Reuters Legal News

A recurring trend: securities fraud complaints targeting key metrics

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AUGUST 2, 2024

In securities litigation, plaintiffs focus on certain types of disclosures on a routine basis. One frequent target area focuses on key performance indicators (KPIs). These key metrics provide meaningful insight into public companies' financial and operating performance. They are not metrics that have uniform definitions or methodologies for calculation subject to industry standards, unlike accounting metrics that are subject to GAAP — generally accepted accounting principles.

The SEC has provided guidance on how companies should disclose KPIs as well as non-GAAP metrics, and it routinely issues comment letters to public companies on these issues. The plaintiffs' bar has taken notice and has found some success in asserting claims predicated on allegedly misleading disclosures relating to these metrics. Cases provide useful insights for companies that report such key metrics to investors.

Making statements about one performance metric but not another

Plaintiffs often claim that a company's disclosure of one metric is materially misleading because it omits disclosure about other, more relevant metrics. A case in point: *Shenwick v. Twitter*, 282 F. Supp. 3d. 1115 (N.D. Cal. 2017). There, plaintiffs challenged disclosures by Twitter about its MAU — Monthly Average Users — a performance indicator used by social networking and other companies to count the number of unique users of a product within a month.

Plaintiffs claimed that Twitter touted the "acceleration" and "turnaround" of its MAU. At the same time, however, it allegedly did not disclose that it was experiencing flat or declining DAU — Daily Active User — trends. Plaintiffs asserted that "MAU was unhelpful at best and misleading at worst in the absence of companion DAU" data that had more bearing on user engagement, which was critical to assessing the advertising opportunity to generate revenue.

Plaintiffs claimed that without disclosure of flat or declining DAU trends, investors were led to believe that Twitter's MAU projections were "viable" and that its MAU growth was "high quality."

The court held that Twitter had no independent duty to disclose DAU. The court, however, found that plaintiffs stated a viable claim that the undisclosed DAU trends rendered implausible the MAU growth trends that Twitter chose to "tout" in its public statements.

The court recognized that both DAU and MAU were critical to Twitter's business and that Twitter's executives would have known about the adverse DAU trends when they spoke positively about MAU trends. Accordingly, the court held that plaintiffs sufficiently alleged a claim. Twitter subsequently settled the case for approximately $800 million.

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Plaintiffs are not always successful in asserting claims based on similar theories, as illustrated in *Jedrzejczyk v. Skillz Inc.*, 2023 WL 2333891 (N.D. Cal. Mar. 1, 2023). There, plaintiffs asserted that Skillz's metrics on user engagement and revenue generation for its mobile gaming platform were false and misleading.

Skillz allegedly disclosed its average revenue per user (ARPU) without disclosing what plaintiffs contended was more relevant — average revenue per paying user (ARPPU). Plaintiffs claimed that defendants obfuscated a downturn in ARPPU by "focusing primarily on reporting the platform's MAU," which allegedly "gave them the impression that adding users to the Skillz platform was the primary factor driving revenues when it was really just a vanity metric."

The court rejected the claim. The court explained that Skillz was "not obligated to disclose any and all metrics relevant to its business — just those that if omitted, would create an impression of a state of affairs that differs in a material way from the one that actually exists."

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The court reasoned that the case was different from *Twitter*: While ARPPU and MAU were related, they were "not contingent: a negative trend in one does not *ipso facto* negate a positive trend in the other."

Alleged manipulation of metrics

Plaintiffs have also accused companies of misleading investors in the way that they define or calculate their key metrics. Consider *Orbis Glob. Equity Fund Ltd. v. NortonLifelock Inc.*, 2023 WL 1800963, at *11 (D. Ariz. Feb. 7, 2023).

> *Companies should consider providing a clear definition of their key metrics and information about how the metric is calculated, including information about the assumptions and inputs and how they are calculated.*

Plaintiffs alleged that Symantec manipulated its non-GAAP operating margin metric to give a misleading picture of the company's profitability by excluding recurring operating expenses as "transition and transformation" ("T&T") costs — which Symantec's peers did not do and which allegedly contradicted Defendants' statements that their T&T expenses were not incurred in the ordinary course. Plaintiffs relied on statements from high-level executives at the company who provided examples of the types of costs "pushed in the T&T bucket" to "inflate" Symantec's profitability.

