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Chapter 89

Corporate Litigation Reporting Obligations

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§ 89:1 Scope note
§ 89:2 Reporting to the SEC
§ 89:3 —Annual reporting
§ 89:4 — —Item 103, legal proceedings
§ 89:5 — —Item 303, MD&A
§ 89:6 — —Item 105, risk factors
§ 89:7 — —Accrual for loss contingencies
§ 89:8 — —Form 20-F, foreign issuers
§ 89:9 —Quarterly SEC reporting
§ 89:10 —Extraordinary SEC reporting on Forms 8-K and 6-K
§ 89:11 Reporting to private parties
§ 89:12 —Notice of claim or changes in circumstances required to be made to liability insurers
§ 89:13 —Disclosure to auditors
§ 89:14 — —Audit response letters
§ 89:15 Regulated industry reporting obligations
§ 89:16 —Broker-dealer reports to FINRA
§ 89:17 —Investment advisor reports to SEC
§ 89:18 Accounting firm reporting obligations
§ 89:19 Other special reporting obligations
§ 89:20 —Foreign regulators
§ 89:21 —Government entity clients
§ 89:22 Sources of exposure
§ 89:23 —Regulatory exposure
§ 89:24 —Private litigation exposure
§ 89:25 — —Use of disclosures by existing plaintiffs
§ 89:26 — —New civil suits arising out of disclosures
§ 89:27 — —Protecting privilege when making disclosures
§ 89:28 Safeguards around litigation disclosures

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§ 89:29 —Legal compliance program
§ 89:30 —Internal control over financial reporting
§ 89:31 Forms—Sample draft response to auditor's request for information
§ 89:32 —Sample Regulation S-K and financial statement disclosures
§ 89:33 —PCAOB Form 3
§ 89:34 —FINRA Form U4
§ 89:35 —FINRA Form U5

§ 89:1 Scope note

For public companies, litigation is often an unfortunate cost of doing business. In addition to creating exposure for the public company, a pending lawsuit or enforcement proceeding frequently triggers reporting and disclosure obligations. Most notably, SEC registrants are subject to a series of disclosure requirements that may call for pending litigation to be disclosed and/or accounted for in the company's financial statements[1] on a periodic[2] or interim[3] basis. Moreover, many companies operate in regulated industries whose licensing boards, administrative agencies, or self-regulatory bodies[4] impose their own separate reporting obligations. Disclosures required by insurers,[5] independent auditors,[6] foreign regulators,[7] and even certain clients[8] also call for companies to provide information on potential or actual litigation exposure. Failure to carefully comply with these reporting obligations can create separate and independent exposure[9] for compa-

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[Section 89:1]

[1]See §§ 89:2 to 89:10.

[2]See §§ 89:3 to 89:9.

[3]See § 89:10.

[4]See §§ 89:15 to 89:16.

[5]See §§ 89:11 to 89:12.

[6]See §§ 89:13 to 89:14.

[7]See § 89:20.

[8]See § 89:21.

[9]See §§ 89:22 to 89:27.

nies involved in litigation[10] or threaten companies' ability to operate in their regulated industries.[11]

This chapter addresses corporate litigation reporting obligations, the exposures they create, and best practices for avoiding exposure. It provides guidance on what reporting considerations companies must make, including assessments regarding the likelihood and amount of potential liability and costs associated with litigation,[12] when they sue or are sued and what problems can arise from inadequate, incomplete, or misleading disclosures. And it offers suggestions for how companies can implement a framework for evaluating and complying with their litigation disclosure obligations[13] while protecting important confidential and privileged information.[14]

This chapter represents the views of the authors only, and does not necessarily represent the views or professional advice of Orrick, Herrington & Sutcliffe LLP, KPMG LLP, or their respective clients. It is for general reference purposes only, and does not constitute legal or accounting advice. References to corporate filings and court decisions are based entirely on publicly available information.

§ 89:2 Reporting to the SEC

For many companies, the most important litigation disclosure obligations arise in connection with reports filed with the United States Securities and Exchange Commission ("SEC").[1] Companies whose stock is traded on public exchanges and registered entities such as broker-dealers[2] and investment advisers[3] must file periodic reports on both an annual[4] and quarterly[5] basis. In certain instances, issuers and registrants must also report intervening material events when they occur between reporting

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[10]See §§ 89:24 to 89:27.

[11]See § 89:23.

[12]See § 89:7.

[13]See §§ 89:28 to 89:30.

[14]See § 89:23.

[Section 89:2]

[1]See, generally, Chapter 88, "Securities" (§§ 88:1 et seq.); Chapter 92, "Regulatory Litigation with the SEC" (§§ 92:1 et seq.).

[2]See § 89:16 for discussion of broker-dealers.

[3]See § 89:17 for discussion of investment advisers.

[4]See §§ 89:3 to 89:8.

[5]See § 89:9.

periods.[6] The rules governing the various SEC filings and their contents are designed to ensure the provision of transparent and understandable information to investors, analysts, regulators, and the public at large. A company has a duty to disclose all material information required by the disclosure rules that is reasonably likely to have a material effect on the company's financial conditions or results of operations.[7] There is disagreement among circuits about whether this duty to ensure accurate public information persists with respect to prior disclosures. There is no duty to update expressly codified in the commonly applied federal securities laws, and courts' differing approaches to this silence have made the issue one of the most convoluted areas of securities litigation.[8] The First,[9] Second,[10] Third,[11] Fifth,[12] Ninth,[13] and Eleventh[14] Circuits have expressed recognition of a duty to update, the contours of which are inconsistent and vary by circuit, while the Seventh Circuit has held that no such duty to update exists.[15] In the interest of decreasing risk, a company may wish to correct or update all material facts in a past disclosure that are

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[6]See § 89:10.

