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3rd Circuit panel raises the bar on risk disclosures as the trend toward greater disclosure continues

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It had been an article of faith in the securities legal community that a registrant has no obligation to disclose possible wrongdoing or a government investigation into its conduct absent some statement that would be rendered misleading without such a disclosure.

However, in recent years that faith has been called into question. The most recent case to call this principle into question is from a panel of the United States Court of Appeals for the Third Circuit. The case is *Jaroslawicz v. M&T Bank Corp.*, 962 F.3d 701 (3rd Cir. 2020).[1]

BACKGROUND AND DISTRICT COURT OPINION

In August 2012, M&T agreed to merge with Hudson City Bancorp. The proposed merger required the approval of the shareholders of both banks. The banks prepared a joint proxy that became effective in late February 2013.

> The Third Circuit reversed the district court's dismissal because M&T had "failed to discuss just how treacherous jumping through those hoops would be."

The proxy stated the parties expected the merger might close in the second quarter of 2013, but there could be no certainty when the transaction would be approved by regulators, or even if it would be approved. The approval was a prerequisite to closing.

In mid-April 2013, M&T issued a supplemental proxy and conducted an earnings call in which the bank disclosed what the Federal Reserve had raised as "regulatory concerns" about its Bank Secrecy Act and anti-money laundering ("BSA/AML") compliance program and disclosed that as a result, the timeframe for closing would be extended substantially.

Six days later, the Hudson City stockholders approved the merger. Ultimately, the Federal Reserve required M&T to make BSA/AML compliance improvements before giving its approval and the merger did not close until November 2015.

In October 2014, more than 18 months after the joint proxy was issued, the Consumer Financial Protection Bureau ("CFPB") announced it was taking action against M&T because the bank had offered free checking accounts, but had not published the eligibility requirements for the free checking that required a minimum balance in the account be maintained.

Between 2009 and 2012 the bank switched customers who did not maintain the minimum balance to fee-based accounts without prior notice. M&T later settled the allegations for a $2.9 million refund to about 59,000 customers and a $200,000 fine. As a point of reference, M&T's revenue for 2013 was approximately $4.82 billion.

A few weeks before the closing, a Hudson City shareholder filed a putative class action against M&T, Hudson City, and their officers and directors, claiming that the joint proxy violated section 14a of the Securities Exchange Act and Rule 14a-9. *See* 15 U.S.C.A. § 78n(a)(1); 17 C.F.R. § 240.14a-9(a).

Relevant to the appeal, the plaintiff, David Jaroslawicz, alleged that the defendants had violated Section 14a in two ways: first, by failing to make disclosure of significant risk factors required under what was then Item 503 of Regulation S-K, and is now Item 105 ("Item 105")[2] — those being the alleged BSA/AML compliance weaknesses and the checking account issue; and second, by publishing a misleading opinion that the merger would be approved in the second quarter of 2013.

Based upon *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), Jaroslawicz alleged the opinion was not sufficiently supported by facts and the joint proxy was not sufficiently transparent.

The district court dismissed the lawsuit, holding the joint proxy adequately disclosed the regulatory risks associated with the proposed merger and that M&T had no duty to disclose the alleged consumer checking account practices.

The district court found that the risk disclosures in the joint proxy were adequate and the proxy's opinion the transaction might close in 2013 was not actionable, in part, because surrounding that opinion and discussing risks, the joint proxy stated, in part, "*although* we currently believe we should be able to obtain all required regulatory improvements in a timely manner, we cannot be certain when or if we will obtain them ... we cannot be certain when or if we will obtain them."

THIRD CIRCUIT OPINION[3]

Reversing the dismissal, the Third Circuit started with the essential elements of a Section 14a claim: "(1) a proxy statement contained a material misrepresentation or omission which (2) caused the plaintiff injury and (3) that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction."

For an omission claim, the plaintiff must plead that either the SEC regulation specifically requires disclosure of the omitted information in a proxy statement, or the omission makes other statements in the proxy statement materially false or misleading.

A cause of action for an actionable omission regarding a risk must allege that "a known risk factor existed at the time of the offering." And, materiality must be judged at the time and in light of the circumstances under which the proxy is published.

> The panel does not explain how a duty to disclose a risk can be triggered with respect to an issue absent credible allegations the registrant knew of the particular risk at the time the proxy was published.

The Third Circuit first determined that the two risks needed to be disclosed under Item 105. It then turned its attention to whether the disclosure was sufficient. The panel acknowledged that M&T had disclosed that the merger hinged on regulatory approvals and had singled out that likelihood the effectiveness of its BSA/AML program would be crucial to obtaining that approval.

There was a description of the requirements the USA Patriot Act imposed on financial institutions and the joint proxy stated the belief that M&T systems complied. The joint proxy spoke of the U.S.'s reforms of financial regulation, stating its expectation that it would face "more intense scrutiny in the examination process and more aggressive enforcement of regulations on both the federal and state levels."

