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Commentary

The Risk In Disclosing Risk Factors

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Every public company, in just about every public filing and press release, discloses "risk factors." Why? Well, for one, it's good practice to inform shareholders of the risks facing the company to help them make informed investment decisions. Also, issuers are required to do so pursuant to an SEC rule—Item 105 of Regulation S-K—which mandates that companies include a discussion of meaningful risks in certain filings and offering documents.

But many companies put in multiple pages of risk factors in the belief—based on statutes and case law—that doing so reduces their exposure to securities litigation. For example, the Private Securities Litigation Reform Act of 1995 (the "PSLRA") expressly provides that companies can protect their "forward-looking statements" (a defined term) from liability if they are "accompanied" by "meaningful cautionary statements." 15 U.S.C.A. § 77z-2. The judicially created "bespeaks caution" doctrine also reduces liability for forward-looking information where the company has provided sufficient cautions. But are there risks to disclosing risk factors?

Unfortunately, it depends. Some courts have ruled that disclosing a risk implies that something exists only as a future risk—that the disclosure is a backhanded way of asserting that the risk is not currently occurring or has not happened in the past. Other courts have held that risk factors speak about the future only; they make no representation about the past or present—one way or the other. Still others have come up with their own tests for determining when risk factors are themselves misleading.

The bottom line is that, until the Supreme Court clarifies the law in this area, companies should review their risk factors knowing that plaintiffs' lawyers and regulators may look for ways to turn companies' risk disclosures against them.

Risk Disclosures in the Ninth Circuit Under *In re Facebook, Inc. Securities Litigation*

Recently, the Ninth Circuit held that a company can be held liable for securities fraud for disclosing something as a "risk" if it knows that such an event has happened in the past. In an October 18, 2023 decision, a two-to-one majority of the court found that plaintiffs adequately alleged Section 10(b) claims against Facebook based on the company's risk disclosures in the wake of the Cambridge Analytica data leak scandal. *In re Facebook, Inc. Sec. Litig.*, 84 F.4th 844 (9th Cir. 2023), *opinion amended and superseded on denial of reh'g*, No. 22-15077, 2023 U.S. App. LEXIS 31898, 2023 WL 8365362 (9th Cir. Dec. 4, 2023). Specifically, Facebook's 2016 10-K filed in February 2017 included the following risk factors:

- "Any 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, which could harm our business and reputation and diminish our competitive position."

- "We provide limited information to . . . third parties based on the scope of services provided to us. However, if these third parties or developers fail to adopt or adhere to adequate data security practices . . . our data or our users' data may be improperly accessed, used, or disclosed."

Plaintiffs—a class of purchasers of Facebook's stock—alleged that these statements were false or misleading because Facebook knew before February 2017 that Cambridge Analytica had improperly collected and harvested users' personal data. The majority agreed. The court found that "the problem is that Facebook represented the risk of improper access to or disclosure of Facebook user data as purely hypothetical when that exact risk had already transpired. A reasonable investor reading the 10-K would have understood the risk of a third party accessing and utilizing Facebook user data improperly to be merely conjectural." 87 F.4th at 949. According to the majority, Facebook's disclosure that its business could suffer harm if there was a security breach was effectively an affirmative statement that no such breach had happened yet.

The dissent takes issue with this reasoning. First, Facebook's risk factor statements did "not represent that Facebook was free from significant breaches at the time of the filing." *Id.* at 959 (Bumatay, J., dissenting in part). Facebook's statements that its business could be harmed in the future by a security breach say nothing about whether a breach had already occurred. A statement of future risk is no more and no less than that—a statement about the future. The dissent also noted that, "[i]ndeed, within the same section, Facebook warned that 'computer malware, viruses, social engineering (predominantly spear phishing attacks), and general hacking have become more prevalent in our industry, have occurred on our systems in the past, and will occur on our systems in the future'" and "expressly advised that it experienced previous attempts to swipe its data and that it would continue to face such threats." *Id.*

Second, one of the "risk" disclosures that plaintiffs claimed was misleading was Facebook's warning that ***its reputation could be harmed*** as a result of a security breach; and yet, there were no allegations that Facebook actually believed that its reputation had been harmed at the time of its 10-K filing. *Id.* at 959–60. So, to the extent that Facebook led investors to believe that the "risk" of harm was merely hypothetical, that was not a false suggestion at the time it was made. Nevertheless, "the majority [took] the surprisingly broad view that it's irrelevant that Facebook did not know whether its reputation was ... harmed at the time of the 10-K filing." *Id.* at 959-60 (citing Maj. Op. at 950).

