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SECURITIES DISCLOSURE

The Devil's in the Disclosures: Compliance After *Panther Partners*

A recent Second Circuit decision may make it more difficult for companies to comply with the requirement of Management's Discussion and Analysis concerning disclosure of "known trends and uncertainties." It remains to be seen whether other circuits will follow.

By Jonathan C. Dickey, Michael Li-Ming Wong, and Nicola M. McMillan

Securities and Exchange Commission (SEC) rules, specifically Management's Discussion and Analysis of Financial Condition and Results of Financial Operations (MD&A) require registrants to disclose "known trends or uncertainties" reasonably expected to "have a material … unfavorable impact on … revenues or income from continuing operations." The Second Circuit's 2012 decision in *Panther Partners v. Ikanos Communications* [1] may make it more difficult for registrants seeking to comply with these disclosure requirements, particularly given the uncertainties inherent in the current economic climate. This article provides an overview of the decision and outlines the key factors focused on by the Second Circuit. It then explores the potential implications for registrants and compares the holding with other recent decisions. It concludes by suggesting that registrants pay particular attention to the risk factors that the Second Circuit identified in *Panther*.

Jonathan C. Dickey and Michael Li-Ming Wong are partners in the New York and San Francisco offices, respectively, of Gibson Dunn & Crutcher LLP. Nicola M. McMillan is an associate in the San Francisco office of the firm.

Regulatory Background

Regulation S-K governs the disclosure requirements of registration statements, periodic reports, and annual reports filed with the SEC. Item 303 of Regulation S-K, MD&A, prescribes a variety of disclosure obligations. Pursuant to Subsection (a)(3)(ii) of Item 303, a registrant must "[d]escribe any known trends or uncertainties … that the registrant reasonably expects will have a material … unfavorable impact on … revenues or income from continuing operations." Instruction 3 to Item 303(a) further provides: "The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." The SEC's MD&A 1989 interpretive release explains that there is a disclosure duty "where a trend, demand, commitment, event or uncertainty is both [1] presently known to management and [2] reasonably likely to have material effects on the registrant's financial condition or results of operations."[2]

Panther Partners Case

In *Panther Partners*, plaintiff alleged that the defendant, a manufacturer of network hardware,

was aware of defects in its main product line and had failed to disclose "the magnitude of the defect issue" in its filings for a secondary offering of its securities, in violation of the Securities Act of 1933.[3] Plaintiff's allegations centered on the defendant's sale of allegedly defective semiconductor chips; plaintiff claimed that the defendant sold the chips—allegedly the defendant's core product—to two customers, accounting for more than 70 percent of the defendant's revenues. According to plaintiff, the two customers then incorporated the chips into network products. In the weeks leading to the secondary offering, according to the complaint, the defendant learned that certain chips were defective and causing the customers' products to fail, and there was no way to determine which chips would need to be replaced. The secondary offering proceeded, with the defendant disclosing that "complex products" of the type it sold "frequently contain[ed] defects and bugs" and that the defendant had "experienced, and may in the future experience, defects and bugs," with resulting damage to its reputation and customer confidence.

After the offering, the defendant was forced to finance the replacement of chips in all of its customers' devices, causing negative revenue and reputational effects that significantly impacted the value of the defendant's stock. The district court dismissed the complaint, finding that plaintiff failed to allege facts demonstrating that the defendant knew of the abnormally high rate of product defects at the time defendant filed its registration statements.

The Second Circuit reversed the dismissal and permitted the case to continue, finding the plaintiff had "plausibly allege[d] that the defect issue and its potential impact on [the defendant's] business, constituted a known trend or uncertainty that [the defendant] reasonably expected would have a material unfavorable impact on revenues or income from continuing operations."[4] The court further found that "generic cautionary language" the defendant used in its disclosures violated Item 303. The court employed a reasonable foreseeability test that deemphasized quantitative factors, holding that the defendant's disclosures were insufficient to comply with Item 303's requirement that the defendant "inform the investing public of the particular, fact-based uncertainties of which it was aware in the weeks leading up to" the offering. The court held that the defendant's "generic cautionary language" was "incomplete" in this regard, but refused to outline a bright line test since the disclosure obligations "do not turn on restrictive mechanical or quantitative inquiries."[5]