[7]See Basic Inc. v. Levinson, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988); see, e.g., 17 C.F.R. § 229.303 (objective of Section 303 disclosure is to "provide material information relevant to an assessment of the financial condition and results of operations of the registrant . . ."); 17 C.F.R. § 229.103 ("Describe briefly any material pending legal proceedings . . ."); Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 101, Fed. Sec. L. Rep. (CCH) P 98340 (2d Cir. 2015), for additional opinion, see, 598 Fed. Appx. 25, Fed. Sec. L. Rep. (CCH) P 98341 (2d Cir. 2015).

[8]Sarah Pyun, The Tensions Between the SEC's COVID-19 Disclosure Guidance and the Muddled Duty to Update, Colum. Bus. Law Rev. (Nov. 12, 2020), https://journals.library.columbia.edu/index.php/CBLR/announcement/view/363.

[9]Backman v. Polaroid Corp., 910 F.2d 10, 16-17, Fed. Sec. L. Rep. (CCH) P 95389 (1st Cir. 1990).

[10]In re Int'l Bus. Machs. Corp. Sec. Litig., 163 F.3d 102, 110 (2d Cir. 1998).

[11]In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1432, Fed. Sec. L. Rep. (CCH) P 99485, 38 Fed. R. Serv. 3d 557 (3d Cir. 1997).

[12]Rubinstein v. Collins, 20 F.3d 160, 170 n.41, Fed. Sec. L. Rep. (CCH) P 98195 (5th Cir. 1994).

[13]Khoja v. Orexigen Therapeutics, Inc., 899 F.3d 988, 1015, Fed. Sec. L. Rep. (CCH) P 100239 (9th Cir. 2018), cert. denied, 139 S. Ct. 2615, 204 L. Ed. 2d 264 (2019) and subsequent determination, 805 Fed. Appx. 525 (9th Cir. 2020).

[14]Finnerty v. Stiefel Laboratories, Inc., 756 F.3d 1310, 1316–17, 58 Employee Benefits Cas. (BNA) 2641, Fed. Sec. L. Rep. (CCH) P 98010 (11th Cir. 2014).

[15]Higginbotham v. Baxter Intern., Inc., 495 F.3d 753, 760, Fed. Sec. L. Rep. (CCH) P 94479 (7th Cir. 2007).

necessary to make that disclosure not misleading.[16]

The Form 10-K annual report[17] and Form 10-Q quarterly report[18] are among the most comprehensive disclosures companies make.[19] Both include detailed financial statements setting forth the company's financial position for the relevant period, explanatory notes regarding those financial statements, as well as narrative disclosures describing the current state of the company's business and material uncertainties, risks, threats, or trends—both internal and external—that may impact the company's future.[20] The 10-K and 10-Q include dedicated sections for disclosure of ongoing legal proceedings. Risks or uncertainties related to those proceedings may need to be disclosed in other portions of the Forms as well, depending on the nature of the proceedings and their potential impact on the company.[21] Each form has a dedicated set of rules describing the kind of information that must be included.[22]

Companies should exercise caution when drafting disclosures regarding pending litigation for inclusion in SEC filings. Although management may take an optimistic view of the likely results of pending litigation against the company, disclosures of the risks associated with litigation—the potential future financial obligations, risk to company reputation, or potential impact on customer and business relationships—need to provide users of the annual filings with sufficient information to understand the potential ef-

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[16]In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1431, Fed. Sec. L. Rep. (CCH) P 99485, 38 Fed. R. Serv. 3d 557 (3d Cir. 1997) (finding that the duty to correct applies "if a disclosure is in fact misleading when made, and the speaker thereafter learns of this") (citing Backman v. Polaroid Corp., 910 F.2d 10, 16–17, Fed. Sec. L. Rep. (CCH) P 95389 (1st Cir. 1990); Starkman v. Marathon Oil Co., 772 F.2d 231, 238, Fed. Sec. L. Rep. (CCH) P 92290 (6th Cir. 1985)).

[17]See § 89:3.

[18]See § 89:9.

[19]U.S. Sec. & Exch. Comm'n, How to Read a 10-K/10-Q, https://www.sec.gov/fast-answers/answersreada10khtm.html (According to the SEC, "the 10-K and 10-Q offer a detailed picture of a company's business, the risks it faces, and the operating and financial results for the fiscal year or quarter, as applicable.").

[20]See generally U.S. Sec. & Exch. Comm'n, Form 10-K, General Instructions, https://www.sec.gov/files/form10-k.pdf.

[21]U.S. Sec. & Exch. Comm'n, Form 10-K, Part I, Item 3 at 8, https://www.sec.gov/files/form10-k.pdf; U.S. Sec. & Exch. Comm'n, Form 10-Q, Part II, Item 1 at 6, https://www.sec.gov/files/form10-q.pdf.

