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Beware of potential securities litigation over risk-factor disclosures

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Plaintiffs are increasingly focusing their securities litigation claims on risk-factor disclosures in Securities and Exchange Commission filings. In the wake of some recent decisions from the 9th U.S. Circuit Court of Appeals in this area, those charged with preparing risk factor disclosures should pay special attention to updating risk factor and cautionary language to make sure that disclosures do not describe risks in hypothetical terms when the risks are alleged to have been actually occurring or to have occurred at the time.

The 9th Circuit's decision in *In re Facebook, Inc. Sec. Litig.,* 87 F.4th 924 (9th Cir. 2023), is the latest case where the 9th Circuit has upheld complaints of securities fraud against public companies facing securities litigation based on risk disclosure statements held to be misleading by omission.

The *Facebook* case arises out of the improper harvesting of personal data from millions of Facebook users by Cambridge Analytica. Facebook shareholders filed a securities class action against Facebook and certain of its officers. The plaintiffs alleged that Facebook made statements that were materially misleading by failing to disclose Cambridge Analytica's improper harvesting.

The gist of the complaint was that Facebook allegedly knew that Cambridge Analytica had improperly accessed and used Facebook users' data while Facebook's contemporaneous SEC filings disclosed in hypothetical terms the risk of improper third-party misuses of Facebook users' data harming Facebook's business, reputation, and competitive prevention. For example, Facebook's 10-K warned that "failure to prevent or mitigate security breaches and improper access to or disclosure of our data or user data could result in the loss or misuse of such data" and that if "third parties or developers fail to adopt or adhere to adequate data security practices ... our data or our user data may be improperly accessed, used, or disclosed."

In a split decision, the 9th Circuit upheld claims alleging that the warnings were misleading, reversing the district court's dismissal. The 9th Circuit's opinion applied the well-established law, *Khoja v. Orexigen Therapeutics, Inc.* and *Brody v. Transitional Hospitals Corp.*, that statements are false and misleading only where (1) they "directly contradict what the defendant knew at the time" or (2) "create an impression of a state of affairs that differs in a material way from one that actually exists."

In concluding that Facebook's risk statements were actionably misleading, the 9th Circuit faulted Facebook's SEC filings for representing the risk of improper access to or disclosure of Facebook data "as purely hypothetical when that exact risk had already transpired." A reasonable investor, the opinion concluded, "would have understood the risk of a third party accessing and utilizing Facebook user data improperly to be merely conjectural."

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The court rejected the argument presented by Facebook (and endorsed by a dissenting opinion) that the complaint failed to plead falsity adequately because the plaintiffs had not alleged that Facebook "knew that its reputation and business were *already* harmed" at the time of its SEC filings. The majority opinion countered that "case law does not require harm to have materialized for a statement to be materially misleading."

Even if Facebook did not yet know the extent of the reputational harm that it would suffer as a result of Cambridge Analytica's breach, since Facebook "presented the prospect of a breach as purely hypothetical when it had already occurred, such a statement could be misleading even if the magnitude of ensuing harm was still unknown." In other words, the court concluded that Facebook had "created an impression of a state of affairs that differed in a material way from the one that actually existed."

The *Facebook* decision relied heavily on the 9th Circuit's earlier decision in *In re Alphabet*, 1 F.4th 687, 703-04 (9th Cir. 2021). In *Alphabet*, the 9th Circuit held that allegations were sufficient to

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survive a motion to dismiss when the complaint plausibly alleged that the company's SEC filings "warned that risks 'could' occur when, in fact, those risks had already materialized."

Alphabet had warned in its 2017 Form 10-K that public concerns about its privacy and security practices "could" harm its reputation and operating results. The following year, Alphabet discovered a privacy bug that had threatened thousands of users' personal data for years. Nonetheless, Alphabet's SEC filings repeated the earlier risk factor warning from 2017 that public concern about its privacy and security "could" cause harm while also stating that there had been "no material changes" to its "risk factors."