On March 4, 2024, Meta and the other *Facebook* defendants filed a petition for a writ of certiorari asking the Supreme Court to review and reverse the Ninth Circuit's decision. Meta argued in its petition, "The Ninth Circuit's extreme rule in this case—which has not been adopted by any other circuit—would require companies to chronicle past instances a risk came to fruition, even if the company has no reason to suspect those events pose any risk of business harm. That outlier approach will spur lawsuits alleging fraud-by-hindsight, make compliance with 10-K disclosure requirements burdensome and unworkable, and ultimately reduce the usefulness of risk-factor disclosures by drowning investors in irrelevant information." *Facebook, Inc., et al., Petitioners, v. Amalgamated Bank, et al., Respondents*, 2024 WL 1009159, at *17–18. As petitioners suggested, a Supreme Court decision on this issue could help resolve the patchwork of legal theories about the importance of risk disclosures spanning across the country.

The SEC Takes Liability for Risk Factors Even Further in Its *SolarWinds* Complaint

Although the majority in *Facebook* took the position that it didn't matter whether the company knew its reputation had been harmed, it was not a huge leap to assume that a widespread data breach on the scale of the Cambridge Analytica scandal would do so. But the SEC's recent enforcement action in *SolarWinds* threatens to subject companies to liability when the risk of harm is even more speculative.

On October 30, 2023, the SEC filed a complaint against SolarWinds and its chief information security officer. From the date of its 2018 initial public offering ("IPO") through December 2020, SolarWinds

allegedly touted its cybersecurity practices while simultaneously making "general, highlevel" disclosures about the risk to its business of cyberattacks. Compl. ¶ 7, *SEC v. SolarWinds Corp.*, No. 23-cv-9518 (S.D.N.Y. Oct. 30, 2023), ECF No. 1. SolarWinds was subjected to a wellknown cyberattack—called "SUNBURST"—in December 2020. Although the company itself was the victim of this security incident, the SEC sued SolarWinds, alleging that it violated the securities laws by misrepresenting the company's cybersecurity practices and risks. Among other allegations, the complaint claims that SolarWinds' risk factors ***even before*** the company discovered the SUNBURST attack were false and misleading because they failed to disclose that there "had been multiple successful intrusions" "or that SolarWinds' overall cybersecurity posture was so poor that something far worse could be just around the corner." *Id.* ¶ 137. The complaint also took the company to task for using the "exact same" "high level" risk disclosures from 2018 through 2020 "despite both . . . ongoing problems and . . . increasing red flags." *Id.* ¶¶ 136, 7.

In their motion to dismiss the original complaint, defendants in *SolarWinds* argued that the SEC's position was impractical: "No company ever achieves a state of perfect security; instead, managing cybersecurity risk is a continuous endeavor. That is, every company *always* has various cybersecurity risks it needs to address and areas in which it needs to improve, which evolve and fluctuate on a daily basis. Requiring companies to keep the investing public constantly apprised of these granular risks would be an impossible task that would flood investors with unnecessary details." Mem. Law Supp. Defs.' Mot. Dismiss Compl. at 13, ECF No. 46. The SEC's theory of liability could require companies to endlessly provide information about potential risks well before such risks materialize, let alone have any effect on their businesses. That would not only be unworkable for businesses but unhelpful for investors who would be "bur[ied] . . . in an avalanche of trivial information." *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988). Rather than respond to SolarWinds' motion, on February 16, 2024, the SEC filed an amended complaint purporting to add more detail to its allegations. But the SEC's amended complaint still includes these problematic allegations—i.e., that risk factors may be misleading if they do not also disclose details about past and current events that, according to the SEC, make the risk more likely to come to fruition—even if the risk has not yet materialized.