[22]U.S. Sec. & Exch. Comm'n, Form 10-Q at 5–7, https://www.sec.gov/files/form10-q.pdf; U.S. Sec. & Exch. Comm'n, Form 10-K at 8–12, https://www.sec.gov/files/form10-k.pdf.

fects of litigation.[23]

The Private Securities Litigation Reform Act of 1995 ("PSLRA") created a safe harbor for forward-looking statements.[24] The safe harbor applies to statements identified as forward-looking that are "accompanied by meaningful cautionary statements identifying important factors that could differ materially from those in the forward-looking statement," or statements that are immaterial.[25] Although companies generally do not opine on potential developments in litigation, if they do, they should identify those statements as forward-looking and include factors that could impact those future developments. However, companies should be careful not to characterize an event that has already materialized as a future risk, as courts have found such statements misleading.[26]

When lawsuits are first filed or government investigations first commenced, companies' public disclosures (if necessary) may be relatively sparse, identifying the matter, where it is pending, and a brief description of its nature.[27] As material developments occur in the litigation, the disclosure should be updated to reflect those developments.[28] Sections 3 to 10 of this chapter discuss in more detail the specific forms on which disclosures about litigation and/or government enforcement actions are to be made, the rules governing disclosures in those forms, and how companies should assess whether disclosure is necessary and, if so, what should be disclosed.

Some issuers not currently facing litigation that must be disclosed will include warnings in their public filings about the risk that litigation may be on the horizon. Those statements, often identified as forward-looking statements and/or statements of opinion, are difficult for plaintiffs or regulators to target as

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[23]See § 89:7 generally for a discussion of loss contingency accounting.

[24]15 U.S.C.A. § 78u-5(c)(1)(A); see Chapter 88, "Securities" (§§ 88:1 et seq.) for discussion of the PSLRA and forward-looking statements.

[25]15 U.S.C.A. § 78u-5(c)(1)(A).

[26]Smith v. NetApp, Inc., 2021 WL 1233354, at *7 (N.D. Cal. 2021); Note, however, that disclosure of the occurrence of event that creates a future risk may require disclosure within the notes to the financial statements.

[27]In re Lions Gate Entertainment Corp. Securities Litigation, 165 F. Supp. 3d 1, 15, Fed. Sec. L. Rep. (CCH) P 99003 (S.D. N.Y. 2016) (holding that a brief description that "[f]rom time to time, the Company is involved in certain claims and legal proceedings" was sufficient to accurately describe currently pending claims or legal proceedings).

[28]In re Lions Gate Entertainment Corp. Securities Litigation, 165 F. Supp. 3d 1, 21, Fed. Sec. L. Rep. (CCH) P 99003 (S.D. N.Y. 2016) (holding that, although an updated risk disclosure is required when any material change occurs in an ongoing investigation, the investigation at hand did not bear on any of the relevant risk factors, such as an increase in the penalty).

misleading or containing a material omission. In at least one case, a plaintiff alleged that a company's generic risk disclosure that, from "time to time, the Company is involved in certain claims and legal proceedings" was materially misleading because it did not disclose that the company was subject to an ongoing government investigation. That allegation was found insufficient to state a claim because investigations are not "pending legal proceedings" for the purpose of the securities laws.[29]

◆ **Practice Tip:** A company may have a duty to update prior disclosures when the company's knowledge or expectations about an issue material to the disclosure have changed. The duty to update is most likely to exist when a clear, factual, forward-looking statement[30] becomes misleading in light of later events. Whenever there have been material developments in litigation or a company's assessment of the litigation risks and exposures, companies should consult their prior disclosures to confirm whether they remain accurate in light of those material developments. If not, the company should update its disclosure accordingly.

§ 89:3 Reporting to the SEC—Annual reporting

Public companies' annual reports on Form 10-K[1] provide the most detailed disclosures of the companies' financial conditions, operations, and material risks.[2] Risks regarding pending legal proceedings and related loss contingencies are a sensitive area of disclosure and are often a focus of government regulators, shareholders, potential plaintiffs, and business partners.[3] In addition to disclosures required within the financial statements, public companies must provide easily understandable, qualitative explanations of these risks. Regulation S-K[4] details reporting requirements for various SEC filings used by public companies.

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[29]City of Westland Police and Fire Retirement System v. MetLife, Inc., 928 F. Supp. 2d 705, 718, Fed. Sec. L. Rep. (CCH) P 97307 (S.D. N.Y. 2013).

[30]See Chapter 88, "Securities" (§§ 88:1 et seq.) for discussion of the PSLRA and forward-looking statements.

[Section 89:3]

[1]Chapter 88, "Securities" (§§ 88:1 et seq.).

[2]U.S. Sec. & Exch. Comm'n, How to Read a 10-K/10-Q, https://www.sec.gov/fast-answers/answersreada10khtm.html.

[3]Alan J. Wilson, Stanley Keller, Randall D. McClanahan, Noël J. Para, James J. Rosenhauer, & Thomas W. White, The ABA Statement on Audit Responses: A Framework That Has Stood the Test of Time, 75 Bus. Law. 2085, 2095 (2020) (noting that "the SEC has continued to focus on the timely accrual and disclosure of loss contingencies in accordance with the requirements of ASC 450-20 . . .").

[4]17 C.F.R. §§ 229 et seq.

