Third Circuit Clarifies Requirements Applicable to Risk Factor Disclosures in Merger Proxies

Securities transactions are subject to a three-tier system of enforcement: oversight by Congress, supervision by regulators such as the Securities and Exchange Commission ("SEC"), and pursuit of private causes of action by private plaintiffs and their attorneys. *Jaroslawicz* v. *M&T Bank Corp.*, 2020 WL 3278679, at *1 (3d Cir. June 18, 2020). On June 18, 2020, the United States Court of Appeals for the Third Circuit issued a decision concerning the third of these tiers and vacated the dismissal of a securities fraud claim brought pursuant to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a). The Court focused its analysis on Item 105 of SEC Regulation S-K relating to risk factors and held that Item 105 disclosures must be specific, in plain English, and framed in the context of the disclosing entity's industry or business; mere boilerplate and generic discussions do not suffice. *Id.* at *9.

The Court reversed a dismissal of claims based on alleged material omissions and affirmed dismissal of claims based on allegedly misleading statements of opinion in a proxy statement/prospectus filed on Form S-4. In so doing, the Court also took the opportunity to "reiterate the longstanding limitations on securities fraud actions that insulate issuers from second-guesses, hindsight clarity, and a regime of total disclosure." *Id.* at *1.

I. Background

On August 27, 2012, Hudson City Bancorp Inc. ("Hudson") and M&T Bank Corp. ("M&T") executed a merger agreement, pursuant to which M&T would acquire Hudson. *Jaroslawicz* v. *M&T Bank Corp.*, 2020 WL 3278679 (3d Cir. June 18, 2020). The merger agreement required approval by the shareholders of both banks. To provide the required notice, Hudson and M&T issued a joint proxy statement/prospectus (the "proxy") and filed a single registration statement on Form S-4 in accordance with SEC rules, which was required to include the information called for by Item 503[1] of Regulation S-K.

On April 12, 2013, M&T issued a press release announcing that the Federal Reserve had raised "concerns" about "M&T's procedures, systems and processes relating to M&T's Bank Secrecy Act and anti-money-laundering compliance program" ("BSA/AML compliance"). *Id.* at 674. M&T explained that, to address these concerns, "the timeframe for closing the transaction will be extended substantially beyond the date previously expected." *Id.* As a result, M&T and Hudson amended their merger agreement and moved the closing out several months. *Id.* The shareholder votes, however, remained as scheduled and resulted in approval of the merger by both sets of shareholders. *Id.*

Over a year later, on October 9, 2014, the Consumer Financial Protection Bureau ("CFPB") announced that it had taken action against M&T for allegedly violating consumer disclosure laws by offering free checking accounts but then switching customers to accounts which carried fees (the "Consumer Violations"). *Id.* A year after that, on September 30, 2015, the Federal Reserve approved the merger. *Id.*

Following the merger, former stockholders of Hudson brought suit in the United States District Court for the District of Delaware, arguing that the two companies violated Section 14(a) by omitting from the proxy significant risk factors required under Item 105 and making misleading statements of opinion in the proxy. *Jaroslawicz*, 296 F. Supp. 3d. at 677. The plaintiffs argued that Hudson and M&T violated Item 105 by not disclosing that "the Merger would be delayed or denied (or that M&T would suffer sanctions) due to the Consumer Violations, and the substantial deficiencies in BSA/AML compliance." *Id.* Further, the complaint alleged that the

1 Item 503 has been recodified as Item 105. *See Jaroslawicz* v. *M&T Bank Corp.*, 2020 WL 3278679, at *1 (3d Cir. June 18, 2020).

proxy was materially misleading or incomplete when it stated that: (1) M&T had "approved policies and procedures that are believed to be compliant with the USA Patriot Act" (the "compliance opinion"); and (2) Defendants "currently believe we should be able to obtain all required regulatory approvals" and complete the merger "in a timely manner" (the "timing opinion"). *Id.* at 678.

The district court stated that Item 105 requires the proxy to provide under the caption "risk factors" only a "concise discussion" of "the most significant factors that make the offering speculative or risky." *Id.* The Court commented that "it is undisputable that there can be no omission where the allegedly omitted facts are disclosed" (*id.*) and found that the following excerpt from M&T Bank's proxy met such a standard:

> "M&T is subject to operational risk, which represents the risk of loss resulting from human error, inadequate or failed internal processes and systems, and external events. Operational risk also encompasses reputational risk and compliance and legal risk, which is the risk of loss from violations of, or noncompliance with, laws, rules, regulations, prescribed practices or ethical standards, as well as the risk of noncompliance with contractual and other obligations. . . . Although M&T seeks to mitigate operational risk through a system of internal controls which are reviewed and updated, no system of controls, however well designed and maintained, is infallible. Control weaknesses or failures or other operational risks could result in charges, increased operational costs, harm to M&T's reputation or foregone business opportunities."

Id. at 677-78.

Although the district court highlighted that there was no discussion in the proxy of risks related to the CFPB or the Consumer Violations, the Court found that "[t]o be actionable, a statement or omission must have been misleading at the time it was made; liability cannot be imposed on the basis of subsequent events" and that "[p]laintiffs have not plausibly alleged that either [the CFPB action or the Consumer Violations] posed a significant risk at the time the Proxy issued." *Id.* at 678.