The *Panther* analysis focused on three factors: (1) whether the company knew of a problem with a core product; (2) whether the company's revenues depended heavily on a core group of customers; and (3) whether the problem was likely to jeopardize the relationships with those core customers. The Second Circuit determined that MD&A required specific disclosure, because the "reasonable and plausible inferences" from the plaintiff's allegations were "not simply that the [defendant] would have to replace and write off a large volume of its chip sets, but also that it had jeopardized its relationship with clients who at that time accounted for the vast majority of its revenues."[6] It was reasonable to expect, the court said, that "the uncertainty surrounding the defect rate, generated by an increasing flow of highly negative information from key customers" might "have a material impact on future revenues."[7]

Foreshadowing the *Panther Partners* court's move toward a qualitative analysis was the Second Circuit's prior decision in *Litwin v. Blackstone Group*.[8] In *Litwin*, the court noted that "[e]ven where a misstatement or omission may be quantitatively small compared to a registrant's firm-wide financial results, its significance to a particularly important segment of a registrant's business tends to show its materiality." As such, any analysis likely should include an examination of the registrant's business divisions, as well as the products that are key to those divisions.

Reasonable Foreseeability in the Future

The Second Circuit's move toward a reasonable foreseeability test that shifts focus away from quantitative factors is troublesome for registrants hoping for bright-line disclosure guidance. The need for registrants to examine qualitative factors is nothing new—the SEC has long held the position that both types of factors need to be addressed. However the shift in court focus, and the increasing number of cases in which the plaintiffs' bar is invoking Item 303 in claims brought under Section 10(b) of the Securities Exchange Act of 1934, is notable. In this regard, the importance of paying close attention to factors explored in the *Panther Partners* opinion has played out in subsequent Second Circuit district court decisions, as discussed below.

Panther Partners and other cases applying its rationale arguably require registrants to reexamine their analytical and disclosure methodology, and in some cases, monitor more carefully any adverse developments in the company's core business lines, including risks to key customer or vendor relationships, trends in orders and backlogs, and the like. The courts' heightened scrutiny under Item 303, as reflected in *Panther Partners,* has empowered plaintiffs' attorneys to use Item 303 to persuade courts that companies have a duty of disclosure that is far more malleable than in past cases. This new trend in the case law in turn creates instability because it adds further shades of gray to the choice facing any registrant: disclose too little and run afoul of strict liability securities penalties; disclose more than necessary about uncertain future events and risk making them certain.

Second Circuit Decisions After *Panther Partners*

Disclosure of uncertain government spending predictions. In *McKenna v. SMART Technologies, Inc.*, Judge Forrest in the Southern District of New York leaned heavily on the "core" products aspects of the *Panther Partners* decision in finding that the plaintiff had made plausible allegations under MD&A.[9]

McKenna dealt with allegations surrounding the sales of an interactive white board products sold mostly to public sector funded schools in the United States. SMART's disclosures stated that it was an "indirect but perhaps substantial beneficiary of the American Recovery and Reinvestment Act" and that if its customers' ARRA funds depleted, the company could experience a loss of revenue growth as a result.[10] Following its IPO in July 2010, SMART's business declined, and the company revised its forecasts significantly just months after the IPO. Even with the company's detailed accounting of its revenue sources and their associated vulnerabilities in the offering documents for the IPO, and extensive risk factor disclosures, the district court found SMART's disclosure in the offering documents concerning risks to its future sales of interactive white board products "was not specific enough" and SMART should have disclosed that it had "indications that ARRA funding [was] less than in prior years."[11]

This higher disclosure duty, if applied in other cases, clearly will burden registrants whose core business involves customers that depend in whole or in part on government funding. But, as the cases discussed below suggest, this heightened duty of disclosure may not be limited to the facts in cases such as *Panther Partners* and *SMART Technologies.*

Disclosure of specific product vulnerabilities. The Southern District of New York recently used the *Panther Partners* decision to find a basis for disclosure obligations where previously it had found none. In *Stratte-McClure v. Morgan Stanley*, Judge Deborah Batts applied both *Panther Partners* and *McKenna* to find that awareness of factually-based uncertainties stemming from known external trends imposed a duty to

disclose.[12] The case dealt with two of Morgan Stanley's 10-Q filings made during the subprime mortgage crisis, which allegedly did not disclose the existence of certain types of mortgage-backed securities. At the time of the filing, the company allegedly knew that the mortgage crisis adversely affected the securities, and were likely to have materially negative effects on both the securities and Morgan Stanley's financial condition. For its part, Morgan Stanley argued that its 10-Q filings sufficiently warned investors about the real-estate downturn and revealed that the company took proprietary positions in mortgage-related securities.