Regulation S-K describes the contents required for each report companies must make under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act").[5]

Public companies are required to disclose information about litigation in several areas of their annual reports. Item 103 of Regulation S-K requires disclosure about certain pending legal proceedings in a dedicated section of the report,[6] while Item 105[7] discusses Risk Factors regarding investment in the entity,[8] and Item 303[9] of Regulation S-K requires that Management's Discussion and Analysis cover certain "trends and uncertainties" as well as items that may affect its liquidity, which could include pending litigation.[10] In addition, companies may need to take an accrual related to pending litigation, or include disclosures about such litigation, in the financial statements or their accompanying notes.[11] Whether, where, and how litigation must be disclosed depends on the rules governing each portion of the Form 10-K and whether the litigation—or developments in the litigation since the last periodic report—have had, or are reasonably likely to have, a material impact on the company's reported operations. Companies and practitioners must thus be sensitive to the distinctions between the disclosures required in the various sec-

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[5]Periodic and continuous disclosure and reporting, 9A Ariz. Prac., Business Law Deskbook § 27C:7 (2020–2021 ed.) ("Regulation S-K is divided into ten subparts: Subpart 1 enumerates the SEC's procedures for forward-looking statements and security ratings; Subpart 100 enumerates disclosures regarding the issuer's business; Subpart 200 identifies disclosure requirements for the company's securities; Subpart 300 sets forth guidance for disclosing information regarding the company's financial information; Subpart 400 addresses management and certain security holders; Subpart 500 sets forth disclosure requirements for the company's registration statement and prospectus; Subpart 600 enumerates required exhibits for certain filings; Subpart 700 discusses "miscellaneous" disclosures regarding unregistered securities and indemnification of directors and officers; Subpart 800 addresses the industries guide for the 1933 Act and 1934 Act filings; Subpart 900 sets forth disclosures for roll-up transactions; and Subpart 1000 (Regulation M-A), addresses to mergers and acquisitions.").

[6]17 C.F.R. § 229.103(a) provides that companies shall "[d]escribe briefly any material pending legal proceedings . . ." See § 89:4.

[7]17 C.F.R. § 229.105(a) provides that companies shall provide "a discussion of the material factors that make an investment in the registrant or offering speculative or risky."

[8]See § 89:6.

[9]17 C.F.R. § 229.303(a) provides that companies shall furnish a "discussion and analysis" to "provide material information relevant to an assessment of the financial condition and results of operations of the registrant including an evaluation of the amounts and certainty of cash flows from operations and from outside sources."

[10]See § 89:5.

[11]See § 89:7.

tions of the Form 10-K. The main areas that may contain litigation-related disclosures are discussed in Sections 4 through 8 of this chapter.[12]

§ 89:4 Reporting to the SEC—Annual reporting—Item 103, legal proceedings

Item 103 is the section of Form 10-K[1] most specifically tailored to disclosure of legal proceedings.[2] Item 103 generally calls for companies to disclose material legal proceedings, other than ordinary routine litigation incidental to the business, to which the company or its subsidiaries are a party.[3] Item 103 also expressly exempts certain kinds of proceedings from disclosure. Generally, a company has no obligation to disclose proceedings involving negligence or claims that normally result from operations, unless the claims depart from the typical kind in a material way.[4] For example, given the nature of its business, a publicly traded healthcare company likely would not be required to disclose every medical malpractice claim against a physician employed by that company, because such claims are normal consequences of a healthcare business.

In addition, actions seeking damages that, exclusive of interest and costs, do not exceed 10 percent of the current consolidated assets of the company and its subsidiaries need not be disclosed. In assessing whether an action exceeds the 10 percent threshold, separate proceedings that present in large degree the same legal or factual issues should be considered on an aggregate basis. This issue arises most frequently in the mass tort context[5] where a corporate defendant may successfully defeat certification of a class action that would exceed the 10 percent threshold but nevertheless confront hundreds or thousands of actions by individual plaintiffs based on the same factual predicates and asserting largely the same claims. Even though the exposure from each individual action is well within the 10 percent threshold, the issuer nevertheless must disclose the collective exposure from the related actions. Examples of such disclosures can be found in public filings by Merck, which reports on approximately 3,520 claims pending in either federal or state court involving its product Fosamax. Merck says in its Product liability Litigation disclosures

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[12]Sample litigation-related disclosures are included at § 89:32.

[Section 89:4]

[1]See § 89:3.

[2]Sample litigation-related disclosures are included at § 89:32.

[3]17 C.F.R. § 229.103.

[4]17 C.F.R. § 229.103(b)(1).

[5]See generally Chapter 128, "Mass Torts" (§§ 128:1 et seq.).

that "Plaintiffs in the vast majority of these cases generally allege that they sustained femur fractures and/or other bone injuries (Femur Fractures) in association with the use of Fosamax,"[6] and by Intel Corporation, which reports that it faces multiple consumer class action lawsuits relating to certain security vulnerabilities generally claiming to have been "harmed by Intel's actions and/or omissions in connection with the security vulnerabilities and assert a variety of common law and statutory claims seeking monetary damages and equitable relief. "[7] Disclosure of large volumes of individual claims has also arisen recently for companies that face mass arbitration claims[8] after their arbitration agreements and class action waivers prevent class actions.[9]

Item 103 also makes disclosure of certain kinds of proceedings mandatory, notwithstanding exemptions. First, "any material bankruptcy, receivership, or similar proceeding" with respect to the company or any of its significant subsidiaries must be disclosed.[10] Second, companies must disclose litigation in which certain related persons are adverse to the company.[11] Third, companies must disclose certain litigation arising under environmental protection laws that meet the 10% materiality threshold or carry the potential of monetary sanctions by a governmental authority that is a party to the proceeding, unless the potential monetary sanctions are reasonably believed to be a relatively de

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[6]Merck & Co., Inc., Annual Report (Form 10-K) (Feb. 25, 2021), at 111, https://www.sec.gov/ix?doc=/Archives/edgar/data/0000310158/000031015821000004/mrk-20201231.htm#iab6577be4c3840fd8181bdedf457fba5_67. Merck's Item 103 refers investors to its product liability litigation disclosures in Note 10: "Contingencies and Environmental Liabilities" disclosures in the financial statements.

