

# Disclosure Obligations Under the Federal Securities Laws in Government Investigations

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*With the prevalence of government investigations into corporate conduct, public companies frequently face decisions about whether, when, how, and where to disclose to investors the existence of such investigations and the facts learned in the course of, or as a result of, those investigations. While the federal securities laws (and the rules and regulations promulgated thereunder) require disclosure of specific events that may arise during an investigation, neither those laws nor the courts that have interpreted them provide clear guidance for many of the disclosure decisions that must be made over the course of an investigation. As a result, counsel must carefully analyze numerous facts and circumstances, understand the company's previous disclosures, make "materiality" assessments, and determine whether to make disclosure in a current report or wait until the next periodic filing. This Article seeks to present, through an analysis of precedent disclosures, caselaw, rules, regulations, and practical ramifications, the considerations counsel must take into account in evaluating disclosure decisions in the context of an investigation. These considerations can help counsel avoid having a disclosure decision worsen the already difficult circumstances posed by the investigation itself.*

## I. INTRODUCTION

Disclosing to investors facts about a government investigation into possible wrongdoing at a public company can be a difficult and sensitive decision that may have enormous business and legal ramifications. There is no statute, regulation, or rule that explicitly imposes a duty to disclose the existence of an investigation to investors and caselaw does not provide much guidance.<sup>1</sup> Counsel and publicly reporting companies must, however, be mindful of the principles that can help guide the analysis of when, how, and where such disclosure should be made if the investigation is to be disclosed at all. Counsel should also be aware of and prepare for the practical consequences that disclosure may have on the market,

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1. See *infra* Part II.B (discussing duty to disclose material information).

business relationships, employees, and relationships with government regulators or prosecutors.<sup>2</sup>

To be sure, the federal securities laws provide rules and regulations that impose a duty to disclose specific events that may arise during an investigation.<sup>3</sup> For example, a company must disclose when an investigation has grown to the point where there is a “material pending legal proceeding,” or where such a proceeding is “known to be contemplated” by a governmental authority, or where a director of an issuer is a defendant in a pending criminal proceeding.<sup>4</sup> And a company must alert investors if it determines that they cannot rely on previously issued financial statements.<sup>5</sup> But absent such specific circumstances, the question of whether to disclose the existence of a government investigation most often begins with an assessment of whether, under all of the facts and circumstances, there is “a substantial likelihood that the . . . fact [of the investigation] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>6</sup> That is, is the investigation “material”?<sup>7</sup> Whether the information is material depends on an assessment of the *probability and magnitude* of the outcome, which, in turn, requires analyzing the nature of the facts or alleged misconduct subject to investigation, the positions of company personnel involved or implicated, the likelihood of an enforcement proceeding or an indictment, and the probable impact of any legal proceeding likely to result.<sup>8</sup> In instances where many issuers are subject to the same or a similar investigation, counsel should also consider what, if anything, those other issuers have disclosed about the investiga-

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2. See *infra* Part IV (discussing various possible consequences of disclosure of investigation).

3. See *infra* Parts II.C & D (identifying rules and regulations that set forth obligation to disclose certain events).

4. See 17 C.F.R. § 229.103 (2009) (disclosure of “legal proceedings”); *id.* § 229.401(f) (disclosure concerning involvement of directors or executive officers in certain legal proceedings). These sections are discussed in Parts II.C & D. But even where specific disclosure requirements are set forth as in United States Securities and Exchange Commission (“SEC”) Form 8-K or Regulation S-K, those requirements are subject to some degree of interpretation. See *infra* Parts II.C & D.

5. SEC Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Item 4.02, <http://www.sec.gov/about/forms/form8-k.pdf> (last visited June 10, 2009) [hereinafter SEC Form 8-K].

6. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Courts have endorsed the materiality analysis framework set forth in SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 19, 1999) [hereinafter SAB 99]. See, e.g., *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162–63 (2d Cir. 2000); see also SEC ADVISORY COMM. ON IMPROVEMENTS TO FIN. REPORTING, FINAL REPORT OF THE ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 80 (2008), available at [www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf](http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf) (addressing the materiality of accounting errors and emphasizing that the assessment must be made through the perspective of the reasonable investor, the committee stated, “We believe that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. The total mix of information should be the main focus of a materiality judgment: while quantitative factors are quite important, *qualitative* factors are also relevant in analyzing the materiality of all errors.” (emphasis added)).

7. *TSC Indus.*, 426 U.S. at 449.

8. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (holding that when assessing the materiality of speculative information or events, one must balance “both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity” (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968))).

tion. This is because if one issuer's disclosure differs from that of others subject to the investigation, investors may misinterpret the significance of the difference.<sup>9</sup> As with any disclosure decisions, "[t]oo little information provides an inadequate basis for investment decisions; too much, particularly of a trivial or speculative nature, can muddle and diffuse disclosure and thereby lessen its usefulness."<sup>10</sup>

Counsel must also inform any disclosure decision with an awareness of the practical consequences of that decision. Disclosure of an investigation may elicit reactions (and overreactions) from analysts, shareholders, customers, suppliers, creditors, and employees.<sup>11</sup> Depending on the content (or lack thereof) of the disclosure, it may also have the unintended consequence of antagonizing government regulators or prosecutors conducting the investigation.<sup>12</sup>

This Article will first examine the legal framework under the federal securities laws governing disclosure decisions, beginning with a discussion of the limited judicial decisions addressing the subject. Next, it will address the form and content of such disclosures. Finally, this Article will analyze the consequences of disclosing or not disclosing information related to certain government investigations.

## II. THE LEGAL FRAMEWORK

### A. THE PRESUMPTION OF CONFIDENTIALITY

At the outset, it is important to recognize that the existence of, and details about, most government investigations is not information available to the public.<sup>13</sup> The

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9. Although some have questioned whether investors have become too complacent about the existence of a government investigation, others have made a business of selling information about undisclosed SEC investigations. See Herb Greenberg, *Why Do Investors Ignore Inquiries?*, WALL ST. J., Apr. 12, 2008, at B3. One company, Disclosure Insight, Inc., states that it provides company risk profiles and information obtained, at least in part, pursuant to Freedom of Information Act requests on companies that may be subject to an SEC investigation but have not disclosed the existence of the investigation. See Disclosure Insight, <http://www.disclosureinsight.com> (last visited June 10, 2009). Indeed, finance professor Jonathan Karpoff at the University of Washington has concluded that the stock price of a company subject to investigation tends to fall an average of 40 percent from the first "revelation of misconduct" until the investigation is resolved, suggesting that the market may view the existence of a government investigation as material information. Greenberg, *supra*, at B3. Karpoff attributes such declines to reputational harm, loss of customers and access to credit, and termination or departure of executives that often result from a government investigation. *Id.* If Karpoff is correct about the potential significance of the mere existence of a government investigation, it may be that inadequate or delayed disclosure of an investigation may form the basis for a violation of the securities laws.

10. Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 355 (2007). In addition, former SEC Commissioner Paul Atkins emphasized the importance of accurate disclosure of the status and nature of an SEC investigation by a company because of the way in which unscrupulous short sellers have tried to manipulate stock prices by initiating rumors of SEC investigations into certain companies or individuals. Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the U.S. Chamber Institute for Legal Reform (Feb. 16, 2006), available at <http://sec.gov/news/speech/spch021606psa.htm>.

11. See *infra* Part IV (discussing consequences of disclosure of an investigation).

12. See *id.*

13. See, e.g., 5 U.S.C. § 552(b)(7)(A) (2006) (exempting from Freedom of Information Act disclosure certain records compiled for law enforcement purposes); FED. R. CRIM. P. 6(e)(2)(B) (limiting disclosure of grand-jury investigations).

United States Securities and Exchange Commission (“SEC” or “Commission”) and the United States Department of Justice (“DOJ”)—two of the most common investigators of corporate misconduct—have explicit procedures for protecting the confidentiality of their investigations.<sup>14</sup> The SEC’s Enforcement Division (the arm of the agency that conducts investigations), in particular, recognizes the value in maintaining the confidentiality of its investigations and the potential for undue harm to individuals and entities that might result from the public becoming aware of the mere existence of an investigation.<sup>15</sup> For that reason, almost all SEC investigations are presumptively nonpublic and the Enforcement staff goes to great lengths to preserve their confidentiality.<sup>16</sup> When the SEC Enforcement staff seeks information voluntarily or by subpoena in the course of its investigations, it routinely advises the recipients of such requests that its investigations are confidential and should not be construed as an indication by the SEC or its staff that any violation of law has occurred or be reflective upon any person, entity, or security.<sup>17</sup>

Notwithstanding this presumption of confidentiality, there are several means by which the SEC is authorized to (and routinely will) share information obtained in the course of its investigations outside the agency, and some of those with whom the SEC may share the information are not subject to the same confidentiality policies as the SEC.<sup>18</sup> For example, the SEC Enforcement staff advises recipients of its requests that information supplied may be shared with other government agencies to coordinate law enforcement activities between the SEC and other federal, state, local, and foreign law enforcement agencies, securities self-regulatory

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14. See *supra* note 13.

15. See SEC. & EXCH. COMM’N DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL § 5.1, at 108 (2008), available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> [hereinafter SEC ENFORCEMENT MANUAL] (“All information obtained or generated by SEC staff during investigations or examinations should be presumed confidential and nonpublic unless disclosure has been specifically authorized.”).