Further, the joint proxy predicted stricter regulations and supervision would "likely increase M&T's costs, reduce its revenue and may limit its ability to pursue certain desirable business opportunities." Finally, the joint proxy warned:

Heightened regulatory practices, requirements or expectations resulting from the Dodd-Frank Act and the rules promulgated thereunder could affect M&T in substantial and unpredictable ways, and, in turn, could have a material adverse effect on M&T's business, financial condition and results of operations.

Despite these warnings, the Third Circuit reversed the district court's dismissal because M&T had "failed to discuss just how treacherous jumping through those hoops would be."

Relying on SEC recommended guidance (not a regulation) about the disclosure of risk factors required by Item 105, the panel affirmed the SEC guidance that "M&T should have 'specifically link[ed]" its general statements to 'each risk to [its] industry, company, or investment' using details that connected the pending merger review to its existing and anticipated business lines." Most critically, the Third Circuit required the joint proxy to disclose "the state of [the bank's] BSA/AML program in the context of regulatory scrutiny."

The panel ruled, while the supplemental disclosure about the BSA/AML program was likely sufficient in content as a matter of law, whether the six days after curative disclosure was sufficient was an issue of fact not appropriate for a motion to dismiss.

With respect to the consumer checking account practices, even though the questioned consumer checking account practices had ceased prior to the publication of the joint proxy, the plaintiff argued that those consumer checking account practices cast doubt on M&Ts controls and compliance systems and, therefore, created a regulatory risk to the merger that had to be disclosed.

The counter-argument would be that the cessation of the practices was indicative that the appropriate corrections in systems had already been made. The panel agreed with the plaintiff, holding the past consumer checking practices had to be disclosed because of the risk to regulatory approval, finding that "[d]espite the fact that M&T had ceased the practice, it is plausible that the allegedly high volume of past violations made the upcoming merger vulnerable to regulatory delay."

The Third Circuit cited two cases as precedent for the adequacy of an Item 105 disclosure. One is the Second Circuit decision in the *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG,* 752 F. 3d 173 (2d Cir. 2104), in which the plaintiffs alleged that UBS inadequately disclosed an offshore tax evasion scheme that allowed Americans to avoid income taxes.

Following the indictment of a number of its employees, multiple legal proceedings and investigations, UBS disclosed the problem and stated that it was exposed to substantial risk of monetary damages, reputation risk, criminal and civil penalties, as well as potential regulatory restrictions.

The plaintiffs argued that UBS had not complied with Item 105(c) because it failed to disclose both that the fraudulent activity was ongoing and the magnitude of its exposure. The Second Circuit disagreed because "disclosure is not a rite of confession and companies do not have a duty to disclose uncharged, unadjudicated wrongdoing." Further, the disclosure of the risks of legal actions and losses was sufficient.

Arguably, there was no allegation in the *Jaroslawicz* complaint that would justify requiring less from UBS for its failure to disclose the alleged ongoing tax evasion scheme than that of M&T for its alleged failure to disclose the extent of its exposure from the state of its BSA/AML compliance program and its terminated consumer checking account practices. UBS made its first disclosure after several of its employees were indicted. M&T was faced with no action by any regulator.

After making a general disclosure of risks associated with the alleged tax evasion scheme due to the materiality of the risks arising from the alleged misconduct, UBS was *not also* required to disclose that its alleged scheme was ongoing because registrants do not have a duty to disclose "uncharged, unadjudicated wrongdoing" the fundamentality of principle should not be understated.

The Third Circuit's professed reliance on the *UBS* case to hold Reg. S-K items 303 and 105 could require a disclosure that M&T's BSA/AML program was inadequate prior to any regulatory charge, finding, or adjudication or that its checking account policy violated consumer laws nine months prior to the CFPB making an allegation is arguably inconsistent with this holding from the *UBS* decision.

> There is a strong argument to be made that the *Jaroslawicz* decision can best be read as part of a continuing trend that may require disclosure of "uncharged, unadjudicated wrongdoing."

In addressing M&T's further argument that the question was whether registrants doing offerings are obligated to predict regulatory action before it occurs, the Third Circuit concluded that M&T knew nine months before the CFPB acted that its consumer checking program "skirted regulatory standards" because, the plaintiff alleged, M&T had curtailed the practices shortly after signing the merger agreement, and the district court could reasonably infer the alleged practices caused a significant regulatory risk to the merger.

The Third Circuit's holding was devoid of any discussion of the CFPB's lack of authority to delay the approval of the merger and there was no allegation in the complaint the Federal Reserve had ever penalized the bank as the result of its BSA/AML practices.