Risk Disclosures in the Sixth Circuit Are "Inherently *Prospective* in Nature"

The Sixth Circuit took a different approach in *Bondali v. Yum! Brands, Inc.*, 620 F. App'x 483 (6th Cir. 2015). There, the defendant-company owned Kentucky Fried Chicken, including a subsidiary that operated KFCs in China. Plaintiffs challenged the following risk disclosures in the company's 10-K: "[F]ood safety issues have occurred in the past, and could occur in the future. Any report or publicity linking us or one of our Concept restaurants, including restaurants operated by our franchisees, to instances of food-borne illness or other food safety issues, including food tampering or contamination, could adversely affect our Concepts' brands and reputations as well as our revenues and profits. . . " *Id.* at 487 (alterations in original). Plaintiffs alleged that these disclosures were misleading because defendant knew at the time that some batches of chicken supplied to a subsidiary had tested positive for drug and antibiotic residues. In a ruling on risk factors at odds with the holding in *Facebook*, the court affirmed dismissal of the complaint:

> Risk disclosures like the ones accompanying 10–Qs and other SEC filings are inherently *prospective* in nature. They warn an investor of what harms *may* come to their investment. They are not meant to educate investors on what harms are currently affecting the company. This is apparent from any dictionary definition of "risk." For example, Webster's Third New International Dictionary lists the primary definition of "risk" as a "*possibility* of loss, injury, disadvantage, or destruction." *Webster's Third New International Dictionary* 1961 (1986) (emphasis added). For these reasons, a reasonable investor would be unlikely to infer anything regarding the current state of a corporation's compliance, safety, or other operations from a statement intended to educate the investor on *future* harms. While there may be circumstances under which a risk disclosure might support Section 10(b) liability, this is not that case.

Id. at 491 (emphases in original).

Thus, according to the Sixth Circuit, a disclosure that something is a "risk" is necessarily a forwardlooking statement that no reasonable investor should read as an assessment of a company's past or current affairs.

Risk Disclosures in Other Circuits Are Only Actionable If the Harm Has Materialized

Other courts have landed somewhere in the middle. The First, Second, Third, Fifth, Tenth and D.C. Circuits have held that a risk disclosure is actionable only when the risk has materialized, ***and*** it is known or near certain that it's had a negative impact on the company's business. In *Williams v. Globus Medical, Inc.*, 869 F.3d 235, 242 (3d Cir. 2017), for example, defendant's risk disclosure stated, "if any of our independent distributors were to cease to do business with us, our sales could be adversely affected." Plaintiffs challenged this statement because the company didn't add that it had in fact already lost an independent distributor. *Id.* at 241. Although the court "agree[d] that a company may be liable under Section 10b for misleading investors when it describes as hypothetical a risk that has already come to fruition," it found that "this is not such a case." *Id.* at 242. The court explained, "[t]he risk actually warned of is the risk of adverse effects on sales—not simply the loss of independent distributors generally. Accordingly, the risk at issue only materialized—triggering Globus's duty to disclose—if sales were adversely affected at the time the risk disclosures were made." *Id.*

The Tenth Circuit reached a similar conclusion in *Indiana Public Retirement Systems v. Pluralsight, Inc.*, 45 F4th 1236 (10th Cir. 2022). Defendant in *Pluralsight* essentially warned in its risk disclosures that if the company failed to expand its sales efforts, its results could be harmed. Plaintiffs alleged these statements were false and misleading because the company was purportedly having trouble hiring and ramping up sales representatives. The court held that "nothing in the complaint supports the inference that Defendants knew Pluralsight was so far behind in its sales ramp capacity plan that it was virtually certain to cause harm to the business." *Id.* at 1256-57. As such, the court affirmed that "[t]he district court correctly determined the risk factors disclosed in [the] 10-K filing were not actionable." *Id.* at 1257. The First, Second, Fifth and D.C. Circuits have taken a similar approach. *Karth v. Keryx Biopharmaceuticals, Inc.*, 6 F.4th 123, 137 (1st Cir. 2021) (a hypothetical risk disclosure is only misleading if the risk is known to have a "near certainty" to cause financial harm); *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 133-34 (2d Cir. 2011) (disclosure that defendant "may" place support bids in auctions not actionable in absence of allegation that defendant "knew with certainty" the market would fail without support bids); *Lormand v. US Unwired, Inc.*, 565 F.3d 228, 247 (5th Cir. 2009) (risk disclosures are only misleading if the defendant knows that a realized risk "posed an imminent threat of business and financial ruin and that some damage from these risks had already materialized."); *In re Harman Int'l Indus., Inc. Sec. Litig.*, 791 F.3d 90, 104 (D.C. Cir. 2015) (statements that merely "implicitly rais[ed] the specter of obsolescence" were misleading because the company failed to disclose that the business had already been "compromised by obsolescence.").