16. See 17 C.F.R. § 203.5 (2009) (“Non-public formal investigative proceedings”) (“Unless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public.”); see also *id.* § 202.5(a) (“Unless otherwise ordered by the Commission, [a formal] investigation or examination is non-public and the reports thereon are for staff and Commission use only.”). SEC Rule 0-4 promulgated under the Securities Exchange Act of 1934 (“Exchange Act”) further provides:

Information or documents obtained by officers or employees of the Commission in the course of any examination or investigation pursuant to section 17(a) . . . or 21(a) . . . shall, unless made a matter of public record, be deemed confidential. Except as provided by 17 C.F.R. [§] 203.2 of the rules relating to investigations, officers or employees are hereby prohibited from making such confidential information or documents or any other non-public records of the Commission available to anyone other than a member, officer, or employee of the Commission, unless the Commission or the General Counsel, pursuant to delegated authority, authorizes the disclosure of such information or the production of such documents as not being contrary to the public interest.

17 C.F.R. § 240.0-4 (2009) (“Non-Disclosure of information obtained in examinations and investigations”).

17. Such advice is contained in SEC Forms 1661 and 1662, which the Enforcement staff provides to recipients of requests for information or subpoenas. See SEC ENFORCEMENT MANUAL, *supra* note 15, § 3.2.3.1, at 47–48.

18. The SEC’s guidelines for its cooperation with other agencies and organizations are set forth in the SEC Enforcement Manual. See *id.* § 5, at 108–22.

organizations, and foreign securities authorities.<sup>19</sup> It also advises that there are circumstances under which it may make information obtained in its investigations available to a congressional office.<sup>20</sup>

Moreover, as discussed above, some private citizens have developed methods for speculating about the existence of an undisclosed SEC Enforcement investigation into a particular company through Freedom of Information Act requests and proceedings.<sup>21</sup> Finally, there is, of course, always the possibility of a leak, which can come from a variety of sources. Accordingly, the existence of an investigation may become public despite the government's presumption of confidentiality—a risk that companies and their counsel must consider when evaluating whether and when to disclose an investigation.

## B. THE DUTY TO DISCLOSE MATERIAL INFORMATION

An issuer has no general obligation to disclose material information as it arises, and certainly no definitive duty to disclose a government investigation absent additional circumstances.<sup>22</sup> The duty to disclose material information arises from: (1) the need to make a periodic filing with the SEC that contains up-to-date information (such as a periodic report, a registration statement for a securities offering, or a proxy statement); (2) a regulatory requirement to disclose certain specific events as they occur; (3) a fiduciary obligation in the context of trading in the

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19. See SEC Form 1662, Supplemental Information for Persons Requested to Supply Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena, <http://www.sec.gov/about/forms/sec1662.pdf> (last visited June 10, 2009).

20. See *id.* While congressional committees have the power to subpoena federal agency records, their rules generally do *not* provide for confidential treatment of the records they subpoena. See, e.g., U.S. House of Representatives, Committee on Energy and Commerce, Rule 16, [http://energycommerce.house.gov/index.php?option=com\\_content&view=category&layout=blog&id=161&Itemid=62](http://energycommerce.house.gov/index.php?option=com_content&view=category&layout=blog&id=161&Itemid=62) (last visited June 10, 2009).

21. See *supra* note 9.

22. The U.S. Court of Appeals for the Eleventh Circuit observed that the “mere possession of material nonpublic information does not create a duty to disclose it” and that the duty question is properly stated as “whether the defendants had a specific obligation to disclose information of the type that the plaintiffs complain was omitted from the registration statement and prospectus.” *Oxford Asset Mgmt., Ltd. v. Jaharis*, 297 F.3d 1182, 1190 (11th Cir. 2002) (quoting *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996)), *cert. denied*, 540 U.S. 872 (2003); see also *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001) (stating that issuers have no “absolute duty to disclose all information material to stock prices as soon as news comes into their possession. . . . We do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose.”); *Cooperman v. Individual, Inc.*, 171 F.3d 43, 49–50 (1st Cir. 1999) (“Although in the context of a public offering there is a strong affirmative duty of disclosure, it is clear that an issuer of securities owes no absolute duty to disclose all material information. The issue, rather, is whether the securities law imposes on defendants a ‘specific obligation’ to disclose information . . . .” (citation omitted)). *But cf.* *Goldsmith v. Rawl*, 755 F. Supp. 96, 97 (S.D.N.Y. 1991) (denying summary judgment on claim alleging violation of section 14(a) of the Exchange Act based on Exxon’s failure to disclose in proxy materials shareholder litigation arising out of the grounding of the Exxon Valdez and the creation of an independent litigation committee because the creation of the committee was an “extraordinary step” and the context of the nondisclosure was a proposal to provide substantial financial benefits to current management).

company's securities;<sup>23</sup> or (4) a selective disclosure (or intended selective disclosure) to a member of the professional investment community or a shareholder that triggers an obligation to disclose to the market generally.<sup>24</sup> Although there is no general duty to continuously update prior communications on a subject upon the discovery or development of new material facts, the issuer acquires a duty to update when the securities laws require the filing of a periodic report, current report, proxy solicitation, or registration statement.<sup>25</sup> In this context, an issuer must evaluate whether it must make a disclosure to ensure that a prior communication is not materially inaccurate, incomplete, or misleading.

Similarly, when a company determines that it has a duty—or otherwise chooses—to disclose information related to material facts, it has a duty to make a complete disclosure.<sup>26</sup> In one action, the SEC filed a settled securities fraud action against the former Chief Financial Officer and General Counsel of FFP Marketing Company, Inc. (“FFP”), for making an incomplete disclosure about the reasons for failing to file a periodic report on time.<sup>27</sup> In that matter, the SEC alleged that the defendant had prepared, and caused FFP to file, notices of late filing of periodic reports on Form 12b-25 that were false and misleading because they vaguely characterized the reasons for the delays as the need to obtain “[c]ertain financial and other data.”<sup>28</sup> While this may have been true, the SEC alleged, the company failed to disclose that the reason for the delays was that the company was investigating its own accounting.<sup>29</sup> Because FFP made a statement that it would delay filing its Form 10-K, it was

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23. Such a duty arises when a corporate insider trades on confidential information. See *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

24. See GARY M. BROWN, *SODERQUIST ON THE SECURITIES LAWS* § 12:7, at 12-31 to 12-35 (5th ed. 2006); 2 JOHN K. VILLA, *CORPORATE COUNSEL GUIDELINES* § 5:22, at 5-28 (2008) (noting that an additional disclosure obligation may be triggered by rules of the various stock exchanges that require disclosure of certain material developments and correction of false market rumors).

25. See, e.g., Regulation S-K, Item 303, 17 C.F.R. § 229.303(a)(1)–(3) (2009) (describing obligation to disclose certain material developments in an annual report's section on management's discussion and analysis of financial condition and results of operations); see also Regulation S-K, Item 103, 17 C.F.R. § 229.103 (2009) (describing obligation to disclose material pending legal proceedings other than routine litigation incidental to the business).

26. See *Staffin v. Greenberg*, 672 F.2d 1196, 1204 (3d Cir. 1982) (holding that a corporation does not have an affirmative duty to disclose a power struggle among its leadership, but if it chooses to disclose some information about the conflict, it has to disclose completely). See also *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 673 (6th Cir.) (declining to dismiss a fraud claim based on Firestone's statement that “[w]e continually monitor the performance of all our tire lines, and the objective data clearly reinforces our belief that these are high-quality, safe tires” where Firestone failed to disclose that its own quality control high-speed durability tests had shown significant rates of failure (alteration in original)), cert. denied, 546 U.S. 936 (2005); *SEC v. Scott*, Litigation Release No. 19077 (Feb. 14, 2005), available at <http://www.sec.gov/litigation/litreleases/lr19077.htm> [hereinafter *SEC Litigation Release No. 19077*] (announcing SEC's settlement of allegations that Rule 12b-25 notices of late filing of periodic reports were fraudulent because they failed to disclose that the delay was attributable to an internal investigation that had shown accounting lapses).

27. SEC Litigation Release No. 19077, *supra* note 26.

28. Complaint at 4, *SEC v. Scott*, No. 3-05 CV 0302 P (N.D. Tex. Feb. 14, 2005), available at <http://www.sec.gov/litigation/complaints/comp19077.pdf>.

29. SEC Litigation Release No. 19077, *supra* note 26.

required to disclose fully the reason for the delay, affirmatively citing its internal investigation.<sup>30</sup>

Likewise, while an issuer need not announce that it or its officers are involved in a criminal or regulatory investigation, or that an internal investigation has been launched into particular conduct,<sup>31</sup> courts generally have held that if one discloses something about an investigation, the disclosure must include all material information. For example, in *In re Immucor Inc. Securities Litigation*, the company issued a press release disclosing an Italian criminal investigation of improper payments, and an internal investigation into the same matter.<sup>32</sup> The release stated that the internal investigation had revealed *one* incident, that the company's President and CEO had been relieved of his responsibilities as CEO, and that the company perceived a need to strengthen the controls in its European affiliates.<sup>33</sup> Because the plaintiffs alleged that, in fact, the investigation concerned *multiple* incidents of legally dubious payments, the court held that "[t]he omission creates a distorted picture of Immucor's alleged liabilities. That is, while parts of the disclosure may have been accurate, Defendants' duty was to describe fully the nature and scope of the conduct under investigation . . . ."<sup>34</sup>

Absent a delineated requirement to disclose an event as it occurs, the duty to disclose may arise only with respect to "material" information.<sup>35</sup> Information is rendered material when there is a substantial likelihood that its disclosure "would [be] viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."<sup>36</sup> Although practices vary with respect to disclosure of government investigations, as a matter of law, the mere existence of a government investigation alone, arguably, is not material information.<sup>37</sup> Rather, it is the information that the company or the government discovers through such investigations that may be material, and therefore may need to be disclosed.<sup>38</sup>

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30. See *id.*

31. See *In re Par Pharm. Cos., Inc. Sec. Litig.*, 733 F. Supp. 668, 674–75 (S.D.N.Y. 1990) (holding that an issuer is "under no duty to announce publicly that it or its officers are guilty of uncharged criminal behavior, or to accuse itself of antisocial or illegal policies").

