

Omissions Regarding “Known Trends” in a 10-Q Report May Support a Securities Fraud Claim

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If a public company fails to disclose in its quarterly or annual reports trends and uncertainties that it could reasonably expect to have a material impact on revenues, at least one significant federal court has held that the company could be subject to claims of securities fraud. On January 12, 2015, the Second Circuit Court of Appeals (covering certain northeastern states including New York) held that omissions from Form 10-Q filings of certain information required to be disclosed pursuant to Item 303 of Regulation S-K may support a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934.

Item 303 of Regulation S-K imposes an affirmative obligation on issuers to disclose in its MD&A (management’s discussion and analysis), among other things, “any known trends or uncertainties...that the registrant reasonably expects will have a material...unfavorable impact on...revenues or income from continuing operations.” This information must be disclosed in registration statements, Form 10-Q and Form 10-K filings. Omissions are actionable under securities laws only when the corporation has a duty to disclose the omitted facts. Because Item 303 does impose an affirmative obligation, the Second Circuit reasoned that failure to disclose “known trends or uncertainties” could be sufficient to support a securities fraud claim.

The burden imposed by this decision is moderated by the requirements for plaintiffs asserting Section 10(b) claims based on a failure to disclose Item 303 information. The first requirement is that plaintiffs must allege that defendants were “at least consciously reckless regarding whether their failure to provide adequate Item 303 disclosures . . . would mislead investors about material facts.” Second, the information required to be disclosed is limited - a “disclosure of a known trend and the ‘manner in which’ it ‘might reasonably be expected to materially impact’ a company’s overall financial position” is sufficient. Third, the omission must be material. Determining materiality of a forward-looking disclosure requires “a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” These requirements shall cause plaintiffs significant hurdles to overcome to show that defendants intended to mislead investors by omitting information or that defendants were consciously reckless in that respect.

The Second Circuit’s decision is in conflict with a decision announced last year from the Ninth Circuit Court of Appeals (covering the western states including California). The Ninth Circuit previously held that “Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5.” This matter may be headed to the United States Supreme Court to resolve the conflict among federal circuits.

Until the United States Supreme Court finally settles the conflict, each public company should refocus attention on whether any known trends or uncertainties may be reasonably expected to have a material effect on the company's revenue or income, and if so, the company should carefully craft an appropriate disclosure for its public filings. If you have any questions about how the Second Circuit's ruling may affect you, please contact an attorney in Benesch's Corporate & Securities Practice Group.

For more information or if you have questions regarding this topic, please contact a member of Benesch's Corporate & Securities Practice Group.

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