Notably, in *Pluralsight*, the Tenth Circuit also examined a 2021 Ninth Circuit case—*In re Alphabet, Inc. Securities Litigation*, 1 F.4th 687 (9th Cir. 2021), *cert. denied sub nom. Alphabet, Inc. v. Rhode Island*, 142 S. Ct. 1227 (2022) (mem.)—that the court relied upon in *Facebook*. In *Alphabet*, defendants warned in public filings of the risk that public concerns about Google's privacy and security practices "could" harm the issuer's reputation and operating results. *Id.* at 703. The *Alphabet* plaintiffs challenged these disclosures because defendants had allegedly discovered a privacy bug that threatened thousands of users' personal data. *Id.* As in *Facebook*, the Ninth Circuit found that plaintiffs in *Alphabet* plausibly alleged a misleading omission. *Id.* In the 2022 *Pluralsight* decision, the Tenth Circuit distinguished *Alphabet* and rejected plaintiff's argument that the case supported expansive liability for disclosing something as a risk that has already occurred. Describing the allegations in *Alphabet*, the Tenth Circuit in *Pluralsight* explained that "[t]his risk factor was materially misleading . . . because Google *already* had suffered a massive cybersecurity vulnerability. And disclosure of the vulnerability was virtually certain to result in the warned-of harm to its business." *Ind. Pub. Ret. Sys.*, 45 F.4th at 1256 (citations omitted). But when the Ninth Circuit revisited *Alphabet* in *Facebook*, it confirmed that, contrary to the Tenth Circuit's opinion, the former court ***did*** intend for its decision to be as expansive as the *Pluralsight* plaintiffs suggested: "Our case

law does not require harm to have materialized for a statement to be materially misleading. Facebook's statement was plausibly materially misleading even if Facebook did not yet know the extent of the reputational harm it would suffer as a result of the breach: Because 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 the ensuing harm was still unknown." *In re Facebook, Inc. Sec. Litig.*, 87 F.4th at 949–50. Meta argued in its recent petition for a writ of certiorari that "[t]he Ninth Circuit's outlier position creates a clear incentive for forum shopping by savvy plaintiffs who know their claims will be dismissed elsewhere . . . ." *Facebook, Inc., et al., Petitioners, v. Amalgamated Bank, et al., Respondents.*, 2024 WL 1009159, at *23

Conclusion and Takeaways

It's more than a little ironic that risk disclosures now often form the basis for securities suits. The PSLRA's safe harbor was designed to provide a defense to liability. It's one thing to find that the defense does not work; it's another, as in some of the cases described above, to rule that these disclosures themselves may misleadingly imply something about the company's present or past.

Even before the PSLRA, courts found that statements about one time period implied nothing about another time period; for example, a company's disclosure about the past suggested nothing about the future. *See*, *e.g., In re VeriFone Sec. Litig.*, 11 F.3d 865, 869 (9th Cir. 1993) (company not liable for securities fraud for omitting "to state the 'fact' that future prospects may not be as bright as past performance."). Accordingly, a company could report record results and not worry about liability for failing to disclose that its prospects were not as rosy going forward. But now, statements about future risks may not work that way. Warning about the future, in some cases, may imply something about what's already occurred.

So, what should a public company do to avoid creating even more risk by disclosing risk factors?

For one, consider noting that the risks you've disclosed have occurred in the past. There may be a big difference between stating that something "may occur" in the future and "has occurred in the past and may also occur in the future."

Also, take care to update your risk factors. It's tempting to recycle risk factors from one document to another, but doing so may create the impression that they reflect little thought on the drafter's part.

Along those lines, consider slimming down your risk factors. "Caution early and often" works only to a point; the more things you call future risks, the more targets you may create for claims that those risks had occurred in the past.

Another possible precaution: state explicitly that your risk factors concern risks going forward; they are not intended to imply that the risks have not occurred in the past.

In sum, take into account that your risk factors—like all your other statements—may form the basis of a securities lawsuit. ■

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