and do not 'alert[ ] the reader that some of these risks may *already have come to fruition*' can mislead reasonable investors."

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For example, in *City of Miami Fire Fighters' & Police Officers' Ret. Tr. v. CVS Health Corp.*, 46 F.4th 22 (1st Cir. 2022), the court held that risk disclosures that "frame risks as merely hypothetical may be misleading when they resemble the 'Grand Canyon' metaphor, in that 'one cannot tell a hiker that a mere ditch lies up ahead, if the speaker knows the hiker is actually approaching the precipice of the Grand Canyon.'" *Id*. at 35 (quoting *Karth*, 6 F.4th at 137). But a speaker only has a duty to disclose facts affecting the likelihood of that risk when the alleged risk had a "near certainty" of causing financial disaster or where the warned-of risk had already begun to materialize.

Similarly, last year the 3rd U.S. Circuit Court of Appeals rejected an argument that the company's disclosures were materially misleading because the company "continued to reiterate theoretical risks without disclosing that they had already shown signs of manifesting." *In re Amarin Corp. PLC Sec. Litig.*, No. 21-2071, 2022 WL 2128560, at *3-4 (3d Cir. June 14, 2022). In that case, the plaintiff alleged that the defendant failed to disclose that the mineral oil placebo used in its clinical drug trial was not inert and could result in skewed test results, causing the disclosure that the mineral oil "might not be biologically inert and might be viewed as artificially" affecting results to be misleading. The court, however, concluded that "the risk disclosed in these filings . . . had not actually materialized at the time that the statements were made."

The 2nd U.S. Circuit Court of Appeals has similarly held: "There is a critical distinction between disclosing the risk a future event *might* occur and disclosing actual knowledge that the event *will* occur." *Set Cap. LLC v. Credit Suisse Grp. AG*, 996 F.3d 64, 65 (2d Cir. 2021); *see also Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, (2d Cir. 2011) (disclosure that defendant "may" place support bids in auctions sufficient disclosure when plaintiff failed to allege facts that defendant "knew with certainty" the market would fail without support bids).

The 10th U.S. Circuit Court of Appeals also agrees: "Where risk factors have been found materially misleading, the risk had materialized or was virtually certain to occur." *Ind. Pub. Ret. Sys. v. Pluralsight, Inc.*, 45 F.4th 1236, 1254-57 (10th Cir. 2022).

To be sure, *Forescout* did not conclude that the company's risk disclosures themselves were misleading. It concluded that the risk disclosures were insufficient to prevent the later May 11, 2020, statement from becoming misleading for omitting the May 8, 2020, phone call. The hypothetical nature of the risk disclosures was beside the point; the point was that they, like the May 11, 2020, statement, did not disclose the May 8, 2020, phone call. In that regard, it is not clear how the court's reasoning will apply to future cases.

Given the increasing risk for claims arising out of risk disclosures, companies should take extra steps to evaluate and minimize those risks and disclosure committees should regularly review risk disclosures.

Companies should consider whether they need to disclose material facts that suggest the risk "might" occur, even if it has not manifested or risen to the level of "near certainty." They should routinely evaluate whether risks described as hypothetical have materialized or are likely to do so. If the company has experienced the materialization of the risk in the past, it may be prudent to say so and provide some specificity about what happened, how the company addressed the risk, how that risk may materialize again, and what the company has done to minimize that risk.

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