32. No. 1:05-CV-2276-WSD, 2006 WL 3000133, at \*3 (N.D. Ga. Oct. 4, 2006).

33. *Id.* at \*13.

34. *Id.*

35. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Materiality alone, however, is not enough to trigger a duty to disclose. See *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997), *cert. denied sub nom. Murphy v. Sofamor Danek Group*, 523 U.S. 1106 (1998).

36. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

37. See *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808–09 (7th Cir. 2001) (affirming the dismissal of securities class action based on the defendant's nondisclosure of a Food and Drug Administration investigation that found deficiencies in manufacturing quality control and culminated in a letter demanding compliance with regulatory requirements because the defendant did not make any false statements or statements that were misleading due to the omission of material information); see also *infra* Part II.C (explaining how an investigation, without more, is not a "legal proceeding").

38. Materiality is a mixed question of law and fact. Courts may make materiality determinations as a matter of law where "reasonable minds cannot differ" as to the information's significance. *TSC Indus.*, 426 U.S. at 450.

Determinations of materiality require assessments of both quantitative and qualitative factors.<sup>39</sup> More specifically, companies and their counsel must consider the extent and nature of the acts or conduct uncovered and the position(s) of the people involved in those acts or conduct.<sup>40</sup> Thus, for example, an investigation that uncovers the inappropriate recognition of small amounts of revenue is not likely to be material unless that improper revenue recognition was directed by a member of senior management who acted in knowing disregard of accounting principles.<sup>41</sup> On the other hand, an investigation related to a company's payment of bribes that do not materially impact the company's financial statements may well be material information if the company derives substantial business from government contracts and a finding of improper payments were to result in the company being barred from participating in such contracts.<sup>42</sup>

In addition, information is likely to be material only when the disclosable event is "substantially certain."<sup>43</sup> Therefore, while the existence and general nature of an investigation may be certain, if the investigation has yet to yield any facts that are substantially certain, there is probably very little additional material information that would require disclosure, even if the conduct being investigated would, if established, alter "the 'total mix' of information made available" to investors.<sup>44</sup> For this reason, a regulatory or criminal investigation in which an officer or director is a subject is not likely, absent additional facts, to be material.<sup>45</sup> A corporate director who is subject to a criminal investigation "was not legally required to confess that he was guilty of an uncharged crime in order that [the company's] shareholders could deter-

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39. See SAB 99, *supra* note 6, at 2–5 (addressing financial statement materiality).

40. See *id.* at 2–3 ("The use of percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. . . . [But a threshold] cannot appropriately be used as a substitute for a full analysis of all relevant considerations.").

41. See *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987).

42. See, e.g., *Avon Prods., Inc.*, Current Report (Form 8-K), at 2 (Oct. 21, 2008) (disclosing, under Item 7.01 (Regulation FD), presumably in anticipation of releasing and discussing with analysts its third quarter results, that it was "voluntarily conducting an internal investigation of its China operations, focusing on compliance with the Foreign Corrupt Practices Act ('FCPA'). The Company, under the oversight of the Audit Committee, commenced in June 2008 an internal investigation after it received an allegation that certain travel, entertainment and other expenses may have been improperly incurred in connection with the Company's China operations. . . . The Company has voluntarily contacted the Securities and Exchange Commission and the United States Department of Justice to advise both agencies that an internal investigation is underway. The internal investigation is in its early stage and no conclusion can be drawn at this time as to its outcome."). *Avon* subsequently identified the potential outcome of the investigation as a "Risk Factor" under Item 503(c) of Regulation S-K in its next Form 10-K. See *Avon Prods., Inc.*, Annual Report (Form 10-K), at F-39 (Feb. 20, 2009) (stating, "Because the internal investigation is in its early stage, we cannot predict how the resulting consequences, if any, may impact our internal controls, business, results of operations or financial position.").

43. *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

44. *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

45. See *United States v. Matthews*, 787 F.2d 38, 49 (2d Cir. 1986) (holding that securities laws do not impose a duty to disclose uncharged criminal conduct).



mine the morality of his conduct.<sup>46</sup> However, if the company learns that an indictment is imminent, that event is “substantially certain” and should be disclosed.<sup>47</sup>

This concept that facts must be “substantially certain” to be material has led some courts to distinguish between “hard” and “soft” information.<sup>48</sup> As a general rule, hard information of a certain quality (which includes historical, factual, and objectively verifiable information) tends to be material and should be disclosed.<sup>49</sup> Conversely, soft information (which includes predictions of future events or opinions) becomes disclosable when it is “‘virtually as certain as hard facts.’”<sup>50</sup> And, of course, when disclosure is made, it must contain *all* material information.<sup>51</sup> Thus, in *Helwig v. Vencor, Inc.*, the defendant, a long-term healthcare provider, announced earnings and stated that it was uncertain about the effect of the Balanced Budget Act and Medicare reductions on the company’s earnings.<sup>52</sup> At the time Vencor made those disclosures, however, the company had analyzed the potential effects of the expected legislation and believed with substantial certainty that the Balanced Budget Act would have significant negative effects on the company’s earnings.<sup>53</sup> Although the predictions were “soft information,” the court held that if a company chooses to “divulge uncertain estimates,” it must divulge the “limitations on the projected realizable values. . . . With regard to future events, uncertain figures, and other so-called soft information, a company may choose silence or speech elaborated by the factual basis as then known—but it may not choose half-truths.”<sup>54</sup>

Likewise, in *City of Monroe Employees Retirement System v. Bridgestone*,<sup>55</sup> the U.S. Court of Appeals for the Sixth Circuit examined the materiality of several statements made by Bridgestone and Firestone prior to a tire recall. Among the statements considered by the court was a Firestone statement that “objective data clearly reinforces our belief that these are high-quality, safe tires.”<sup>56</sup> But Firestone’s own internal testing had raised questions about the safety of the tires, so the court held that the statement concerning “objective data” was not “puffery,” but rather a material misrepresentation.<sup>57</sup>

46. *Id.*

47. *See Starkman*, 772 F.2d at 241.

48. *See Helwig v. Vencor, Inc.*, 251 F.3d 540, 554 (6th Cir. 2001), *cert. denied*, 536 U.S. 935 (2002); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 401–02 (6th Cir. 1997), *cert. denied sub nom.* Murphy v. Sofamor Danek Group, 523 U.S. 1106 (1998).

49. *Sofamor Danek*, 123 F.3d at 401 (citing *Garcia v. Cordova*, 930 F.2d 826, 830 (10th Cir. 1991)). The safe harbor provision of the Private Securities Litigation Reform Act of 1995 (“PSLRA”) codifies this distinction to some degree, providing immunity for certain forward-looking statements that are identified as such and that are accompanied by meaningful cautionary language. PSLRA § 27A, 15 U.S.C. § 78u-5(c)(1) (2006).

50. *Sofamor Danek*, 123 F.3d at 402 (quoting *Starkman*, 772 F.2d at 241).

51. *See supra* notes 26–34 and accompanying text.

52. 251 F.3d 540, 554 (6th Cir. 2001), *cert. denied*, 536 U.S. 935 (2002).

53. *Id.* at 556.

54. *Id.* at 561.

55. 399 F.3d 651, 669 (6th Cir.), *cert. denied*, 546 U.S. 936 (2005).

56. *Id.* at 671.

57. *Id.* at 672. The court expressed no opinion as to whether Firestone had a duty that was independent of its voluntary statement to divulge information about safety concerns, holding instead that once the company disclosed information, the disclosure could not be misleading. *See id.* at 673.

Similarly, in *Alpern v. UtiliCorp United, Inc.*, the U.S. Court of Appeals for the Eighth Circuit held that UtiliCorp's statements of continued financial success may have been materially misleading when the company knew from its internal investigation that a portion of that growth was attributable to employees using company funds to pay substantial kickbacks as part of a scheme to sustain a "growing" business.<sup>58</sup> As in the other cases mentioned above, the defendant in *Alpern* gleaned concrete facts from an internal investigation that it then failed to disclose, instead painting a picture of continued growth and financial success.<sup>59</sup>

These are the general principles that underlie most disclosure decisions. Next, we address how these principles apply in the statutory and regulatory framework governing decisions to disclose government investigations and the facts that arise therein.

### C. REGULATION S-K, ITEM 103: DISCLOSURE OF "LEGAL PROCEEDINGS"

One of the most common locations of disclosure of a government investigation is in the "Legal Proceedings" section of the nonfinancial statement portion of a registration statement or an annual or other periodic report under section 13 of the Exchange Act.<sup>60</sup> The requirements for disclosure under the "Legal Proceedings" section are set forth in Item 103 of Regulation S-K.<sup>61</sup> Item 103 provides:

Describe briefly any *material pending legal proceedings*, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the *factual basis* alleged to underlie the proceeding and the *relief sought*. Include similar information as to *any such proceedings known to be contemplated by governmental authorities*.<sup>62</sup>

This is the closest that the statutory disclosure framework comes to explicitly requiring the disclosure of a government investigation. An investigation on its own is not a "pending legal proceeding" until it reaches a stage when the agency or prosecutorial authority makes known that it is contemplating filing suit or bringing charges. For example, most would consider an SEC investigation to have evolved into a "proceeding known to be contemplated by a government agency" when the SEC Enforcement staff issues a Wells notice. A Wells notice is issued

58. 84 F3d 1525, 1538 (8th Cir. 1996).

