Duty to Update Previously Disclosed Information

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An examination of the duty of an issuer to update disclosure that was accurate when made but has become inaccurate in light of later developments. This Article examines cases where courts have found a duty to update under certain circumstances even though under the federal securities law there is no specific duty to update. Typical examples of when a company may be faced with a decision regarding the application of the duty to update and best practices for a company to follow are also set out in this Article.

The US federal securities laws require public companies to disclose all material nonpublic information and to correct prior statements of material fact that were false or misleading at the time they were made. No similar provisions exist that require a public company to update previously disclosed information that was accurate when made, but has become inaccurate in light of later developments. While at least one court has taken the position that the federal securities laws do not impose any duty to update, other courts have recognized a duty to update under certain circumstances. Accordingly, the duty to update is an unsettled area of law which can make it difficult for a company to apply when seeking to comply with disclosure requirements.

This Article provides a summary of companies' duty to disclose and the current status of the duty to update previously disclosed information.

DUTY TO DISCLOSE UNDER FEDERAL SECURITIES LAWS

A reporting issuer (also referred to as a public company) is an entity which has completed an offering of debt or equity securities and has registered those securities with the SEC under the Securities Act and the Exchange Act. Registration under the Securities Act permits the securities registered to be sold in a particular transaction. Registration under the Exchange Act subjects the company to the current and periodic reporting requirements of the Exchange Act, the "duty to disclose."

The current and periodic reports and other information made publicly available form the basis for the market's evaluation of the company and the pricing of its securities. Investors in the secondary market use this information to make their investment decisions. In addition, each of the securities exchanges, such as the New York Stock Exchange (NYSE) and NASDAQ Stock Market (NASDAQ), generally requires their listed companies to promptly disclose material information about the company to the public.

The Exchange Act, NYSE and NASDAQ all have rules relating to the prompt disclosure of material information to the public. Information is material if it could affect a person's decision to buy, sell or hold a company's securities. Even if a public company may not be required to disclose material information under the federal securities laws, a public company remains subject to the rules of the securities exchange on which it is listed. In addition, a public company faces both internal and external pressure beyond the federal securities laws and the rules of the securities exchanges to have an open communication policy.

There is no liability for the failure to disclose information unless the law imposes a duty to disclose. Typically, the duty to disclose arises out of one of two scenarios:

- Where there is a statute or regulation mandating disclosure (such as Regulation FD).
- Where disclosure is required to avoid rendering existing statements misleading.

In addition, only material information is subject to disclosure requirements. For more information on materiality and the duty to disclose information, see *Practice Note, Disclosing Nonpublic Information (http://us.practicallaw.com/2-382-5502)*.

Section 10(b) and Rule 10b-5 under the Exchange Act are important liability provisions under US securities law. These provisions prohibit fraud or manipulation in connection with the purchase and sale of securities. Rule 10b-5 prohibits making an untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading. These provisions also apply in offerings that are exempt from the registration requirements under the Securities Act.

Accordingly, a company is obligated to correct prior statements that were false or misleading when made and this duty to correct is a corollary of the duty imposed by the Exchange Act to disclose all material, nonpublic information. . The duty to correct is different and can be distinguished from the duty to update as the duty to correct is based on correcting information which was misleading or false when made.

For a discussion of the principal federal securities law provisions that potentially impose liability on an issuer for material misstatements and omissions of any material facts, see *Practice Note, Liability Provisions: Securities Offerings (http://us.practicallaw.com/6-381-1466)*.

DUTY TO UPDATE UNDER FEDERAL SECURITIES LAWS

The duty to update is a subset of the broader duty to disclose. Liability resulting from a failure to comply with the duty to update requires:

- The existence of the duty to update in the given circumstances.
- Materiality concerning the relevant disclosure required by the applicable duty to update.

Typical examples of when a company may be faced with a decision regarding the application of the duty to update are:

- In the context of previously disclosed earnings projections.
- The company's expectations regarding an anticipated substantial business transaction.

When a company discloses its expectations regarding future earnings results or the pursuit of a substantial business transaction, the company may later be faced with the question of whether a duty to update exists if the company later determines that the statements made should no longer be relied on by investors. While the Seventh Circuit Court of Appeals has taken the position that federal law does not impose any duty to update, other courts have recognized a duty to update under certain circumstances.

Generally the duty to update exists when a clear, factual and forward-looking statement containing some continuing representation to investors becomes misleading in light of later events. Given that this standard relies on a heavily fact-based and somewhat subjective analysis, the standard can be challenging for a company to apply when it seeks to comply with disclosure requirements. In addition, with courts still struggling to define the boundaries of the duty to update, the challenge for companies remains difficult.

Companies may be entitled to rely on certain defenses when an allegation is made that they breached a duty to update a forward-looking statement:

- Safe-harbor for forward-looking statements.
- Bespeaks caution doctrine.

For information on these defenses which may be available to issuers in certain limited circumstances, see *Box, Available Defenses for Forward-looking Statements*.