Eventually, Ernst & Young ("EY") was retained to study Symantec's practices related to non-GAAP measures and found "significant problems." Symantec subsequently disclosed that it had "relatively weak and informal processes with respect to some aspects of the review, approval and tracking of transition and transformation expenses."

The court ruled that plaintiffs adequately alleged securities fraud The court explained: "While Defendants were not obligated to report non-GAAP measures, once they chose to do so they were bound to do so in a manner that wouldn't mislead investors." The court credited statements from company employees who corroborated the plaintiffs' claim that over $365 million of T&T costs during the relevant period were improperly excluded — a significant percentage of the non-GAAP measures that Symantec reported.

The court also found that E&Y's determinations precluded dismissal of the case, particularly in light of its analysis showing that only two out of Symantec's 38 peers adjusted their non-GAAP measures for 'transition costs' and one stopped doing so during the relevant period. This undercut Symantec's assertion that its non-GAAP metrics "facilitated comparisons to its peers." The company settled related class claims for over $70 million.

Other companies have defeated claims that they manipulated their metrics by pointing to clear disclosures defining the metric and its calculation. In *Shen v. Exela Technologies, Inc.*, 2021 WL 2589584 (N.D. Tex. June 24, 2021), plaintiffs accused Exela, a global business process automation provider, of deceiving investors about its financial condition. Plaintiffs claimed that Exela touted its "adjusted EBITDA." EBITDA is a metric that stands for earnings before interest, taxes, depreciation, and amortization. Adjusted EBITDA, on the other hand, is a metric that approximates the normal earnings power of a business excluding non-cash expenses and excluding, or adding back, non-recurring cash expenses.

Plaintiffs alleged that Exela engaged in "accounting shenanigans" by adding back supposedly non-routine expenses when, in fact, the expenses were routine, recurring expenses.

The court ruled that Exela told "the whole truth and nothing but about how it was calculating adjusted EBITDA." The court pointed out that for non-GAAP metrics there is no "'right' formula because, unlike GAAP metrics, they have no uniform definition." After reviewing Exela's disclosures on the subject, the court was convinced that "Exela expressly disclosed" that certain of its non-cash "optimization and restructuring expenses" were added back into Adjusted EBITDA.

A court reached a similar conclusion in *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (N.D. Cal. Nov. 18, 2005). Plaintiffs alleged that Netflix misled investors about its "churn rate," and other key metrics derived from it, including average subscriber lifetime and the subscriber lifetime value.

Plaintiffs claimed that the reported churn rate was artificially deflated to make Netflix's customer base look stronger than it was. Plaintiffs challenged Netflix's measurement of churn as "inaccurate, illogical, and unconventional."

The court rejected plaintiffs' securities fraud allegations. Importantly, the court observed that Netflix repeatedly disclosed its definition of churn and disclosed the raw data that would enable investors and analysts to calculate churn using the definition and methods preferred by the plaintiffs. Even if there were "other, more common methods that would have been more predictive, descriptive, or consistent," that did not make Netflix's disclosures fraudulent.

The court explained it was "not a case in which defendants used one calculation method when another is mandated by industry practice, generally accepted accounting principles, or federal securities regulations." In the absence of any mandated way of disclosing "churn," the court found that the "critical key to understanding Netflix's methodology was adequately and repeatedly disclosed."

Key takeaways

Key performance metrics provide useful insights about business performance and prospects. Because these metrics are frequently the focus of securities litigation, public companies and those charged with preparing disclosures should consider taking steps to minimize the risk of facing securities litigation claims predicated on allegations that the presentation or disclosure of the metrics is misleading.

As a starting place, it is important that company leaders carefully review the SEC's rules, regulations, and guidance on KPIs and

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non-GAAP metrics. Companies should consider providing a clear definition of their key metrics and information about how the metric is calculated, including information about the assumptions and inputs and how they are calculated. If the company changes its definition or methodology, disclosures about those changes and the reasons for the changes would be prudent.

With appropriate attention routinely given to how key metrics are utilized internally and disclosed externally, companies can help minimize the risk of securities litigation centered on this subject of recurring interest to the plaintiffs' bar.

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This article was first published on Reuters Legal News and Westlaw Today on August 2, 2024.

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