59. For a similar example, see *In re Immucor Inc. Securities Litigation*, No. 1:05-CV-2276-WSD, 2006 WL 3000133, at \*13 (N.D. Ga. Oct. 4, 2006), in which the court held that public disclosure of an investigation may be materially misleading if it fails to reveal complete information about the results of the investigation or it actively misrepresents the results.

60. 15 U.S.C. § 78 (2006).

61. 17 C.F.R. § 229.103 (2009).

62. *Id.* (emphasis added). There are particular requirements for disclosure of administrative or judicial proceedings related to environmental violations that "shall not be deemed 'ordinary routine litigation incidental to the business.'" *Id.* (Instruction No. 5).

by the Enforcement staff to persons involved in an investigation, stating that the staff is prepared to recommend that the Commission file an enforcement action,<sup>63</sup> even though the Commission has not yet had an opportunity to consider the recommendation.<sup>64</sup> On the other hand, in the experience of the authors, an investigation probably has not ripened into a “contemplated proceeding” when the Enforcement staff and the issuer are engaged in pre-Wells discussions about what it might take to resolve an investigation.

#### D. REGULATION S-K DISCLOSURE OF MATTERS THAT MAY ARISE IN AN INVESTIGATION

##### 1. Item 303—Financial Condition and Results of Operations

Regulation S-K also addresses the disclosure of facts and circumstances that may arise in the course of an investigation. For example, Item 303 of Regulation S-K, titled “Management’s discussion and analysis of financial condition and results of operations” (“MD&A”), addresses disclosure obligations arising from changes in a registrant’s financial condition and results of operations.<sup>65</sup> It states, in relevant part, that the MD&A in a registration statement or periodic filing must

[d]iscuss registrant’s financial condition, changes in financial condition and results of operations. The discussion shall provide information . . . that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. . . . Where in the registrant’s judgment a discussion of segment information or of other subdivisions of the registrant’s business would be appropriate to an understanding of such business, the discussion shall focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole.<sup>66</sup>

The MD&A must address any known trends and uncertainties that the registrant reasonably expects will have a material unfavorable impact on net sales or revenues or income from continuing operations.<sup>67</sup> Item 303 also provides explicit disclosure requirements related to off-balance sheet arrangements and known events or uncertainties that are reasonably likely to result in termination or material reduction in liquidity and capital availability to the registrant.<sup>68</sup> Counsel should keep these explicit obligations in mind if the investigation reveals facts or circumstances that will affect the financial condition or off-balance sheet arrangements

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63. See *id.* § 202.5(c) (“Enforcement activities”); Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310 (Sept. 27, 1972), reprinted in SEC ENFORCEMENT MANUAL, *supra* note 15, § 2.4, at 26–29.

64. The staff may issue a Wells notice with the approval of a Deputy Director of Enforcement; approval by the SEC Commissioners is not required. SEC ENFORCEMENT MANUAL, *supra* note 15, § 2.4, at 23.

65. 17 C.F.R. § 229.303 (2009).

66. *Id.* § 229.303(a).

67. *Id.* § 229.303(a)(3).

68. *Id.* § 229.303(a)(4).

of the company. For example, the costs associated with an investigation may have a material effect on the results of operations.<sup>69</sup> In addition, an investigation may uncover an improper sales or accounting practice that, when stopped, will materially affect the reported financial performance of the company.<sup>70</sup> Pride International disclosed under Item 303 extensive information about its internal investigation of potential Foreign Corrupt Practices Act (“FCPA”) violations and its finding that then-members of senior operations management “were aware, or should have been aware” of improper payments made to foreign officials.<sup>71</sup> It then went on to state, among other things, the range of possible monetary penalties and other sanctions that could be imposed on the company, including prohibition of its participation in or curtailment of business operations in foreign jurisdictions and seizure of assets.<sup>72</sup> Finally, it stated:

In addition, disclosure of the subject matter of the investigation could adversely affect our reputation and our ability to obtain new business or retain existing business from our current clients and potential clients, to attract and retain employees and to access the capital markets. No amounts have been accrued related to any potential fines, sanctions, claims or other penalties, which could be material individually or in the aggregate.

We cannot currently predict what, if any, actions may be taken by the DOJ, the SEC, any other applicable government or other authorities or our customers or other third parties or the effect the actions may have on our results of operations, financial condition or cash flows, on our consolidated financial statements or on our business in the countries at issue and other jurisdictions.<sup>73</sup>

## 2. Item 503(c)—Changes in Risk Factors

Item 503(c) of Regulation S-K, which applies to prospectuses in securities offerings and is incorporated into periodic filings by Item 1A of the instructions to Forms 10-K and 10-Q, requires a discussion of the most significant risk factors the company faces.<sup>74</sup> Even an investigation in its preliminary stages may warrant

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69. See, e.g., BankAtlantic Bancorp, Inc., Annual Report (Form 10-K), at 65 (Mar. 16, 2009) (disclosing, under Item 303, “During 2008 the Parent Company incurred higher professional fees associated with a securities class-action lawsuit filed against the Company and the formal investigation into the class-action lawsuit matter by the Securities and Exchange Commission.”); Computer Scis. Corp., Annual Report (Form 10-K), at 31 (May 27, 2008) (disclosing, under Item 303, “Selling, general and administrative (SG&A) expenses as a percentage of revenue increased .3% points to 6.2% for fiscal 2007 primarily as a result of additional compensation expense due to the incremental impact of the adoption of SFAS No. 123(R) and the legal expenses related to the investigation by the Securities and Exchange Commission and the Department of Justice into the Company’s stock option granting practices.”).

70. See, e.g., Pride Int’l, Inc., Annual Report (Form 10-K), at 27–29 (Feb. 25, 2009).

71. *Id.* at 28.

72. *Id.*

73. *Id.* at 28–29.

74. See 17 C.F.R. § 229.503(c) (2009) (“Prospectus summary, risk factors, and ratio of earnings to fixed charges”); SEC Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Part I, Item 1A, Risk Factors, <http://www.sec.gov/about/forms/form10-k.pdf> (last

disclosure if its subject matter is sufficiently serious that it could materially impact the business of the organization.<sup>75</sup> For example, in what would appear to have been a discovery during pre-acquisition due diligence by Oracle Corporation, Sun Microsystems (“Sun”) disclosed in a Form 10-Q that it had identified potential violations of the FCPA, the resolution of which could possibly have a material effect on its business.<sup>76</sup> On the same day, Oracle, likewise, disclosed to its investors in a Form 8-K that before it signed its definitive acquisition agreement with Sun, Sun had informed Oracle of potential violations of the FCPA.<sup>77</sup>

Prudent companies will also want to evaluate whether additional risk factor disclosure is necessary as they more closely examine their risk profiles and risk mitigation strategies and commence internal reviews of activity that may give rise to government investigations, such as inquiries into conduct that may violate the FCPA.

### 3. Item 401(f)—Involvement of Directors or Executive Officers in Legal Proceedings

Regulation S-K also provides that in identifying and describing the backgrounds of its directors, registrants must describe certain events that are “material to an evaluation of the ability or integrity of any director, person nominated to become a director or executive officer of the registrant.”<sup>78</sup> Included in such events under Item 401(f) is whether the person is “a named subject of a pending criminal proceeding.”<sup>79</sup> This provision, coupled with caselaw, should generally lead counsel to advise that disclosure be made when an indictment is “imminent.”<sup>80</sup>

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visited June 10, 2009) (“Set forth, under the caption ‘Risk Factors,’ where appropriate, the risk factors described in Item 503(c) of Regulation S-K (§ 229.503(c) of this chapter) applicable to the registrant. Provide any discussion of risk factors in plain English in accordance with Rule 421(d) of the Securities Act of 1933 (§ 230.421(d) of this chapter).”).

75. See 17 C.F.R. § 229.503(c) (2009).

76. See Sun Microsystems, Inc., Quarterly Report (Form 10-Q), at 40 (May 8, 2009) (“We have identified potential violations of the Foreign Corrupt Practices Act, the resolution of which could possibly have a material effect on our business. During fiscal year 2009, we identified activities in a certain foreign country that may have violated the Foreign Corrupt Practices Act (FCPA). We initiated an independent investigation with the assistance of outside counsel and took remedial action. We recently made a voluntary disclosure with respect to this and other matters to the Department of Justice (DOJ), Securities and Exchange Commission (SEC) and the applicable governmental agencies in certain foreign countries regarding the results of our investigations to date. We are cooperating with the DOJ and SEC in connection with their review of these matters and the outcome of these, or any future matters, cannot be predicted. The FCPA and related statutes and regulations provide for potential monetary penalties, criminal sanctions and in some cases debarment from doing business with the U.S. federal government in connection with FCPA violations, any of which could have a material effect on our business.”).

77. Oracle Corp., Current Report (Form 8-K), at 1 (May 8, 2009) (“On May 8, 2009, Oracle Corporation (“Oracle”) confirmed that, prior to its signing of the definitive agreement to acquire Sun Microsystems, Inc. (“Sun”), Oracle had received disclosures from Sun regarding the potential violations of the Foreign Corrupt Practices Act, which were disclosed in Sun’s Form 10-Q for the quarterly period ending March 29, 2009, filed with the U.S. Securities and Exchange Commission on May 8, 2009.”).

