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IMPORTANT COURT DECISION ON WHEN TO DISCLOSE AN SEC INVESTIGATION

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For a public company, determining whether and when to disclose a Securities and Exchange Commission (SEC) investigation can be a tough judgment call. There are no bright-line rules, and the legal precedents are sparce. The decision may hinge on many factors. How far has the investigation progressed? What has the SEC said? For example, has it issued a 'Wells notice' indicating a likely enforcement proceeding? And what has the company previously said publicly about the subject now under investigation?

In May 2022, the US Court of Appeals for the Second Circuit, which sits in New York City, provided guidance on this subject in *Noto v. 22nd Century Group, Inc.* (2022). The *Noto* decision highlights circumstances in which courts may disapprove of companies' decisions not to disclose a pending investigation. While it remains to be seen whether the decision will lead to more such disclosures, the decision suggests that courts may more closely scrutinise companies that do not disclose an SEC investigation pertaining to a subject previously discussed by the company.

Noto – the facts

Noto was an appeal from the granting of a motion to dismiss a securities class action complaint alleging that a public company, 22nd Century, had misled investors by engaging in an illegal stock promotion scheme and by failing to disclose an

SEC investigation into the company's financial control weaknesses. The Second Circuit affirmed the dismissal of the claims about the promotion scheme but vacated the dismissal of the claims about failing to disclose the SEC investigation. The court held that these allegations – assumed to be true on a motion to dismiss – stated a material misrepresentation actionable under SEC Rule 10b-5(b).

The complaint alleged that, between 2016 and 2018, 22nd Century had, in its annual and quarterly reports, publicly disclosed material weaknesses in its internal financial controls, but not an SEC investigation into these controls, which allegedly had begun in 2016. Then, in a 2018 quarterly report, 22nd Century reported that it had completed implementing and testing a remediation plan designed to eliminate those weaknesses – essentially the company gave the 'all clear' to investors.

Two articles on the website 'Seeking Alpha', in October 2018 and April 2019, disputed the 'all clear' and alleged that the SEC was investigating 22nd Century's internal controls. The articles quoted the July 2018 denial by the SEC of a Freedom of Information Act request for information about the investigation; the denial had cited the FOIA provision allowing the "withholding of records or information compiled for law enforcement purposes, but only to the extent that production of such law enforcement records or information... could reasonably be expected to interfere with enforcement proceedings". In response, 22nd Century issued two

press releases calling the articles "highly deceptive" and saying 22nd Century "has no knowledge of any enforcement proceeding against [it] by the SEC or any other regulator".

The second press release also said the second article "falsely alleges that [the company] is supposedly under SEC investigation". A close reading of the allegations suggests that the statement about no enforcement proceedings was true. The statement about no investigation was false, if read as referring to 2016, but perhaps was true if read as referred to 2018-19 (the SEC sometimes does not declare an investigation to be at an end or 'formally' close it, but simply stops pursuing it).

The Second Circuit's decision

The Second Circuit vacated the dismissal of the allegations about the SEC investigation, holding that plaintiffs plausibly alleged that 22nd Century's disclosures of the accounting weaknesses were misleading because 22nd Century did not disclose the SEC investigation.

The Second Circuit explained that the company and its officers had a duty to disclose the SEC investigation "in light of the specific statements they made about the company's accounting weaknesses". It cited precedent establishing that, even if a company has no independent duty to disclose information, once it "speaks on an issue or topic, there is a duty to tell the whole truth". Liability under Rule 10b-5 arises for an omission that is material, that is, "when a reasonable investor would attach importance to it when making a decision".

The court focused on 22nd Century's disclosure of material weaknesses in its financial controls, followed by its statement that the issue had been resolved. As the court put it: "Here, the fact of the SEC investigation would directly bear on the reasonable investor's assessment of the severity of the reported accounting weaknesses. Thus, the company had a duty to disclose the SEC investigation into the weaknesses throughout the class period. Because defendants here specifically noted the deficiencies and that they were working on the problem, and then stated that they had solved the issue, 'the failure to disclose [the investigation] would cause a reasonable investor to make an overly optimistic assessment of the risk'." The court also focused on 22nd Century's affirmative denials, which the court said were "misleading in their own right" and constituted evidence of the misstatement's materiality.