The district court held that *Panther Partners* required the court to reverse its previous finding that Morgan Stanley had no duty of disclosure under MD&A. Applying *Panther Partners*, the court found that the company: (1) was aware at the time of the filing that trends in the subprime market were affecting adversely the undisclosed subprime assets; (2) had already written down the assets in light of their vulnerability; and (3) had acknowledged the vulnerability of the assets to subprime trends by taking proactive steps to find new strategies to sell them. Accordingly, the court held, the company was "aware of factually-based uncertainties, stemming from subprime and real estate trends, that were reasonably likely to have material effects on [the contested subprime assets] and Morgan Stanley's financial condition," and that the 10-Q disclosures were not sufficient.[13] The *Stratte-McClure* decision confirms the need for companies to disclose known trends and related effects on products even when the company is taking steps to address known product vulnerabilities and the disclosure may cause the vulnerability to become a certainty.

Other Circuit Court Decisions After *Panther Partners*

It remains to be seen whether other circuits will follow the Second Circuit's *Panther Partners* lead. Certain district courts outside the Second Circuit recently have examined MD&A disclosures in the wake of *Panther Partners* and do not yet appear to be borrowing the case's qualitative interpretation of disclosure duties under Item 303. However, it is too early to tell whether these new cases outside the Second Circuit are anomalies, or an accurate indication of a split among the courts that will remain in Item 303 interpretation going forward. We discuss below just a few examples of court rulings that conflict with *Panther Partners.*

In *Mallen v. Alphatec Holdings, Inc.*, the Southern District of California found no known trend or uncertainty when it determined that a broad disclosure—similar to that made by the defendants in *McKenna*—was enough to defeat an omission argument.[14] The *Mallen* plaintiffs alleged, in part, that reduced distributor sales were a "known trend or uncertaint[y]" and should have been disclosed. Judge Roger Benitez disagreed, determining that a prior history of terminated orders did not support a claim that the defendants knew of a material trend or future uncertainty. In contrast to *Panther Partners*, the court focused on cases emphasizing the quantitative-factor approach, specifically referencing cases that found, for example, "a five-month decline in [] prices" and a "two month period of time" did not (as a matter of law in the second instance) establish a trend for the purposes of Item 303.[15]

Recently in *In re Netflix, Inc.*, the Northern District of California found no violation of MD&A where the defendant had "repeatedly stated" that the success of its business model depended on a variety of factors, including the general need to keep its customer base happy.[16] A Netflix shareholder plaintiff class filed its complaint in the wake of the media company's 2011 decision to discontinue its hybrid offering of online and DVD media rentals for a single monthly fee. In the ensuing months, Netflix experienced a subscriber backlash and a steep decline in its stock price. The plaintiffs' class alleged that Netflix had "misled investors about the prospects

of the new streaming-focused model, thereby artificially inflating Netflix's stock price."[17]

The district court held that plaintiffs' claims were "not plausible," but granted leave to amend. While the court provided scant reasoning and did not cite *Panther Partners,* the facts of the case provide some interesting factor-based scenarios for a hypothetical *Panther Partners* analysis:

First, the case appears to deal with a "core product"—the delivery of online and DVD media.

Second, the customer base comprises a large group of individual customers. While this may seem at first glance to constitute the polar opposite of the two large customers in *Panther Partners,* there are similarities. Consumers of both Netflix and Ikanos—the defendant in *Panther Partners*—generally shared a very similar customer experience by purchasing an undifferentiated underlying product; hence both companies could reasonably expect that any glitch or problem would affect its customer base in a relatively uniform way. Moreover, the reputational impact of any glitch or problem had the potential to be devastatingly universal.

Third, in both cases, uncertainties arose from events that were internal to each company. In *Panther Partners* the uncertainty stemmed from a glitch in the manufacturing process. For Netflix, the problem arose from the company's business strategy for developing and deploying its streaming media services.