The federal securities laws and rules do not impose a specific duty to update. However, some courts have found that companies have a duty to update under certain circumstances. *In re Time Warner, Inc. Securities Litigation* (*Time Warner*) was one of the earliest cases considering the duty to update (*9 F.3d 259 (2d Cir. 1993)*). In this case, Time Warner sought to alleviate its debt troubles by seeking investments from strategic partners. When the plan to form strategic alliances failed, Time Warner turned to an equity raise, which resulted in the dilution of existing shares. Shareholders sued Time Warner claiming that it misrepresented the status of its partnership discussions and failed to disclose its plans to pursue an alternative stock offering.

The Second Circuit Court of Appeals held that the statements regarding strategic alliances were insufficiently specific to give rise to a duty to update, which required forward-looking statements with "definitive positive projections." However, the Second Circuit acknowledged that Time Warner may have a duty to update for statements concerning its plans to seek alternative financing in the form of an equity raise. Specifically, the Second Circuit indicated that where "a corporation is pursuing a business goal and announces that goal as well as an intended approach for reaching it, it may come under a duty to disclose other approaches to reaching that goal where those approaches are under active and serious consideration."

AVAILABLE DEFENSES FOR FORWARD-LOOKING STATEMENTS

The *Private Securities Litigation Reform Act of 1995* (PSLRA) contains a safe harbor from liability under the Securities Act for forward-looking statements by certain qualifying issuers. It contains a key requirement that the forward-looking statements be identified and accompanied by meaningful cautionary statements and factors that may cause results to differ materially from those in the forward-looking statements. SEC rules also provide safe harbors for forward-looking statements, but the safe harbors in those rules are tied to whether the forward-looking statements were made without a reasonable basis or disclosed other than in good faith (*Rule 175, Securities Act* and *Rule 3b-6, Exchange Act*).

The PSLRA added Section 27A to the Securities Act and Section 21E to the Exchange Act. Section 27A and Section 21E define forward-looking statements generally as statements that reference future plans or performance, including revenue projections and statements tied to future economic performance of a company. One of the key criteria for the forward-looking statement is that the statement must be truly forward-looking (a projection of the future) to be protected by the safe harbor. If the company is aware of any facts that would undermine the projection, the statement would not qualify as looking forward and would not be protected by the safe harbor.

Application of the PSLRA depends on whether the communication is written or oral. In a written statement, the forward-looking statement must be identified as a forward-looking statement and be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. These cautionary statements must be included on all press releases and SEC filings.

During oral communications, such as conference calls, the company must announce at the beginning of the call that:

- It can provide forward-looking information.
- Actual results could differ materially.
- The factors that can cause the difference are explained in the "risk factors" section of the company's SEC filings.

The company should also specifically identify the relevant SEC filings. If the document identified contains a meaningful description of the risks facing the company, the oral forward-looking statements cannot be the basis of a private securities suit, even if they turn out to be inaccurate.

The PSLRA safe harbor is not available to, among others, issuers not yet subject to Exchange Act reporting requirements under Section 13(a) or Section 15(d) (this includes an initial public offering issuer) or to disclosures made in connection with tender offers. For more information on the scope of the PSLRA safe harbor, see *Practice Note, Disclosing Nonpublic Information (http://us.practicallaw.com/2-382-5502)*.

The "bespeaks caution" doctrine is a concept developed in case law holding that statements that include projections and expectations about a company's prospects (that is, statements that are forward-looking) are not misleading if they are accompanied by adequate risk disclosure to caution readers about specific risks that may materially impact the forecasts. *In re Worlds of Wonder Securities Litigation (35 F.3d 1407 (9th Cir. 1994))* is one of many cases that illustrates how the concept has been applied in litigation. Although the doctrine predates the PSLRA, it has also been applied after adoption of the PSLRA in part because it may provide a defense where the statutory safe harbor under the PSLRA is not available.

WHERE DO COMPANIES DISCLOSE FORWARD-LOOKING STATEMENTS?

A section defining forward-looking statements and identifying certain risk factors affecting the company (often captioned "Forward-Looking Statements") is usually included in the prospectus or relevant periodic report preceding or immediately following the risk factors section. This section should be carefully reviewed to ensure the most significant risks appear first (same as the risk factors section) and that the risks are current and specific.

In the years following Time Warner, courts have sought to clarify the reach of the duty to update. While the courts have not arrived at an unequivocal standard for determining when the duty to update exists, many courts have embraced the broad conclusion that the duty to update is triggered when the statement in question is clear, factual and forward-looking, such that some continuing representation remains "alive" in the mind of investors when circumstances change.

For example, in *In re Burlington Coat Factory Securities Litigation*, the Third Circuit Court of Appeals considered the issue of whether a company had a duty to update specific earnings projections (*114 F.3d 1410 (3d Cir. 1997)*) (*Burlington Coat*). In this case, the Third Circuit:

- Asserted that the duty to update is only triggered if the projections contained a representation that remained "alive" in the minds of investors as a continuing representation.
- Found no duty to update specific earnings forecasts in Burlington Coat.