The question whether the Third Circuit failed to follow the oft-cited principle of disclosure because registrants do not have a duty to disclose "uncharged, unadjudicated wrongdoing" is compounded by its citation early in the opinion to the requirement that to plead an omission claim a plaintiff must allege that a known risk factor existed at the time of the offering, but its apparent contradiction of that principle later in the opinion, when it states that "whether M&T had actual knowledge of the shortcomings of its BSA/AML compliance or its consumer checking practices is of no moment; it is the risk to the merger posed by the regulatory inspection itself that triggered the need for disclosures under Item 105."

The panel does not explain how a duty to disclose a risk can be triggered with respect to an issue absent credible allegations the registrant knew of the particular risk at the time the proxy was published.

The second case the Third Circuit discusses is *Silverstrand Investments v. AMAG Pharmaceuticals Inc.*, 707 F. 3rd 95 (1st Cir. 2013). In *Silverstrand Investments* the First Circuit overruled the district court's dismissal of the complaint. Defendant AMAG had a drug in development and sought approval from the FDA, which AMAG first disclosed in a form 8-K the filing.

AMAG's disclosures included information concerning patients' "serious adverse events" ("SAEs"), which are potential adverse reactions to the drug that were observed during clinical trials. The FDA initially declined to approve the drug because of a possible SAE and other factors, but later approved the drug.

The drug was AMAG's key product. One year later AMAG sold 3,000,000 shares of common stock in a public offering, but the prospectus did not disclose that it had reported additional SAEs since the drug had gone to market at twice the occurrence rate as in the clinical trial. Later, the FDA took a variety of steps to increase risk disclosures to prospective patients, which drove sales lower.

The First Circuit ruled that the failure to disclose the SAEs that had occurred after the drug went on the market but before the public offering was a plausibly pled violation of Section 11 for failure to provide information required by Item 303, uncertainties, and Item 105, material risks.

The court ruled the allegations allowed the reasonable inference that before the offering AMAG knew or could predict that SAEs could prompt FDA action based on its prior response to SAEs.

Arguably, the *Jaroslawicz* decision is more aligned with the decision in *Silverstrand*, but the two situations are distinguishable in ways critical to registrants with complex regulated operations.

AMAG had already faced an FDA refusal to approve its drug based on an SAE similar to several suffered after the drug went to market, so there could be more predictability about how the FDA might react; further, each of the SAEs was an identifiable event catalogued by AMAG.

In contrast, the state of M&T's BSA/AML compliance program was not such an identifiable event — it was a matter of the regulators' future interpretation of the requirements for a compliant BSA/AML program and their assessment of M&T's program against that metric.

One can reasonably conclude that the banks sought and obtained the best securities disclosure guidance available in the preparation of the joint proxy. The supplemental disclosure arguably demonstrates a willingness to detail a risk once there is a real-world event, such as a regulator's comment, indicating the potential materiality of the particulars of a generalized risk has risen.

There is a strong argument to be made that the *Jaroslawicz* decision can best be read as part of a continuing trend that may require disclosure of "uncharged, unadjudicated wrongdoing" and government investigations of possible wrongdoing prior to a government decision to commence a proceeding.

It suggests also that detailed disclosures regarding possible, even disputed, weaknesses in culture or systems may be becoming the expectation, which for institutions that are highly regulated and maintain extensive monitoring and control systems across a complex, often global enterprise, may result in the regulatory expectation the institution will conduct periodic assessments across the enterprise for the purpose of identifying and disclosing a potential risk.

The disclosure itself might generate government scrutiny and presents the concern that "too much is never enough" under what is now Item 105 and Item 303.

Notes

[1] The SEC's aggressive stance, as demonstrated by *SEC v. RPM International Inc.*, No. 16-cv-1803, *complaint filed*, 2016 WL 4710252 (D.D.C. Sept. 9, 2016), over that company's failure to book and disclose a loss contingency arising in a Department of Justice False Claims Act investigation before settlement, is one driver of the trend. *Lapin v. Goldman Sachs Group Inc.*, 506 F. Supp. 2d 221 (S.D.N.Y. 2006) is perhaps the earliest example. In this case, a registrant's statements regarding its "dedication to complying with the letter and spirit of the laws" and that its success depended on compliance were actionable in light of failure to disclose alleged conflicts and misconduct in its stock research and analysis.

[2] 17 C.F.R. 229.105(a) (2021). Former Item 503(c) was relocated and revised to Item 105. See, 84 FR 12674, 12718, Apr. 2, 2019. Item 105(a) requires "a discussion of the material factors that make an investment in the registrant or offering speculative or risky." At the time Item 503(c) required disclosure of "the most significant factors that make an investment in the registrant or offering speculative or risky."

[3] Following the first panel decision, the court granted M&T's request for reconsideration by the panel. See *Jaroslawicz v. M&T Bank Corp.*, 925 F.3d 605 (3d Cir. 2019). The M&T request for *en banc* consideration was denied. The petition for certiorari was denied by the Supreme Court.

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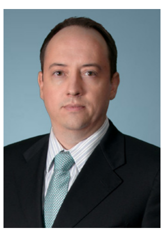

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