[7]Intel Corp., Annual Report (Form 10-K) (Jan. 22, 2021), at 107, https://www.sec.gov/ix?doc=/Archives/edgar/data/0000050863/000005086321000010/intc-20201226.htm#i63d840d8a6434f9ea0b4b4bad0e8d3d6_22. Intel's Item 103 is cross-referenced to its litigation disclosures in Note 19: "Commitments and Contingencies" disclosure in the financial statements.

[8]See Chapter 61, "Arbitration" (§§ 61:1 et seq.) for discussion of class action waivers in arbitration agreements.

[9]See, e.g., Comcast Corp., 2015 Annual Report (Form 10-K) (Feb. 5, 2016), at 20, https://www.sec.gov/Archives/edgar/data/902739/000119312516452423/d49239d10k.htm; see Chapter 25, "Class Actions" (§§ 25:1 et seq.) for additional discussion of arbitration and class action waivers.

[10]17 C.F.R. § 229.103(c)(1).

[11]Item 103 disclosures shall include "[a]ny material proceedings to which any director, officer or affiliate of the registrant, any owner of record or beneficially of more than five percent of any class of voting securities of the registrant, or any associate of any such director, officer, affiliate of the registrant, or security holder is a party adverse to the registrant or any of its subsidiaries, or has a material interest adverse to the registrant or any of its subsidiaries." 17 C.F.R. § 229.103(c)(2).

minimis amount.[12]

As a general matter, Item 103 does not require companies to disclose investigations that have not yet resulted in legal proceedings. For instance, a Wells Notice issued by the SEC does not trigger a duty to disclose under Item 103, nor does notice from a state attorney general that a company is under investigation.[13] However, if there are proceedings "known to be contemplated by government authorities," Item 103 calls for such proceedings to be disclosed. A proceeding is not "known to be contemplated," however, simply because an investigation is underway.[14]

When a matter is required to be disclosed, Item 103 also specifies certain information that must be included with the disclosure. The disclosure must contain the name of the court or agency in which proceedings are pending, the date the proceeding was commenced, the principal parties to the proceedings, a brief description of the factual basis alleged to underlie the proceedings, and the relief sought.

The SEC's 2020 update to Regulation S-K disclosure rules[15] allows issuers to cross-reference between sections and include hyperlinks to legal proceedings disclosed elsewhere in the document, such as in the Management's Discussion & Analysis ("MD&A"),[16] in order to reduce repetition.[17] Cross-references and hyperlinks allow the user of annual reports to more easily

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[12]17 C.F.R. § 229.103(b)(2); see Chapter 177, "Environmental Claims" (§§ 177:1 et seq.).

[13]Richman v. Goldman Sachs Group, Inc., 868 F. Supp. 2d 261, 272, Fed. Sec. L. Rep. (CCH) P 96926 (S.D. N.Y. 2012); In re Lions Gate Entertainment Corp. Securities Litigation, 165 F. Supp. 3d 1, 19, Fed. Sec. L. Rep. (CCH) P 99003 (S.D. N.Y. 2016) (Wells Notice is not the beginning of a pending legal proceeding because the notice only informs that Enforcement Division staff are "considering recommending that the SEC file an action, but the SEC itself has not yet determined whether or not to bring a case."); City of Westland Police and Fire Retirement System v. MetLife, Inc., 928 F. Supp. 2d 705, 718, Fed. Sec. L. Rep. (CCH) P 97307 (S.D. N.Y. 2013) (ASC 450 does not require disclosure under Item 103 because state investigations were not pending or threatened litigation.).

[14]Case law speaks to what is insufficient to show that an action is "known to be contemplated" rather than when a legal proceeding is known to be contemplated. See, e.g. In re Lions Gate Entertainment Corp. Securities Litigation, 165 F. Supp. 3d 1, 19, Fed. Sec. L. Rep. (CCH) P 99003 (S.D. N.Y. 2016) (A legal proceeding is not "known to be contemplated" prior to the commencement of the SEC's legal proceeding.); Plymouth County Retirement System v. Patterson Companies, Inc., 2019 WL 3336119, at *14 (D. Minn. 2019) (A legal proceeding is not "known to be contemplated" until a complaint is filed by Federal Trade Commission.).

[15]See § 89:3 for discussion of Regulation S-K disclosures.