78. 17 C.F.R. § 229.401 (2009) (“Directors, executive officers, promoters and control persons”).

79. *Id.* § 229.401(f)(2) (“Involvement in certain legal proceedings”).

80. See *id.*; see also *supra* note 47 and accompanying text.

Similarly, while not explicitly required, counsel will generally recommend that a company disclose when the SEC Enforcement staff notifies an executive officer or director that it is prepared to recommend that the SEC file charges against the officer or director through the issuance of a Wells notice.<sup>81</sup>

#### 4. Form 8-K Disclosable Events

The federal securities laws also require that information in periodic reports be kept current through timely disclosure of certain events before the next periodic report.<sup>82</sup> Thus, if the company learns of certain information between its periodic reports, it may be required, depending on the nature of the information, to make the information public.<sup>83</sup> A public announcement filed with the SEC through Form 8-K is the mechanism for doing so.<sup>84</sup> Form 8-K generally requires that disclosures of specified events be made within four business days of the event.<sup>85</sup> Some events arising in an investigation that might require disclosure through Form 8-K are (1) the resignation or removal of a director or certain officers; (2) the conclusion that previously issued financial statements should no longer be relied upon because of an error in the financial statements; (3) the resignation or dismissal of the company's auditor; and (4) entry into a "material definitive agreement" with a government agency to conclude an investigation.

81. See *supra* Part II.C (describing obligations to disclose legal proceedings).

82. See, e.g., 17 C.F.R. pt. 229 (2009) (Reg. S-K); *id.* § 240.13a-1 ("Requirements of annual reports").

83. See *id.* § 249.308 ("Form 8-K, for current reports").

84. See *id.* § 240.13a-11 ("Current reports on Form 8-K").

85. See SEC Form 8-K, *supra* note 5, § B.1. Even more rapid public dissemination of information on Form 8-K is required in the event of a selective disclosure under Regulation FD. If a registrant intends to hold an analyst call or meeting and wants the freedom to be able to answer anticipated questions about a government investigation, the registrant may use Item 7.01 of Form 8-K to disseminate preemptively such information to the investing public at large. Regulation FD under the Exchange Act requires that:

Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to [a member of the professional investment community (e.g., a broker-dealer, investment adviser, investment company or any shareholder) under circumstances in which it is reasonably foreseeable that the shareholder will purchase or sell the issuer's securities on the basis of the information], the issuer shall make public disclosure of that information . . . .

(1) Simultaneously, in the case of an intentional disclosure; and

(2) Promptly, in the case of a non-intentional disclosure.

17 C.F.R. § 243.100(a) (2009) (Reg. FD). "Promptly" is defined as "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)." *Id.* § 243.101(d).

The New York Stock Exchange also has a rule requiring listed companies to disclose on the same schedule and by the same method provided for by Regulation FD "any news or information which might reasonably be expected to materially affect the market for its securities." NYSE, INC., NYSE LISTED COMPANY MANUAL § 202.05 (2009), available at <http://www.nyse.com/regulation/listed/1182508124422>; see also NASDAQ, Listing Rule 5250(b)(1), <http://nasdaq.cchwallstreet.com> (last visited June 10, 2009) (requiring prompt disclosure of "any material information that would reasonably be expected to affect the value of [a listed company's] securities or influence investors' decisions").

*a. Item 5.02—Resignation or Removal of Director or Executive Officer*

Item 5.02 of Form 8-K requires disclosure when a director or certain officers have resigned or left the company, a situation that can arise when it is discovered that they have engaged in wrongdoing. Item 5.02(a)(1) requires disclosure when a director has “resigned or refuses to stand for re-election to the board of directors . . . because of a disagreement with the registrant, . . . on any matter relating to the registrant’s operations, policies or practices, or if a director has been removed for cause from the board of directors.”<sup>86</sup> Item 5.02(a)(1) also requires that in such a situation the registrant provide a “brief description of the circumstances representing the disagreement that the registrant believes caused, in whole or in part, the director’s resignation, refusal to stand for re-election or removal.”<sup>87</sup>

In a recent cease-and-desist administrative proceeding, the SEC found that Hewlett-Packard (“H-P”) violated the reporting requirements of the Exchange Act when the company disclosed the resignation of one of its directors without addressing the circumstances of his resignation.<sup>88</sup> The director had resigned because he objected to the way the company had presented to the board of directors the results of its investigation into boardroom leaks.<sup>89</sup> H-P had concluded that it was unnecessary to describe the circumstances of this board member’s resignation because he merely resigned due to a disagreement with the company’s chairman, and not because of a disagreement with the “registrant” or company on a matter relating to its “operations, policies or practices.”<sup>90</sup> The SEC disagreed, finding, among other things, that the board member’s disagreement regarding the handling of sensitive information constituted a disagreement over the company’s operations, policies, or practices.<sup>91</sup>

In contrast to H-P’s decision not to characterize the circumstances of its director’s resignation, a Form 8-K dated August 17, 2006, filed by Telos Corporation provided significant detail, including the following:

Mr. Baker, Mr. Sterrett and Mr. Byers also stated they were each resigning because of a disagreement with the Registrant on a matter relating to the Registrant’s operations, policies or practices, and required that the Registrant file a form 8-K with regard to their resignation and include a copy of their letter with the filing. The Registrant believes that the following circumstances may have represented the disagreements that might, in whole or in part, caused or contributed to the resignations of Mr. Baker, Mr. Sterrett, and Mr. Byers from the board of directors of the Registrant. The Registrant believes that they may have disagreed with the decision of Mr. David Borland to resign from the audit committee of the board of directors and as Chairman of the management development and compensation committee of the board of directors,

86. SEC Form 8-K, *supra* note 5, Item 5.02(a)(1).

87. *Id.*

88. *In re* Hewlett-Packard Co., Exchange Act Release No. 34-55801 (May 23, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55801.pdf>.

89. *Id.* at 3.

90. *Id.* at 4.

91. *Id.* at 4–5.

but to remain as a director and as a member of the management development and compensation committee. Mr. Borland's resignation from the audit committee of the board of directors and as the Chairman of the management development and compensation committee of the board of directors of the Registrant was disclosed on a filing on Form 8-K filed on August 21, 2006. The Registrant also believes that they may have disagreed with Mr. John R.C. Porter, the owner of a majority of the Registrant's Class A Common Stock, over the extent of any asset sale or other strategic transaction that the Registrant might conduct, over their rights and responsibilities to Mr. Porter as the owner of a majority of the Registrant's Class A Common Stock, and, in the case of Mr. Byers, with regard to his obligations as set forth in the proxy agreement.<sup>92</sup>

Telos also attached as exhibits to its Form 8-K the resignation letters of each of the directors, which spelled out differences with the company and with other board members.<sup>93</sup>

Item 5.02(b) sets forth similar disclosure requirements when the registrant's "principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer, retires, resigns or is terminated from that position."<sup>94</sup> Item 5.02(b) does not require the registrant to describe the reasons for a resignation or termination of an executive officer; however, the company may decide that it is better to address the reasons for the termination to avoid speculation that the circumstances are more egregious than they actually are<sup>95</sup> or because the reasons relate to circumstances previously addressed in a periodic filing or otherwise, such as the receipt of a Wells notice from the Enforcement Division of the SEC.<sup>96</sup>

#### *b. Item 4.02—Non-Reliance on Financial Statements*

In investigations involving financial reporting, a company may discover sufficiently significant financial statement errors that reliance on previously issued

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92. Telos Corp., Current Report (Form 8-K), at 1 (Aug. 17, 2006).

93. See *id.* exhs. 17.1–17.6. Many issuers now follow a practice of attaching to the Form 8-K copies of resignation letters from the board member in which the resigning board member recites that he or she is not resigning due to "any disagreement with the Company on any matter relating to the Company's operations, policies or practices." See, e.g., MMC Energy, Inc., Current Report (Form 8-K), Exh. 99-2 (June 2, 2006).

94. SEC Form 8-K, *supra* note 5, Item 5.02(b). Item 5.02(c) also requires that certain information be disclosed about the departing executive officer's successor. *Id.* (Item 5.02(c)).

95. For example, UCI Medical Affiliates, Inc., made the following disclosure about its departing principal financial officer:

On December 17, 2008, the Board of Directors of UCI Medical Affiliates, Inc. (the "Company") terminated, effective immediately, the employment of Jerry F. Wells, Jr. from all positions he currently holds with the Company and each of its subsidiaries, including Executive Vice-President of Finance, Chief Financial Officer, and Secretary, based upon the preliminary results of the Company's internal investigation of improper expense reimbursements to Mr. Wells.

UCI Med. Affiliates, Inc., Current Report (Form 8-K), at 1 (Dec. 18, 2008).