Fourth, although Ikanos Communications had knowledge of the chip defect at the time of the disputed filings, it remains to be seen whether Netflix had similar knowledge that its decision to split its streaming media and DVD media business would lead to a customer backlash. Judge Conti's decision suggests that while Netflix had knowledge of the potential impact an unhappy customer base could have on its profits and business structure, it might not have been reasonably foreseeable to Netflix that its decision to cease offering a hybrid DVD-by-mail and streaming subscription would have the negative impact on Netflix's customer base that it ultimately had.

More Uncertainty for Issuers Concerning the Impact of the Global Financial Crisis

The global financial crisis has spawned uncertainty that adds a further layer to *Panther Partners'* reasonable foreseeability analysis.

In *Brasher v. Broadwind Energy, Inc.*, the Northern District of Illinois specifically referenced the crisis and found that the plaintiffs could not show "what the defendants—or any other market participant—should have 'reasonably expected.'"[18] As such, the court found that the defendants acted reasonably in waiting until a later filing to report that known demand forecast cuts were indicative of the business environment rather than a short-term event. Given the unprecedented uncertainties caused by the global economic crisis *Brasher* may prove to be something of an outlier as the global markets recover, although for now the holding does stand in contrast to *McKenna*.

Brasher further indicates that courts might treat differently uncertainties caused by rapidly developing external events, as opposed to internal business events such as was the case in *Panther Partners.* To the extent that the global economy improves, other courts may well give less leeway to companies than the court did in *Brasher.* On the other hand, cases emerging from actions taken during the onset and initial months of the global economic crisis may present illuminating tests of the *Panther Partners* court's reasoning.

Conclusion

Registrants seeking to comply with *Panther Partners* and its progeny in addressing uncertainties

should consider asking themselves the following questions: First, does the uncertainty surround a "core" product, service, or aspect of the registrants business, or the business of one of the registrant's divisions? Second, might any such uncertainty impact key customers? Third, did the uncertainty arise from events that were internal to the registrant's company or business? Fourth, at the time the company made an SEC filing, did that company have knowledge of facts underpinning the uncertainty? Fifth, was the uncertainty prompted by known external economic trends that have impacted the company or a particular product to a greater and undisclosed extent than might be reasonably be expected?

To the extent that the answer to any of these questions is "yes," the registrant should consider whether the use of the kinds of "generic cautionary language"—disapproved of by the Second Circuit in *Panther Partners*—will fully explain the uncertainties involved. It remains to be seen whether other circuits will follow the Second Circuit's lead, though the ease with which district courts have embraced—and even extended—the *Panther Partners* decision is indicative of an emerging split among courts in different circuits on this issue. Given this uncertainty, registrants would be well advised to take stock of internal and external trend indicators as they craft their MD&A disclosures going forward.

Notes

1. *Panther Partners Inc. v. Ikanos Comms, Inc.*, 681 F.3d 114 (2d Cir. 2012).
2. Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, Exchange Act Release No. 26, 831, Investment Company Act Release No. 16,961, 42 SEC Docket 1330 (May 18, 1989).
3. *Panther Partners* at 118.
4. *Id.* at 121.
5. *Id.* at 122.
6. *Id.* at 121.
7. *Id.* at 120.
8. *Litwin v. Blackstone Group, L.P.* 634 F.3d 706 (2d Cir. 2011).
9. *McKenna v. SMART Technologies Inc.*, No. 11 Civ. 7673, 2012 WL 3589655 (S.D.N.Y. Aug. 21, 2012).
10. *Id.* at *6.
11. *Id.*
12. *Stratte-McClure v. Morgan Stanley*, No. 09 Civ. 2017, 2013 WL 297954 (S.D.N.Y. Jan. 18, 2013).
13. *Id.* at *6.
14. *Mallen v. Alphatec Holdings, Inc.*, 861 F. Supp. 2d 1111 (S.D. Cal. 2012).
15. *Id.* at 1128 citing *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 218 (5th Cir. 2004) and *Blackmoss Inv. Inc. v. ACA Capital Holdings, Inc.*, No. 07 Civ. 10528, 2010 WL 148617, at *10 (S.D.N.Y. Jan. 14, 2010).
16. *In re Netflix, Inc.*, No. 12-00225, 2013 WL 542637 (N.D. Cal. Feb. 13, 2013).
17. *Id.* at 3.
18. *Brasher v. Broadwind Energy, Inc.*, No. 11 CV 991, 2012 WL 1357699 (N.D. Ill. April 19, 2012).