[16]See § 89:5.

navigate an entity's disclosures and decreases potentially overlapping and duplicative disclosures. Thus, under this update, companies will not be required to repeat litigation disclosures in multiple sections of a 10-K, but instead may place that discussion in one section and link to that discussion in other items that otherwise would require discussion of pending litigation. NextGen Healthcare, Inc.'s 10-K is illustrative. Its most detailed discussion of ongoing litigation is in the notes to the financial statements, where it summarizes the current state of litigation brought by a former director and significant shareholder of the company. NextGen also discusses risks associated with potential False Claims Act exposure in the Risk Factors section of its 10-K. In its Item 103 Legal Proceedings, rather than repeat those disclosures, NextGen refers readers to "the discussion of regulatory and litigation risks within 'Item 1A. Risk Factors' and to Note 16, 'Commitments, Guarantees and Contingencies' of our notes to consolidated financial statements included elsewhere in this Report for a discussion of current legal proceedings."[18]

Q&A

Q: ***When facing numerous separate proceedings raising similar allegations, what factors and considerations weigh into the decision regarding whether to aggregate separate proceedings for purposes of Item 103 disclosures?***

A: The predominant considerations in whether the claims must be aggregated are the nature of the claims, the similarity between the allegations, and the potential for consolidation of actions or potential class certification. If aggregation is appropriate, disclosure will largely depend on whether the total aggregate damages across all cases exceed ten percent of current consolidated assets. Outside counsel should be consulted and the company should consider whether additional analysis regarding potential liability of individual cases could inform disclosure considerations. The company and outside counsel should implement tracking of the number of cases, the procedural posture, and claimed compensatory and punitive damages.

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[17]Modernization of Regulation S-K Items 101, 103, and 105, Final Rule, SEC Release No. 33-10825 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10825.pdf.

[18]NextGen Healthcare, Inc., 2020 Annual Report (Form 10-K) (May 27, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/708818/000156459021030107/nxgn-10k_20210331.htm.

§ 89:5 Reporting to the SEC—Annual reporting—Item 303, MD&A

Item 303, commonly referred to as Management's Discussion and Analysis[1] ("MD&A"), includes management's commentary on the state of the business, consideration of events and trends affecting the business, description of risks facing the company, and other material information relevant to an assessment of the financial condition and results of operations of the registration.[2] While not specifically focused on litigation, a company's legal proceedings are often sources of uncertainty or risk and, as such, may need to be disclosed or referred to in the MD&A.

Unlike Item 103 that specifically defines the types of proceedings that must be disclosed and information about those proceedings that must be provided,[3] Item 303 requires disclosure of any material information relevant to an assessment of the financial condition and results of operations of the registrant.[4] However, because Item 303 requires disclosure of information pertaining to the financial condition and results of operations of an entity, it is more likely that Item 303 disclosures—or lack thereof—will create litigation exposure, rather than require disclosure of existing litigation.

Item 303 disclosures can be used to allege that the issuer failed to disclose "known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[5] Although plaintiffs may use MD&A disclosures to substantiate securities claims against a company, an issuer is not expected to be able to predict the future. "Item 303 requires the registrant to disclose only those trends, events, or uncertainties that it ***actually knows*** of when it files the relevant report with the SEC."[6] Allegations that the issuer "should have known of the existing trend, event, or uncertainty" will not be sufficient to sup-

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[Section 89:5]

[1]17 C.F.R. § 229.303.

[2]Sample litigation-related disclosures are included at § 89:32.

[3]See § 89:4.

[4]17 C.F.R. § 229.303(a).

[5]17 C.F.R. § 229.303(b)(2)(ii).

[6]Indiana Public Retirement System v. SAIC, Inc., 818 F.3d 85, 95, Fed. Sec. L. Rep. (CCH) P 99048 (2d Cir. 2016) (emphasis added); see also Panther Partners, Inc. v. Ikanos Communications, Inc., 538 F. Supp. 2d 662, 673 (S.D. N.Y. 2008), judgment aff'd, 347 Fed. Appx. 617 (2d Cir. 2009) ("what must be disclosed . . . is a 'known trend' or 'uncertainty' that the offering party expects will have a 'material' impact on the business.").

port a claim.[7]

The question whether an omission in violation of Item 303 is, by itself, sufficient to breach a company's duty to disclose for purposes of a federal securities fraud claim[8] has split various courts. The Second Circuit has that Item 303 creates an actionable duty to disclose such that violation of Item 303 will support a cause of action so long as the other elements of a claim, and in particular the materiality requirements of *Basic v. Levinson*, are met.[9] The Ninth Circuit, on the other hand, has held that violation of Item 303 is not automatically actionable because "[m]anagement's duty to disclose under Item 303 is much broader than what is required under the standard" for a fraud claim under Rule 10b-5.[10] Even within the Ninth Circuit, however, material facts omitted from the MD&A could give rise to a securities fraud claim if plaintiffs are able to plead facts sufficient to show a duty to disclose independent of Item 303, as well as fact sufficient to support the other elements of the claim.

◆ **Practice Tip:** Under Item 303 of Regulation S-K, a "known trend" or "uncertainty" must be presently known, and it must be reasonably likely that it would have material effects on the registrant's financial conditions or results of operations. In considering whether disclosure is required, the company should examine not only whether the trend or uncertainty is actually and presently known, but whether it would be material even if

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[7]Indiana Public Retirement System v. SAIC, Inc., 818 F.3d 85, 95, Fed. Sec. L. Rep. (CCH) P 99048 (2d Cir. 2016).

[8]See generally Chapter 88, "Securities" (§§ 88:1 et seq.).