96. See, e.g., Shuffle Master, Inc., Current Report (Form 8-K), at 2 (Nov. 18, 2008). The report stated:



financial statements is called into question. Item 4.02 of Form 8-K requires disclosure if the company concludes that any previously issued financial statements covering one or more years or interim periods for which the registrant is required to provide financial statements should no longer be relied upon because of an error in such financial statements.<sup>97</sup> Under these circumstances, among other things, the registrant must provide “a brief description of the facts underlying the conclusion to the extent known to the registrant at the time of filing.”<sup>98</sup> Likewise, Item 4.02 requires a company to disclose if its independent auditor advises that “disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements.”<sup>99</sup>

*c. Item 4.01—Change in Certifying Accountant*

The resignation or dismissal of an issuer’s independent auditor generally triggers a disclosure obligation. Item 4.01 requires disclosure that the principal auditor of the company’s financial statements, or “an independent accountant upon whom the principal accountant expressed reliance in its report regarding a significant subsidiary, resigns (or indicates that it declines to stand for re-appointment after completion of the current audit) or is dismissed.”<sup>100</sup> This parting of the ways

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As a result of receiving [a] Wells Notice, the Company has required [one of its Senior Vice Presidents] to step down as an Executive Officer of the Company. He has been placed on administrative leave, with pay, pending the outcome of this SEC matter. During this period, [the Senior Vice President] will not be performing his duties as Senior Vice President, but will assist in work related to some matters that he was previously handling.

*Id.*

97. SEC Form 8-K, *supra* note 5, Item 4.02(a) (“Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review”).

98. *Id.* (Item 4.02(a)(2)). For an example, see Office Depot, Inc., Current Report (Form 8-K), at 2 (Nov. 9, 2007). The report stated:

On October 29, 2007, Office Depot announced that its Audit Committee initiated an independent review principally focused on the accounting for certain vendor program funds. The Audit Committee, with the assistance of independent legal counsel and forensic accountants, assessed the timing of recognition of certain vendor program arrangements. The investigation revealed errors in timing of vendor program recognition and included evidence that some individuals within the Company’s merchandising organization failed to provide Office Depot’s accounting staff with complete or accurate documentation of future purchase or performance conditions in certain vendor programs that would have otherwise required recognition of the related vendor funds to be deferred into future periods in accordance with the Company’s established practices.

As a result of the Audit Committee’s review and after discussion with the Company’s independent accountants, Deloitte & Touche LLP, on November 8, 2007, the Board of Directors of the Company approved a restatement of the Company’s 2006 financial statements including changes in amounts reported in the third and fourth quarters of the year and the first and second quarters of 2007 (collectively, the “Restated Periods”), and the Company will amend its Form 10-K for the fiscal year 2006 and its Form 10-Qs for the first and second quarters of 2007.

*Id.*

99. SEC Form 8-K, *supra* note 5, Item 4.02(b).

100. *Id.* (Item 4.01(a)) (“Changes in Registrant’s Certifying Accountant”).

may happen where an issuer and its auditor have a significant disagreement with respect to an accounting or reporting matter.<sup>101</sup>

*d. Item 1.01—Material Definitive Agreements*

If a government investigation concludes with a settlement, the terms of that settlement likely will require disclosure as a “material definitive agreement” under Item 1.01 of Form 8-K.<sup>102</sup> Item 1.01 requires disclosure of such agreements not made in the ordinary course of business and states that a “material definitive agreement” means:

[A]n agreement that provides for obligations that are material to and enforceable against the registrant, or rights that are material to the registrant and enforceable by the registrant against one or more other parties to the agreement, in each case whether or not subject to conditions.<sup>103</sup>

Of course, many SEC and DOJ settlements include terms that would fit this definition, such as undertakings to perform certain remedial measures, court-ordered injunctions, and administrative cease-and-desist orders enjoining the company indefinitely from violating whatever statute or regulation formed the basis for the investigation.<sup>104</sup> However, as discussed later, these agreements are not final until

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101. See, e.g., Reddy Ice Holdings, Inc., Current Report (Form 8-K), at 2 (Nov. 18, 2008). The report stated:

On November 12, 2008, the Company (x) dismissed Deloitte & Touche LLP (“Deloitte”) as its independent registered public accounting firm and (y) appointed PricewaterhouseCoopers LLP (“PwC”) to serve as the Company’s independent registered public accounting firm. The decision to dismiss Deloitte was recommended and approved by the Company’s board of directors.

... On March 5, 2008, the Company and certain of its employees, including members of its management, received grand jury subpoenas issued from the U.S. District Court for the Eastern District of Michigan seeking information in connection with an investigation by the Antitrust Division of the United States Department of Justice (“DOJ”) into possible antitrust violations in the packaged ice industry. On March 6, 2008, the Company’s Board of Directors formed a special committee of independent directors to conduct an internal investigation of these matters. As a result of the ongoing DOJ investigation and resulting Special Committee investigation, Deloitte has periodically requested, and the Special Committee has provided, limited information regarding the scope and findings of the investigation from the Special Committee in connection with Deloitte’s quarterly review procedures. The Special Committee’s investigation is ongoing and therefore Deloitte’s dismissal occurred prior to Deloitte receiving a full report on the scope and results of the investigation. Deloitte has indicated that it will therefore not be in a position to determine whether any additional information with respect to the DOJ and Special Committee investigations would materially impact previously issued audit reports or underlying financial statements or cause Deloitte to be unwilling to rely on Management’s representations or be associated with the Company’s financial statements. The Company has indicated to Deloitte that it will not be requested to issue a consent with respect to its prior audit reports in the future.

*Id.*

102. SEC Form 8-K, *supra* note 5, Item 1.01, Instruction 1 (“Entry into a Material Definitive Agreement”).

103. *Id.* (Item 1.01(2)(b)).

104. See, e.g., SEC v. Siemens AG, Litigation Release No. 20829 (Dec. 15, 2008), available at <http://www.sec.gov/litigation/litreleases/2008/lr20829.htm> (“SEC Files Settled Foreign Corrupt Practices Act Charges Against Siemens AG for Engaging in Worldwide Bribery with Total Disgorgement and Criminal

the Commission itself approves them,<sup>105</sup> companies must balance the need for disclosure of current information with sensitivity to disclosing prematurely agreements with the SEC staff.

*e. Item 8.01—Other Events*

Finally, Form 8-K provides a catch-all disclosure option under which the company *may* disclose any events, with respect to which information is not otherwise called for, that the company deems of importance to security holders.<sup>106</sup> Depending on how an investigation unfolds and the likelihood of the public learning about it through other means, notwithstanding the absence of an explicit requirement to make a disclosure, the company may choose to avail itself of this option rather than waiting until it files its next periodic report or until a specific triggering event requires disclosure.<sup>107</sup> This will frequently occur when a registrant wishes to inform the public that it has reached a resolution with the government.<sup>108</sup>

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Fines of over \$1.6 Billion”); Siemens AG, Report of Foreign Private Issuer (Form 6-K), at 2 (Dec. 15, 2008). If the agreement has not yet been reached but terms have been discussed that could have a material affect on the issuer’s financial statements or operations, the company may reasonably decide that filing a Form 8-K is not required, but merely update the “Legal Proceedings” section of its next periodic report. *See, e.g.*, T.D. Ameritrade Holding Corp., Quarterly Report (Form 10-Q), at 30 (Feb. 5, 2009) (“The SEC and other regulatory authorities are conducting investigations regarding the sale of ARS. TDA Inc. has received subpoenas and other requests for documents and information from the regulatory authorities. The Company is cooperating with the investigations and requests. The Company and regulatory authorities are in discussions regarding the possible resolution of the investigations with respect to TDA Inc., which could include the Company offering to purchase certain client ARS over time. As of February 2, 2009, the Company’s clients held ARS with an aggregate par value of approximately \$694 million in TDA Inc. accounts, including \$192 million custodied for clients of independent registered investment advisors.”).

105. 17 C.F.R. § 201.240(c)(7) (2009).

106. SEC Form 8-K, *supra* note 5, Item 8.01 (“Other Events”).

107. *See, e.g.*, Par Pharm. Cos., Inc., Current Report (Form 8-K), at 2 (Mar. 27, 2009) (disclosing, under Item 8.01, “Par Pharmaceutical Companies, Inc. recently learned that the United States Department of Justice is currently investigating . . . promotional practices in the sales and marketing of [one of our subsidiaries]. We were served with a subpoena by the Department of Justice for documents . . . and we intend to fully cooperate with the Department of Justice’s inquiry.”).

108. *See, e.g.*, Interpublic Group of Cos., Inc., Current Report (Form 8-K), at 2 (May 1, 2008). The report stated:

In May 2008, we reached a settlement with the SEC concluding the investigation that began in 2002 into our financial reporting practices. The SEC filed a complaint on May 1, 2008 in the United States District Court for the Southern District of New York charging Interpublic and our subsidiary McCann-Erickson Worldwide Inc., or McCann, with violations of the federal securities laws. The charges under the antifraud provisions of the federal securities laws relate to intercompany accounting practices at McCann that were addressed in our restatement of 1997 to 2002 results first announced in August 2002 and that were also the subject of a class action under the federal securities laws that we settled in 2004. The charges relating to violations of the disclosure, internal controls and books and records provisions of the federal securities laws also relate to the restatement we presented in our Annual Report on Form 10-K for the year ended December 31, 2004 and the restatement of the first three quarters of 2005 that we made in our 2005 Annual Report on Form 10-K, as well as the restatement we first announced in August 2002. Without admitting or denying the allegations, Interpublic and McCann agreed to an injunction against

## 5. Financial Statement Disclosures

Aside from the disclosures required in the nonfinancial portions of periodic filings or current reports, disclosure in the financial statements may also be required if the company or its auditors determine that a contingency reserve must be accrued. If an investigation becomes likely to result in a loss that can be reasonably estimated, then Statement of Financial Accounting Standards No. 5 (“FAS 5”)<sup>109</sup> may require the company to accrue a “loss contingency” and disclose the nature of the accrual in the footnotes to the company’s financial statements.<sup>110</sup> These steps may become necessary when a company is notified that the regulatory or prosecutorial agency has concluded its investigation and is prepared to file an action or wishes to engage in settlement discussions that are likely to result in payment of a fine or disgorgement of ill-gotten gains.<sup>111</sup>

### III. FORM AND CONTENT OF DISCLOSURE OF AN INVESTIGATION

Once a company has decided to disclose an investigation, the next question is what that disclosure should say. The answer depends on the facts and circumstances of the investigation, but the general principles and issues discussed below should be analyzed and ultimately drive that decision.