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Given that the risks of Alphabet had "ripened into actual harm" when the privacy bug was discovered, the warning of risks that "could" or "may" occur was held to be "misleading to a reasonable investor when Alphabet knew those risks had materialized." In short, risk 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 investors."

A third recent 9th Circuit decision reinforces the point that allegedly misleading risk disclosure statements can be the focus of securities litigation claims. In *Glazer Capital Management, L.P. v. Forescout Technologies, Inc.*, 63 F.4th 123, 137-38 (9th Cir. 2023), the 9th Circuit held that a company "cannot rely on boilerplate language describing hypothetical risks to avoid liability." There, Forescout Technologies made positive statements about closing a pending merger with Advent International.

What the company allegedly did not disclose is that Advent had advised Forescout that it was considering not closing. It was not enough, the 9th Circuit held, that Forescout made multiple warnings about the transaction and the risk of the merger not closing. That is because, the court concluded, the risk was presented as hypothetical at the same time that Forescout had notice that the merger might not, in fact, close.

Although *Facebook*, *Alphabet*, and *Forescout* involved relatively unusual corporate events (data privacy and merger transaction), it can be expected that plaintiffs will seize upon these decisions to try to bring securities fraud claims with regard to more routine-type risk disclosures.

In a recent case, a court held that the following risk-factor statement regarding excess inventory could give rise to a securities fraud claim: "If demand or future sales do not reach forecasted levels, we could have excess inventory that we may need to hold for a long period of time, write down, sell at prices lower than expected or discard." *Ferreira v. Funko Inc.*, 2021 WL 8820650, at *15 (C.D. Cal. Oct. 22, 2021).

The court held that the risk factor itself was potentially actionable because it "only discussed possible future risks and did not affirmatively state Funko had no excess or obsolete inventory; the statement set forth various hypothetical risks associated with maintaining excess inventory without disclosing that this risk had materialized." The claim was substantiated by allegations from former employees who said that excess inventory had been discussed in sales meetings, emails, and internal reports, and that unloaded inventory sat in ports at the time the statements were made.

Risk disclosures about competition have likewise triggered claims. Consider Snap's disclosure that one of its business risks was direct competition from Instagram. A court found that "hypothetical risk disclosures — e.g., Instagram Stories 'may be directly competitive' — do not absolve Defendants of their duty to disclose known material adverse trends *currently affecting* Snap's user growth and the viability of its platform." *In re Snap Inc. Sec. Litig.*, 2018 WL 2972528, at *6 (C.D. Cal. June 7, 2018).

The foregoing examples demonstrate that the plaintiffs' bar is increasingly targeting the risk factor sections of SEC filings. As such, companies should consider evaluating risk factor discussion not only to make sure that there are no new risks worth disclosing, but also for outdated risks, as well as risks that have materialized or are materializing. This could be particularly important for companies that have made it a practice for their 10-Q filings to incorporate risk-factors discussed in earlier-filed 10-K filings. What *may* have been a risk when the 10-K was filed may be an occurring issue when a later 10-Q is filed.

Companies should carefully review disclosures to make sure that they are not described in contingent or hypothetical language if the risks have occurred, or are occurring, or recurring. It may be helpful to have risk disclosures reviewed by business leaders who have visibility into a corporation's operational, sales, accounting, financial, and legal issues. Those charged with drafting risk disclosures should consider reviewing current reports to the board of directors and the C-suite to evaluate whether business issues and risks that are being elevated internally are adequately captured in those public disclosures. Reviewing peer or competitors' risk disclosure discussions can also be beneficial in ensuring that a company's risk disclosures capture industry and macro-economic developments when appropriate.

The cases discussed in this article highlight that the plaintiffs' bar has set it sights on risk factor disclosures with success in some cases. While the 9th Circuit may remain an outlier in how it has viewed risk factor disclosure, given the increased scrutiny by plaintiffs, public companies should redouble their efforts at carefully reviewing, revising, and updating their risk factor disclosures so that they do not face enhanced securities litigation risk.

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