Noto's place in case law regarding duty to disclose

What is interesting about the opinion is that 22nd Century's statements may possibly have been literally true. The complaint does not allege that the SEC ever brought an enforcement proceeding. And while the complaint alleges that the SEC began an investigation in 2016, it does not allege that the investigation was active or ongoing by the time 22nd

Century issued its present-tense denial of an SEC investigation in 2019.

It is relatively well-settled law that a company is under a duty to disclose: (i) where an independent statute or regulation requires it; or (ii) to avoid rendering existing statements misleading. There is generally no duty to disclose a government investigation, without more. A duty to disclose legal proceedings that are pending or known to be contemplated by government authorities arises when an investigation "matures to the point where litigation is apparent and substantially certain to occur.

Noto could be read as expanding this line of precedent by suggesting that the existence of a government investigation could trigger a duty to disclose – even if no legal proceeding is pending or threatened by the government – at least where a company has already spoken about the topic that the government is investigating. But it is not clear the opinion goes this far. Nor does the opinion clarify whether – and, if so, when – a failure to disclose an investigation, without more, may give rise to liability.

One wonders how the court would have viewed the case had 22nd Century said, in 2018-19, words to this effect: "We never were the subject of an SEC enforcement proceeding. We were the subject of an SEC investigation in 2016 but so far as we know that investigation has ended." Would that have sufficed? Or did the disclosure of accounting issues mean that 22nd Century also had to disclose the SEC investigation in 2016? The opinion does not say. What the opinion does suggest is that slippery affirmative statements about investigations are dangerous. No surprise: bad facts lead to 'bad' law.

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The Second Circuit's decision vacated the District Court's decision at the motion to dismiss stage – not on the merits. On remand, the defendants have again moved to dismiss, this time focusing on the issue of scienter (defendants' state of mind). Nevertheless, the *Noto* decision may give plaintiffs some ammunition in the early stages of shareholder litigation. At a minimum, companies seeking to avoid Rule 10b-5 lawsuits should heed *Noto*'s warning by avoiding slippery statements and considering whether silence as to an investigation may leave in false light statements they have made in the past.

What comes next?

Thus far, *Noto* has been cited only once, but that case is interesting. AdaptHealth went public through a de-special purpose acquisition company (SPAC) transaction. In urging approval of the transaction, AdaptHealth touted the business acumen of Luke McGee, its chief executive, but did not mention that he was the subject of a criminal tax fraud investigation in Denmark and some civil suits in the US, both unrelated to AdaptHealth. Some months after approval of the de-SPAC, authorities in Denmark charged McGee with tax fraud and he was forced out as AdaptHealth's chief executive. AdaptHealth's stock price fell.

Stockholders sued under Rule 10b-5, the defendants moved to dismiss, and the US District Court for the Eastern District of Pennsylvania denied their motion, holding: "As part of its secondary offering in January 2021, AdaptHealth cited its experienced management, led by McGee, as a 'meaningful differentiator'. Other references highlighted McGee as the key to the company's success. These laudatory statements about McGee triggered a duty to disclose any fact which would make them not misleading. Mr McGee's ties to a major tax fraud scheme and his potential criminal and civil liability made AdaptHealth's previous statements about how integral he was to the company misleading, as they did not disclose that his future at the company was in jeopardy" (*Delaware County Employees Retirement System v. AdaptHealth Corp.* (2022)).

Issuers and their counsel should consider *Noto* and *AdaptHealth* when deciding whether to disclose an investigation. Neither case sets forth any bright-line test, but both emphasise the importance of considering context and, in particular, considering whether silence may make misleading something that the company previously had said. CD

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