First, the disclosure should include enough information to minimize the need to supplement it in the near future. If disclosure is contemplated at the outset of an investigation, there will be several key pieces of information to evaluate before drafting it:

- The type of inquiry—Any disclosure decision should take into consideration whether the initial request by the government agency is pursuant to a subpoena or an informal request for information, and whether the subject matter of the investigation is the conduct of the company or the company is merely a source of information for an investigation into a third party;<sup>112</sup>
- The subject matter of the inquiry—The company must assess whether the investigation relates to historical or current activity, whether it relates to

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violating the applicable provisions of the federal securities laws, and McCann agreed to pay a \$12 million civil penalty and disgorgement of one dollar.

*Id.*

109. Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (Mar. 1975), available at <http://fasb.org/pdf/fas5.pdf>.

110. See KIRKPATRICK & LOCKHART PRESTON GATES ELLIS LLP, THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 162–63 (2d ed. 2007).

111. On June 5, 2008, the Financial Accounting Standards Board released a draft revised FAS 5, which would require substantially more disclosure with respect to, among other things, contingent losses. Press Release, Fin. Accounting Standards Bd., FASB Issues Exposure Draft on Disclosure of Certain Loss Contingencies (June 5, 2008), available at <http://www.fasb.org/jsp/FASB/Page/nr060508.shtml>.

112. See, e.g., SEC ENFORCEMENT MANUAL, *supra* note 15, § 2.3, at 13–23 (describing the various forms of inquiries and investigations that might be initiated by the staff of the SEC).

the conduct of a senior executive or director, and what other companies have disclosed, if anything, about the investigation;

- The status of the investigation—The company should determine how long the investigation has been pending, the extent to which information has already been provided to the regulatory or prosecutorial agency, whether the company needs additional time to understand the circumstances of the matter through an internal investigation, and whether the government is preparing to disclose publicly information itself, by, for example, filing a complaint or an indictment; and
- What (if anything) the company has already said—The company must analyze whether its prior public statements will be misleading if not updated.

Some examples illustrate how registrants have first disclosed the existence of an investigation by covering these points in their disclosures. In its 2002 Form 10-K, Hewlett-Packard disclosed that it had learned of the commencement of an informal SEC inquiry as follows:

HP was contacted informally by the San Francisco District Office of the Securities and Exchange Commission (“SEC”) in March 2002 requesting the voluntary provision of documents and related information concerning HP’s relationships and communications with Deutsche Bank and affiliated parties generally and communications regarding the solicitation of votes from Deutsche Bank and affiliated parties in connection with the Compaq acquisition. The SEC has advised HP that the inquiry should not be construed as an indication by the SEC or its staff that any violations of the law have occurred, nor should it be considered a reflection upon any person, entity or security. HP is fully cooperating with this inquiry.<sup>113</sup>

StarMedia Network disclosed in a November 19, 2001, Form 8-K that it had commenced an internal investigation as follows:

A Special Committee of the Company’s Board of Directors is conducting an investigation of accounting issues with respect to revenue recognition by two of the company’s Mexican subsidiaries, AdNet S.A. de C.V. (“AdNet”) and StarMedia Mexico, S.A. de C.V. The Special Committee has retained outside counsel to assist in the investigation, which has led the Company to a preliminary conclusion that revenues aggregating approximately \$10 million were improperly recognized by those subsidiaries during the period from October 1, 2000 through June 30, 2001.<sup>114</sup>

The same principles apply when a company updates a periodic disclosure of an investigation. In the following manner, Tyson Foods updated a prior 10-K disclosure of an SEC investigation when certain of its former employees received Wells notices:

On or about June 6, 2001, [Tyson subsidiary] IBP was advised the SEC had commenced a formal investigation related to the restatement of earnings made by IBP in

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113. Hewlett-Packard Co., Annual Report (Form 10-K), at 18 (Jan. 21, 2003).

114. StarMedia Network, Inc., Current Report (Form 8-K), at 2 (Nov. 19, 2001).

March 2001, including matters relating to certain improprieties in the financial statements of DFG, a wholly-owned subsidiary. The Company has been informed that three former employees of DFG received a so-called "Wells" notice advising them that the SEC had determined to recommend the initiation of an enforcement action and providing them an opportunity to provide their arguments against such an enforcement action. IBP is cooperating with this investigation.<sup>115</sup>

*Second*, the disclosure should avoid predicting the outcome of the investigation. Nothing is gained by making an assessment as to the merits or outcome of the investigation, particularly since a prediction that is wrong can be a disastrous precursor to private litigation or the basis for a regulatory action.<sup>116</sup> In all events, it will raise the ire of the regulatory or prosecutorial agency conducting the investigation. Xerox Corporation carefully disclosed the following both to update its disclosure and emphasize the uncertainty of the outcome:

In 2000, the Company was advised that the Division of Enforcement of the Securities and Exchange Commission (SEC) had entered an order of a formal, non-public investigation into our accounting and financial reporting practices. The investigation initially focused on accounting and financial reporting practices in Mexico. Subsequent SEC inquiries have included certain of our accounting policies and procedures and the application thereof referred to in Note 2. We are cooperating fully with the SEC. Among ongoing SEC matters, the Company is also engaged in a review with the SEC's Division of Corporation Finance and its Office of the Chief Accountant concerning the Company's method of accounting for sales-type leases under the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 13 ("SFAS No. 13"). The review concerns whether the Company's method of applying SFAS No. 13 results in an appropriate allocation of revenue among the various elements of its sales-type leases; equipment, financing, service and supplies. The Company be-

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115. Tyson Foods, Inc., Annual Report (Form 10-K), at 13–14 (Nov. 27, 2002). Previously, Tyson Foods had disclosed:

On or about June 6, 2001, IBP was advised the SEC has commenced a formal investigation of IBP related to the restatement of earnings made by IBP in March 2001. The investigation appears to relate primarily to certain improprieties in the financial statements of its DFG subsidiary which resulted in [a] restatement.

Tyson Foods, Inc., Annual Report (Form 10-K), at 15 (Dec. 21, 2001).

116. *See, e.g.*, Black Box Corp., Current Report (Form 8-K), Exh. 99.1, at 3 (Oct. 28, 2008) ("Although it is not possible to predict or identify all risk factors, they may include the timing and final outcome of the ongoing review of the Company's stock option practices, including the related Securities and Exchange Commission ('SEC') investigation . . ."); Whitney Info. Network, Inc., Annual Report (Form 10-K), at 9 (Jan. 15, 2009) (noting that "certain government agencies are conducting inquiries regarding us, including the Department of Justice ('DOJ') and the SEC. . . . While we continue in our efforts to cooperate with the government investigations, we cannot predict the duration or the outcome of the investigation, and the investigations may expand, and other regulatory agencies may become involved. The outcome and costs associated with these investigations could have a material adverse effect on our business, financial condition, or results of operations, and the investigations could result in adverse publicity and divert the efforts and attention of our management team from our ordinary business operations. The government investigations and any related legal and administrative proceedings could also include the institution of administrative, civil injunctive or criminal proceedings against us and/or our current or former officers or employees, the imposition of fines and penalties, suspensions and/or other remedies and sanctions.").

lieves both the methodology and the financial results it reports are in accordance with SFAS No. 13 and GAAP. The Company cannot predict when the SEC will conclude either its investigation or its review or the outcome or impact of either.<sup>117</sup>

*Third*, if an SEC investigation is at the stage where a resolution is close, one must appreciate the distinction between the authority of the SEC staff and that of the Commission. Only the Commission, by vote, can authorize a settlement that includes the filing of a court or administrative order.<sup>118</sup> Although a company may be anxious to disclose that it has reached with the SEC staff an agreement “in principle” to settle a matter, the Commission may be displeased by such a disclosure prior to having had the opportunity to weigh in on the agreement’s terms.<sup>119</sup> Former Commissioner Paul Atkins was particularly vocal on this subject, expressing that when the SEC Enforcement staff agrees to recommend to the Commission that it approve a settlement, there are many more steps before the Commission agrees to that recommendation, and an agreement with the staff is not necessarily an event that must be reported to shareholders.<sup>120</sup> Atkins stated, “It has become a common occurrence lately that I see public companies disclosing an agreement, or settlement, ‘in principle’ with the SEC. I can’t tell you how frustrated this makes me. . . . I can assure you that the next step in the process is not a rubber stamp approval by the Commission.”<sup>121</sup> Moreover, Atkins has stated that such premature disclosure may be grounds for a separate violation of the securities laws:

When public companies determine that disclosure of a “settlement in principle” with the SEC is appropriate, and when they then make such a disclosure, they assume a risk. There is the possibility that the statement will, in hindsight, appear inaccurate or misleading if the Commission disapproves or requires a material modification of the terms of the settlement. The trouble is that the public does not typically understand the nuances, and the press does not always sufficiently convey them. Thus, the disclosure that is disseminated to the public can be materially misleading.<sup>122</sup>

Such disclosures were commonplace before Atkins’s public expression of exasperation.<sup>123</sup> Tyson Foods initially announced terms of a settlement with the Enforcement staff, only to have to issue a new disclosure after the Commission rejected the proposed settlement as containing an insufficient penalty against the

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117. Xerox Corp., Quarterly Report (Form 10-Q), at 17 (Nov. 13, 2001).