- Indicated that a reasonable investor would not interpret the specific earnings projections as continuing representations in light of the current regulatory structure of periodic disclosure.
- Indicated that an accurate report of past success does not contain the implicit representation that a trend will continue.

In *In re International Business Machines Corporation Securities Litigation*, the Second Circuit reached a similar conclusion (*163 F.3d 102 (2d Cir. 1998)*). The Second Circuit considered the plaintiff's claim that IBM had a duty to update a previous statement that its dividend was secure when its position on dividends materially changed. Understanding the duty to update as applicable to statements that remain "alive" in the minds of investors as continuing representations of the company, the Second Circuit rejected the plaintiff's claim and explained that there was no duty to update a dividend statement that was a vague statement of opinion without "definitive positive projections." In addition, in *In re Sanofi-Aventis Securities Litigation*, the court held that a company did not have a duty to update statements about the safety of its product when those statements concerned only currently available safety information and were not forward-looking (*No. 07-cv-10279-GBD (S.D.N.Y. Mar. 30, 2011)*). These decisions suggest that for a duty to update to exist there must be some specific and material representation regarding a future event that, without updating, would mislead investors.

In *McCarthy v. C-COR Electronics, Inc.*, the US District Court for the Eastern District of Pennsylvania suggested certain elements to consider in determining whether the duty to update exists (*909 F. Supp. 970 (E.D. Pa. 1995)*). For example, predictions of success in the future were believed to be less reliable and difficult, which the Court weighed against the application of a duty to update. In contrast, substantially specific predictions was a factor weighing in favor of a duty to update.

Although many courts have focused their analysis on whether the statement in question contains continuing representations, some courts have taken the analysis in a different direction. For example, in April 2010, the Third Circuit explained in *United States v. Schiff* that the duty to update was a narrow duty because of its potentially burdensome consequences (*Nos. 09-1903, 08-1909 (3d Cir. Apr. 7, 2010)*). In refusing to hold a company liable for its failure to update information relating to sales volumes, the Third Circuit suggested that the duty to update was only plausible in cases where the initial statement concerned a fundamental change in the company, such as a merger or liquidation, and when later developments produced a drastic change in the validity of the initial statement.

A month before in March 2010, the Second Circuit issued *Illinois State Board of Investment v. Authentidate Holding Corp., No. 09-1751-cv. (2d Cir. Mar. 12, 2010)* (*Authentidate*). This case involved whether a company had a duty to update statements concerning imminent amendments to certain key agreements when it became clear that there would be no amendments. Although the Second Circuit acknowledged that a previous statement has to be forward-looking and contain continuous factual representations to trigger the duty to update, it also asserted that updating was not required where a statement is accompanied by appropriate cautionary language. Liability did not attach to the press release at issue in *Authentidate* because the press release contained a statement that there was "no guarantee" that an agreement would be reached.

However, this does not mean that boilerplate cautionary language shields a company from liability. The Second Circuit emphasized in *Authentidate* that non-specific cautionary language does not adequately alert investors to risks and accordingly cannot be relied on to negate liability. Specifically, the Second Circuit noted that the boilerplate warning recited at the beginning of a conference call stating that forward-looking statements were "subject to certain risk and uncertainties" did not put investors on notice of the particular risk at issue.

While other courts struggle to define the boundaries of the duty to update, the Seventh Circuit Court of Appeals has stood firm in rejecting the existence of a duty to update. In *Stransky v. Cummings Engine Co.*, the Seventh Circuit concluded that Rule 10b-5 under the Securities Exchange Act of 1934 does not contemplate a duty to update since such duty comes after the original statement in question and the rule restricts liabilities to "circumstances under which they were made" (*51 F.3d 1329 (7th Cir. 1995)*) It further suggested that the securities laws approach is not backward looking, just as a statement true when made does not become fraudulent because things unexpected go wrong, so a statement materially false when made does not become acceptable because it happens to come true.

In *Gallagher v. Abbott Laboratories* the Seventh Circuit again refused to acknowledge a duty to update (*269 F.3d 806 (7th Cir. 2001)*). In this case, the Seventh Circuit rationalized that US securities regulation is premised on a periodic disclosure system which, unlike a continuous disclosure system, does not require a duty to update.

BEST PRACTICES FOR A COMPANY DETERMINING WHETHER TO UPDATE PREVIOUSLY DISCLOSED INFORMATION

In light of the uncertainties surrounding the duty to update, companies should be mindful of the general principles and should carefully consider updating any statement that is likely to be read as factual, material and forward-looking with continuing representations. In addition, it is advisable for companies to include specific cautionary language with its forward-looking statements, to protect the company and its officers from claims that the company or its officers are making continuing representations giving rise to a duty to update.

This can be accomplished by putting cautionary language in the body of a release or disclosure document, not merely including boilerplate language at the beginning or end of the disclosed information. However, this can be more challenging when officers are making disclosures orally. Therefore, to avoid creating a duty to update, counsel should remind officers that when talking about future assumptions the statements should be made in a manner that alerts the listener that the statements are expectations that may change at any time.

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