[9]Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103, Fed. Sec. L. Rep. (CCH) P 98340 (2d Cir. 2015), for additional opinion, see, 598 Fed. Appx. 25, Fed. Sec. L. Rep. (CCH) P 98341 (2d Cir. 2015) (citing Basic Inc. v. Levinson, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988); see In re Nielsen Holdings PLC Securities Litigation, 510 F. Supp. 3d 217, Fed. Sec. L. Rep. (CCH) P 101003, 2021 WL 22722, at *5 (S.D. N.Y. 2021) (allegations that management knew about adverse trend affecting the business but did not timely disclose the trend sufficiently show scienter to overcome a motion to dismiss).

[10]In re NVIDIA Corp. Securities Litigation, 768 F.3d 1046, 1054–56, Fed. Sec. L. Rep. (CCH) P 98212 (9th Cir. 2014) ("In sum, we hold that Item 303 does not create a duty to disclose for purposes of section 10(b) or Rule 10b-5. Such a duty to disclose must be separately shown according to the principles set forth by the Supreme Court in Basic and Matrixx Initiatives."). The Third Circuit and Eleventh Circuits follow this same reasoning. Oran v. Stafford, 226 F.3d 275, 288, Fed. Sec. L. Rep. (CCH) P 91205, 55 Fed. R. Evid. Serv. 872 (3d Cir. 2000) ("a violation of SK-303's reporting requirements does not automatically give rise to a material omission under Rule 10b-5"); Carvelli v. Ocwen Financial Corporation, 934 F.3d 1307, 1331, Fed. Sec. L. Rep. (CCH) P 100539 (11th Cir. 2019) ("Item 303 imposes a more sweeping disclosure obligation than Rule 10b-5, such that a violation of the former does not ipso facto indicate a violation of the latter.").

known with certainty. Macro-level events, such as pending global recessions, social, cultural or racial movements, political unrest, or a widespread health pandemic should be considered as "known trends" during the company's 303 analysis.

§ 89:6 Reporting to the SEC—Annual reporting—Item 105, risk factors

Item 105 requires a discussion of material factors that make investment in the company risky. The SEC encourages companies to describe risks that are specific to that company and its business, rather than merely identify generic risks that could apply generically to any company or investment. Item 105 disclosures are included in their own section of the 10-K, entitled "Risk Factors."[1] The SEC recently revised the rules governing the content and organization of the Risk Factors section, requiring the discussion to be "organized logically with relevant headings" and to include subcaptions describing each individual risk. As suggested by the most recent modernization of Regulation S-K disclosures[2] updating the rules in 2020, Risk Factor disclosures are often lengthy and generic, despite the SEC's direction to focus on the "most significant" risks and to avoid boilerplate disclosures.[3]

Unlike Item 103[4] and, to a lesser extent, Item 303,[5] Item 105 provides relatively little specific guidance on how companies identify which risks to include and how those risks are described. Accordingly, companies and their counsel must exercise their discretion in determining when a litigation-related risk is of sufficient significance to merit its own separate discussion in the Risk Factor disclosures. NextGen Healthcare, Inc.'s 2020 10-K Section 105 discussion of regulatory and litigation risks[6] shows an example of when companies may disclose litigation risks in their Risk Factors discussion even if they are not separately discussed elsewhere in the 10-K. NextGen's Risk Factors describe potential risks associated with false or fraudulent claims laws and the company's exposure to treble damages if it is found to have violated those laws, even though NextGen does not disclose

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[Section 89:6]

[1]Sample litigation-related disclosures are included at § 89:32.

[2]See § 89:3 for discussion of Regulation S-K disclosures.

[3]Modernization of Regulation S-K Items 101, 103, and 105, Final Rule, SEC Release No. 33-10825 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10825.pdf.

[4]See § 89:4.

[5]See § 89:5.

[6]See § 89:4.

any specific pending false claims proceeding.[7]

◆ **Practice Tip:** Punitive and treble damages are often difficult to ascertain, but when alleged or available they may substantially outweigh direct damages or compensatory damages claims. The threat of enhanced damages frequently influences settlement considerations, both in terms of whether the company will settle and for how much. In considering how to describe the risks of particular litigation in Risk Factor disclosures, companies should be careful to assess the threat of these enhanced damages and whether they pose a material risk.

Q&A

Q: ***What kind of disclosures must be made regarding potential future claims against the company that relate to our core business operations?***

A: The company's business operations and potential legal liability that could arise in connection with that business should be addressed in Item 105 Risk Factors. Discussion of material factors that make an investment speculative or risky are appropriate disclosures for Item 105. The company should consider whether other factors may warrant further discussion in Item 303 even if no legal proceeding is pending or anticipated. For instance, if the company has previously been involved in litigation related to a certain risk factor, the company should consider disclosing a potential litigation trend that is reasonably likely to impact results of operations or financial conditions in the future.

§ 89:7 Reporting to the SEC—Annual reporting—Accrual for loss contingencies

Analysis of whether loss contingencies[1] need be disclosed or accrued in an entity's financial statements begins at the codified guidance on contingencies and loss recoveries. The Financial Accounting Standards Board is a standard-setting body responsible for establishing and developing Generally Accepted Accounting Principles ("GAAP") that apply to financial statements reported by public and private issuers in the United States. The Accounting Standards Codification ("ASC") is the current single source of

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[7]NextGen Healthcare, Inc., 2020 Annual Report (Form 10-K) (May 27, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/708818/000156459021030107/nxgn-10k_20210331.htm.