118. See 17 C.F.R. § 201.240(c)(7) (2009).

119. See Atkins, *supra* note 10.

120. *Id.*

121. *Id.*

122. *Id.*

123. See, e.g., AmeriQuest Techs., Inc., Current Report (Form 8-K), at 2 (Oct. 25, 2005) (“AmeriQuest Technologies, Inc. (AMQT.pk) today announced that it had executed an agreement in principle with the Division of Enforcement of the Securities and Exchange Commission whereby AmeriQuest will consent to the entry of an order revoking the registration of each class of its securities registered under section 12 of the Securities Exchange Act of 1934 pursuant to Exchange Act section 12(j).”); TALX Corp., Current Report (Form 8-K), at 2 (Aug. 13, 2004) (“On August 12, 2004, TALX Corporation (the ‘Company’) issued a press release announcing that it had reached an agreement in principle with the staff of the U.S. Securities and Exchange Commission to settle its ongoing investigation of

company's former Chairman, Don Tyson.<sup>124</sup> In its first quarter 10-Q for 2005, the company announced:

In December 2004, following discussions with the staff regarding resolution of this matter, the Company proposed that the Company, without admitting or denying wrongdoing, would pay a civil penalty of \$1.5 million and consent to the entry of an administrative cease and desist order, and that Don Tyson proposed that he, also without admitting or denying wrongdoing, would pay a civil penalty of \$200,000 and consent to the entry of an administrative cease and desist order. These settlement proposals are subject to mutual agreement on the language of the order. The SEC staff has agreed to recommend both of these offers of settlement to the SEC. The proposed settlements and the proposed order are subject to final approval by the SEC.<sup>125</sup>

The Commission rejected the settlement and demanded an additional \$500,000 penalty from Mr. Tyson, leading the company to issue this disclosure:

As previously reported, Tyson Foods had offered to pay the SEC a civil penalty of \$1.5 million while Mr. Tyson had proposed to pay a civil penalty of \$200,000. The SEC has accepted the company's offer and, after further negotiations, has agreed to accept a penalty of \$700,000 from Mr. Tyson.<sup>126</sup>

It may become necessary to disclose the nature of an agreement reached with the SEC staff if the company decides to accrue a reserve to cover any monetary component of the penalty.<sup>127</sup> While there is a risk that an offer of settlement to

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the Company's accounting of certain items, which was the subject of the Company's restatements of its 2001 and 2002 financial statements."); Knight Trading Group, Inc., Current Report (Form 8-K), Exh. 99.1 (July 7, 2004) (Knight Trading Group press release) ("Knight Trading Group, Inc. (Nasdaq: NITE) today announced that its wholly owned subsidiary, Knight Securities, L.P. (KSLP) had reached an agreement in principle with the staffs of the U.S. Securities and Exchange Commission (SEC) and NASD to settle investigations in connection with specific institutional trade activity, conduct and supervision that occurred in 1999 and 2001; and books and records, document production and record-keeping deficiencies. The agreement in principle is subject to the drafting of settlement papers and final approval by the SEC and NASD."); Virbac Corp., Current Report (Form 8-K), Exh. 99.1 (Aug. 31, 2005) (Virbac Press Release) ("Virbac expects that these elevated expenses will subside substantially in the second half of 2005, as the Company has completed the restatement of its historical financial statements and reached a settlement agreement in principle with both the SEC in regards to their investigation and the plaintiffs in the shareholder class action lawsuit.").

124. See Tyson Foods, Inc., Current Report (Form 8-K), Exh. 99.1 (May 3, 2005) (Tyson press release).

125. Tyson Foods, Inc., Quarterly Report (Form 10-Q), at 41 (Feb. 9, 2005).

126. Tyson Foods, Inc., Current Report (Form 8-K), Exh. 99.1 (May 3, 2005) (Tyson press release).

127. See, e.g., Diagnostic Prods. Corp., Annual Report (Form 10-K), at 50 (Mar. 16, 2005) ("During the year ended December 31, 2004, the Company recorded fourth quarter amounts of \$2.4 million . . . to reflect a tentative settlement reached with the Department of Justice and the Securities and Exchange Commission regarding the Company's Chinese subsidiary . . ."); Scientific-Atlanta, Inc., Current Report (Form 8-K), Exh. 99.1 (July 25, 2005) (Scientific-Atlanta press release) ("Scientific-Atlanta previously reported on investigations by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) concerning the company's 2000 and 2001 marketing support agreements with Adelpia and Charter and the manner in which Adelpia and Charter accounted for these transactions. The company recorded a \$20.0 million reserve in the fourth quarter based on discussions with the staff of the SEC regarding a tentative settlement of its investigation. This reserve had a \$20.0 million pre-tax and after-tax impact on earnings. Scientific-Atlanta continues to cooperate with the DOJ with respect to its investigation.").



the SEC staff will be rejected by the Commission, the best practice with respect to disclosure of such an offer is to be clear that offers of settlement to the staff are not agreements (or even tentative agreements) with the SEC itself.<sup>128</sup>

#### IV. CONSIDERING THE CONSEQUENCES OF DISCLOSURE

While not determinative of whether the disclosure threshold has been reached, companies must nevertheless be mindful of some of the consequences of making a disclosure, and of the contents of any disclosure. To some degree, these consequences are inevitable, but companies are well advised to prepare for and manage them to the extent possible. Some of the possible consequences are the following:

- The market, including shareholders and analysts, often will react (and sometimes overreact) to disclosure of material information coming out of an investigation.<sup>129</sup> For example, when Intel Corporation announced that the Federal Trade Commission had opened a formal antitrust investigation on June 7, 2008, its stock price dropped 4.1 percent.<sup>130</sup>
- Depending on the nature of the disclosure, the company and its officers and directors may be named as defendants in private securities litigation.<sup>131</sup>
- An issuer's relationships with customers, suppliers, creditors, and business partners may be affected. These effects may range from questions to the termination of a relationship. Those charged with managing those relationships should receive instruction on how to address the subjects disclosed with those entities.

128. See, e.g., Raytheon Co., Current Report (Form 8-K), Exh. 99.1 (Apr. 15, 2005) (Raytheon Press Release) ("Raytheon Company (NYSE: RTN) today announced that it has submitted an offer of settlement to the staff of the Securities and Exchange Commission ('SEC'), which the staff has agreed to recommend to the SEC, to resolve a pending, previously-disclosed investigation into the Company's disclosures and accounting practices, primarily related to its Raytheon Aircraft Company ('RAC') commuter aircraft business, during the period from 1997 to 2001. Following discussions with the SEC staff, the Company made an offer of settlement to the SEC staff in order to resolve this matter. The Company, without admitting or denying any wrongdoing, offered to pay a civil penalty of \$12 million and consent to the entry of a cease and desist order with respect to violations of Sections 17(a)(2)–(3) of the Securities Act of 1933 and Sections 13(a) and 13(b)(2)(A)–(B) of the Securities Exchange Act of 1934, and related SEC rules. The SEC staff has agreed to recommend that the SEC approve the offer of settlement. The proposed settlement is subject to approval by the SEC."). See also *supra* note 127 (describing disclosures by Diagnostic Products and Scientific-Atlanta).

129. See Greenberg, *supra* note 9, at B3.

130. See Rob Curran, *AIG, Lehman Brothers, Best Buy Drop—Oil Surge, Jobs Data Deal Blow to Retail and Finance Stocks*, WALL ST. J., June 7, 2008, at B3; see also *Gallagher v. Abbott Labs.*, 269 F.3d 806, 807–08 (7th Cir. 2001) (noting that Abbott's stock price dropped more than 6 percent when it disclosed that it was in substantial compliance with FDA regulations but that the FDA was seeking substantial penalties resulting from an investigation into Abbott's business practices, and that the parties were engaged in settlement discussions).

131. See, e.g., *In re Greenman Sec. Litig.*, 94 F.R.D. 273, 275 (S.D. Fla. 1982) (noting that government investigations had spawned twenty-four individual investor suits); *Mallozzi v. Zoll Med. Corp.*, No. 94-11579-NG, 1996 WL 392146, at \*4–5 (D. Mass. Mar. 5, 1996) (denying motion to dismiss a securities fraud claim where defendants disclosed an FDA warning letter, but failed to disclose, among other things, the scope of the FDA investigation).

- Employees, even those whose conduct is not relevant to the investigation, are likely to be concerned, and morale may suffer. Management should take steps to communicate with employees and provide opportunities for them to receive current information.
- Issuers should consider giving the appropriate government staff a preview of any proposed disclosure. The SEC staff or DOJ prosecutors will not advise issuers about what to say, but they will frequently be willing to tell an issuer that a particular sentence or topic causes them some concern.

## V. CONCLUSION

Disclosure decisions related to government investigations are layered with judgments made against the backdrop of general principles for which little interpretive guidance has been issued by courts or the SEC. Even the fairly specific disclosure requirements delineated by Form 8-K are subject to interpretation, as illustrated by the Hewlett-Packard case. It is only with careful analysis of the potentially disclosable event and thorough consideration of the range of consequences of disclosing a government investigation that counsel can appropriately exercise the judgment necessary to reach the right decision about whether and how to disclose the investigation. Even then, deciding exactly what to disclose will be driven by balancing the desire to communicate enough to make the disclosure complete with the need to restrain the registrant from making statements about what is believed to be likely rather than what is actually known about the investigation.