Treat Risk Disclosures as Opinions to Clean Up Fraud Challenges

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Gibson Dunn's Michael Kahn argues risk factors should be analyzed as statements of opinion, offering a clearer legal standard and reducing uncertainty for both companies and courts.

The Bottom Line

- Dismissal of appeal in securities case leaves open questions about how to analyze securities fraud claims that challenge risk disclosures.
- Supreme Court has created framework through case precedent that could facilitate risk factor disclosure analysis.
- Treating risk factor disclosures as statements of opinion has sound basis in law and common sense and would help companies.

Risk factor disclosures fundamentally are an expression of a company's opinions and beliefs about what poses a risk to their business. Because a company's belief is a matter of opinion, risk factor disclosures should be analyzed as statements of opinion.

The US Supreme Court's decision to dismiss the appeal in *Facebook Inc. v. Amalgamated Bank* last year left unanswered how courts should analyze securities fraud claims challenging risk factor disclosures. Securities lawsuits increasingly claim that a company's risk factor disclosures—which typically warn that "if" an adverse event occurs, "then" the company could suffer harm—are misleading when they fail to disclose that the adverse event occurred in the past.

Courts are split on whether this is a viable theory and whether and when adverse past events should be disclosed with risk factors. This uncertainty presents challenges for companies drafting risk disclosures. It's unclear which adverse events must be disclosed, and it remains an open question how courts should make that determination.

However, the Supreme Court has already created a framework to analyze statements of opinion in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*. Risk factor disclosures should be analyzed under this framework.

This approach would reduce the current uncertainty in the law. Parties and courts are familiar with analyzing whether opinion statements are false (for example, if a company doesn't subjectively believe in the opinion being made).

And companies may consider expressly stating in their Securities and Exchange Commission filings that their risk factor disclosures are statements of opinion to underscore for investors and courts that risk factors are opinions about what may affect the company in the future, not representations about events that occurred in the past.

Uncertainty Surrounding Claims

Item 105 of Regulation S-K requires public companies to disclose in their SEC filings "under the caption 'Risk Factors' a discussion of the material factors that make an investment in the registrant or offering

speculative or risky." For example, if a company's business is dependent on a complex supply chain, it may disclose as a risk that disruptions to the supply chain could harm its business.

Securities lawsuits increasingly include claims that such risk factor disclosures are misleading.

Take the hypothetical risk factor disclosure about supply chains. Assume that a year before that disclosure, the company experienced a disruption to its supply chain, this disruption wasn't disclosed by the company, and a few months after the disclosure, the company's stock price declined following a news article about the supply chain disruption.

In this scenario, a shareholder plaintiff filing a securities class action lawsuit might claim the risk factor disclosure was misleading because it framed the risk of a supply chain disruption as hypothetical when that risk had already materialized. The plaintiff in this hypothetical would claim that the past disruption should have been disclosed.

The plain terms of Item 105 don't require such a disclosure because it doesn't impose an obligation to disclose past events. Nonetheless, some courts have held that under certain circumstances, this can be a viable theory of securities fraud. These decisions typically find that risk factor disclosures contain an implied representation that the warned-of adverse event hasn't occurred, and that the failure to disclose the past event can render the risk factor misleading.

This presents a practical problem for companies. How does a company know which adverse events must be disclosed and which don't need to be?

To continue with the supply chain hypothetical, it isn't clear whether the company needs to disclose every time there was a supply chain disruption in the company's history. Disruptions could have happened a decade ago, or more recently. They also could have been immaterial, such as a single truck in the fleet going out of commission. There also isn't clarity about whether companies need to disclose a disruption that had already been reported.

Item 105 doesn't address these problems because again, it requires disclosure of risks, not past events. Some courts therefore have created their own rules for what past events must be disclosed, leading to uncertainty for companies as they craft their risk factor disclosures, and for parties and courts in disputes about these disclosures.

Statements of Opinion

Courts could resolve this uncertainty by holding that the framework the Supreme Court established for statements of opinion in *Omnicare* governs risk factor disclosures. There is a sound basis in law and common sense for this approach.

Under Item 105 of Regulation S-K, a company must disclose "material factors" that make an investment "risky." This is inherently a subjective analysis—a company must use its judgment to make that determination.

In other words, disclosures made pursuant to Item 105 necessarily reflect a company's belief about the factors that the company thinks make investing in the company risky. And as the Supreme Court recognized in *Omnicare*, statements of belief are statements of opinion.

Companies typically don't preface their risk factor disclosures by stating "we believe" that if an adverse event happens, then that could be bad for the business. But that doesn't matter because adding "we believe" to the beginning of the typical risk factor disclosure doesn't change its meaning.

Saying "if a disruption to our supply chain occurs, then our business may be negatively impacted" is no different than saying "we believe if a disruption

to our supply chain occurs, then our business may be negatively impacted." Regardless of the phrasing, risk factor disclosures fundamentally are statements of opinion about the factors that make an investment in the company risky.

The framework by courts that has required the disclosure of past events in the context of risk factors is flawed. The analysis in all securities fraud cases requires "identifying affirmative assertions" made by companies and then "determining if other facts are needed to make those statements 'not misleading.'"

The only "affirmative assertion" made by disclosures under Item 105 is that the company believes the factors it discloses are the factors that pose a material risk to the company's business. Risk disclosures don't include an implied representation that the warned-of adverse event hasn't occurred in the past. Courts that have made this assumption miscomprehend the disclosure requirements of Item 105.

Again, the plain terms of Item 105 don't require disclosure of past events. This contrasts with other securities law provisions. For example, Item 106 requires certain disclosures about "previous cybersecurity incidents" and Item 303 requires disclosures of "known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact" on the company.

Applying *Omnicare*

Properly understood as statements of opinion, risk factor disclosures should be analyzed under the *Omnicare* framework. Under *Omnicare*, there are three ways in which plaintiffs could establish the falsity of risk factor disclosures.

First, it is false if a speaker doesn't actually hold their stated belief. So, if a company doesn't believe the factors it discloses under Item 105 are the material factors that make an investment risky, then that could give rise to a claim.

Second, if opinion statements "contain embedded statements of fact," then plaintiffs can establish falsity by proving the embedded factual statement is false. This is a bread-and-butter securities claim—if a risk factor disclosure contains an assertion of fact, and that assertion is false or misleading, then the company could be subject to liability.

Finally, if the "facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view" are different than what a "reasonable investor" would expect, then a plaintiff could establish the falsity of that opinion.

For example, the Supreme Court explained if a company says it believes its conduct is lawful without consulting a lawyer, a plaintiff may be able to establish that this statement of opinion is misleading. This framework also could be applied to how companies form their views about which risk factors to disclose under Item 105.

To help bolster the conclusion that risk factor disclosures are statements of opinion, companies may consider expressly stating in their SEC filings that their risk factor disclosures reflect their opinions about the risks facing the company.

They may also consider expressly stating that their risk factor disclosures aren't purporting to make any factual representations about whether the warned-of risk has materialized in the past. This type of language could help courts confronting risk factor claims conclude—correctly—that these disclosures are statements of opinions.

The cases are Facebook Inc. v Amalgamated Bank, U.S., 23-980, decided 4/30/24 and Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund , U.S., 13-435, decided 3/24/15 .

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