[Section 89:7]

[1]Loss contingencies are defined and discussed in detail below.

GAAP. The accounting for possible gains or losses that are contingent on some future occurrence, codified as ASC 450, Contingencies, is derived from Statement of Financial Accounting Standards No. 5, and adds substantially more guidance on contingencies to FAS No. 5, which was issued in 1975. ASC 450-20 is focused on the appropriate accounting for loss contingencies, including litigation risks, within the financials, and the necessary disclosures to reduce the risk that investors could find the balance sheet misleading.[2] Thus, the disclosures required under ASC 450 are distinguishable from disclosures required by Regulation S-K,[3] which appear outside of the financial statements. Disclosure under ASC 450 may be required even when not necessary under Item 103[4] or other[5] Regulation S-K sections.[6] When ASC 450 requires disclosure, companies typically do so in the notes to their financial statements, in particular notes addressing the company's accounting for contingencies.[7]

In recognition of this, the SEC has provided guidance comparing the disclosure obligations of Item 103 with those that ASC 450 requires. In a release,[8] the SEC identified the differences between legal proceeding disclosures required GAAP and those of Section 103 under Regulation S-K,[9] noting that GAAP disclosures are more expansive for every type of litigation matter.[10] The SEC guidance states that GAAP and Regulation S-K disclosures

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[2]Kevin C. Smith, Alison H. Kronstadt, & Tae Sang Yoo, Litigation Contingency Disclosure under ASC 450: A Survey of 2011 SEC Comment Letters, Practical Law Article 3-517-8001 (Feb. 9, 2012).

[3]See §§ 89:4 to 89:6.

[4]See § 89:4.

[5]See §§ 89:5 to 89:6.

[6]Securities and Exchange Commission v. RPM International, Inc., 282 F. Supp. 3d 1, 18–24, Fed. Sec. L. Rep. (CCH) P 99895 (D.D.C. 2017) (The SEC adequately alleged violation of 450 by failing to disclose and accrue for the loss contingency related to a DOJ investigation.).

[7]Jonathan Schiff, Allen Schiff, Hannah Rozen, Accounting for Contingencies: Disclosure of Future Business Risks, 13 Mgmt. Accounting Q., Spring 2012, at 3.

[8]See Disclosure Update and Simplification, Proposed Rule, SEC Release No. 33-10110 (July 13, 2016), https://www.sec.gov/rules/proposed/2016/33-10110.pdf.

[9]17 C.F.R. § 229.103.

[10]See Disclosure Update and Simplification, Proposed Rule, SEC Release No. 33-10110 (July 13, 2016), https://www.sec.gov/rules/proposed/2016/33-10110.pdf. In light of the multiple, and varying, comments in response to the proposed changes, the SEC retained Item 103 disclosures without amendment in order to "further consider the implications of potential changes to these requirements." See Disclosure Update and Simplification, Final Rule, SEC Release No 33-10532, at 92 (Aug. 17, 2018), https://www.sec.gov/rules/final/2018/33-10532.pdf. In 2020, the Simplification and Modernization of Disclosures Under Regula-

regarding legal proceedings should be separated in order to avoid convoluted or generalized consolidated disclosures. Notwithstanding the SEC's guidance, the topic continues to be an area of focus by the SEC staff in reviewing a registrant's periodic filings to confirm that qualitative and quantitative information regarding loss contingencies are sufficiently informative.

GAAP - FAS No. 5/ ASC 450, contingencies

ASC 450 defines a loss contingency as "[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."[11] Uncertainty is inherent in all loss contingencies given that they depend on the potential occurrence of a future event. Resolution of uncertainty in the context of a loss contingency may confirm the loss, the impairment of an asset, or the incurrence of a liability.

ASC 450-20 uses "probable," "reasonably possible," and "remote" to assess the likely occurrence of the future event that would confirm a loss, an impairment of an asset, or the incurrence of a liability. No quantitative metrics are used in the codified definitions of "probable," "reasonably possible," or "remote." Accordingly, entities need to exercise judgement when applying the terms.

ASC 450 indicates that a loss is: (i) ***probable*** when "the future event or events are likely to occur";[12] (ii) ***reasonably possible*** when "the chance of the future event or events occurring is more than remote but less than likely";[13] and (iii) ***remote*** when "the chance of the future event or events occurring is slight."[14]

Whether a loss contingency results in an accrual or disclosure depends on the likelihood of the loss occurring and whether the amount of the loss is reasonably estimable.[15] When a loss contingency is both ***probable*** and ***reasonably estimable***, a loss

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tion S-K made certain changes to Item 103 disclosures, none of which address the overlap or differences between GAAP and Regulation S-K.

[11]A loss contingency is broadly defined: "The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses." FASB ASC glossary "loss contingency," https://asc.fasb.org/glossary&letter=L.

[12]FASB ASC glossary "probable," https://asc.fasb.org/glossary&letter=P.

[13]FASB ASC glossary "reasonably possible," https://asc.fasb.org/glossary&letter=R.

[14]FASB ASC glossary "remote," https://asc.fasb.org/glossary&letter=R.

[15]"An estimated loss from a loss contingency shall be accrued by a charge to income" when "[t]he amount of loss can be reasonably estimated." ASC 450-20-25-2. A loss does not need to be reasonably estimable before it should be disclosed.