The district court also rejected the allegedly false opinion claims consistent with *Omnicare, Inc.* v. *Laborers Dist. Council Const. Indus. Pension Fund*, 575 U.S. 175, 178 (2015). The Court commented that, instead of pleading particular facts about the compliance opinion as required by *Omnicare*, the complaint pleads hypotheticals like "[h]ad any of the defendants at that time performed adequate due diligence, they would have discovered. . . that M&T's 'Know Your Customer' obligations . . . were non-compliant." *Id.* at 679. Regarding the timing opinion, the Court observed, "[t]aking context into account, no reasonable investor would have been misled by the timing opinion. Plaintiffs cherry-picked the phrase 'timely manner' out of a caveat about timing: '*Although* we currently believe we should be able to obtain all required regulatory approvals in a timely manner, *we cannot be certain when or if we will obtain them....*'" *Id.* at 680.

The district court allowed the plaintiffs to amend the pleadings, but the plaintiffs asked for a final order of dismissal with prejudice to file an appeal. *Jaroslawicz*, 2020 WL 3278679, at *3. The Court granted the plaintiffs' request, and the appeal followed.

II. The Third Circuit Clarifies the Requirements of Item 105

The Third Circuit found that plaintiffs' complaint plausibly alleged that the anti-money-laundering deficiencies and consumer checking practices were known to M&T, and posed significant risks to the merger, before issuance of the proxy. *Jaroslawicz*, 2020 WL 3278679, at *5. The Court commented, "[i]n short, while Item 105 seeks a 'concise' discussion, free of generic and generally applicable risks, it requires more than a short and cursory

overview and instead asks for a full discussion of the relevant factors. That, as we will see, is where the Joint Proxy fell, in a word, short." *Id.* at *7.

The Third Circuit began its discussion of Item 105 by highlighting guidance from the SEC and other circuits that it found illuminating. *Id.* at *5. In the SEC's Legal Bulletin on the subject, under the section titled "Risk Factor Guidance," the SEC explains that "issuers should ***not*** present risks that could apply to any issuer or any offering." *Id.* at *5 (citing SEC Division of Corporation Finance: Updated Staff Legal Bulletin No. 7, "Plain English Disclosure," Release No. SLB-7, 1999 WL 34984247, *1 (June 7, 1999) ("Legal Bulletin No. 7") (emphasis added). The SEC guidance continues that Item 105 risk factors fall into three broad categories: (i) industry risks, which companies face by virtue of the industry in which they operate; (ii) company risks, which are specific to the company; and (iii) investment risks, which are specifically tied to the security that is the subject of the disclosure document. SEC Legal Bulletin No. 7, 1999 WL 34984247, at *5-6. "When drafting risk factors, [companies must] be sure to specifically link each risk to [the] industry, company, or investment, as applicable." *Id.*

The Third Circuit discussed two cases from other courts of appeal that it found instructive concerning the scope of adequate disclosures under Item 105. In *Silverstrand Investments* v. *AMAG Pharmaceuticals, Inc.*, the Court of Appeals for the First Circuit found that plaintiffs plausibly alleged inadequate disclosures under Item 105, where a pharmaceutical company's offering documents failed to mention almost two dozen "Serious Adverse Events" that it had reported to the Food and Drug Administration ("FDA") in clinical trials of its drug. 707 F.3d 95, 98-99 (1st Cir. 2013). The First Circuit held that "a complaint alleging omissions of Item [105] risks needs to allege sufficient facts to infer that a registrant knew, as of the time of an offering, that ... a risk factor existed." *Id.* at 103. Given the many adverse reports the company submitted to the FDA, the Court concluded the allegations "more than suffice" to plead a plausible claim of undisclosed risk. *Id.* at 104.

In *City of Pontiac Policemen's and Firemen's Retirement System* v. *UBS AG*, the Court of Appeals for the Second Circuit found that plaintiffs' allegations did not plausibly allege inadequate disclosures under Item 105, where the company disclosed "multiple legal proceedings and government investigations" showing exposure "to substantial monetary damages and legal defense costs," along with "criminal and civil penalties, and the potential for regulatory restrictions." 752 F.3d 173, 183–84 (2d Cir. 2014). The Second Circuit found that "disclosure is not a rite of confession, and companies do not have a duty to disclose uncharged, unadjudicated wrongdoing." *Id.* at 184 (internal quotation marks and footnote omitted). By disclosing the possible problems that could flow from the multiple investigations, UBS was found to have complied with Item 105. *Id.* The Third Circuit observed that these two decisions could be reconciled, as each reflected the text of Item 105: the issuer in *Silverstrand* allegedly knew that the FDA would scrutinize the reported effects of its products—an obvious risk to their business—so failing to disclose that risk factor was enough to state a claim, whereas the issuer in *City of Pontiac* sufficiently disclosed the existence of "multiple legal proceedings," making the imposition of further disclosure obligations tantamount to creating an obligation grounded in guesswork. 2020 WL 3278679, at *7.

The Third Circuit in *Jaroslawicz* applied these decisions to find that "shortcomings in M&T's proxy become clear." *Id.* at *8. Starting with the alleged compliance omission, the Court highlighted that M&T knew that the state of its compliance program would be subject to extensive review from federal regulators and that failure to pass regulatory scrutiny could sink the merger. *Id.* at *8. The Court observed that this knowledge alone makes it clear that M&T had a duty to disclose more than generic information about the impending regulatory scrutiny. *Id.*

Because in "*every case* under the Bank Merger Act" the "[Federal Reserve] Board must take into consideration. . . records of compliance with anti-money-laundering laws," M&T's generic disclosures essentially only state that obvious regulatory hoops stood between the proposed merger and a final deal, but failed to disclose "just how treacherous jumping through those hoops would be." *Id.* "M&T offered information generally applicable

to nearly any entity operating in a regulated environment. In fact, M&T said that: '[l]ike all businesses,' it was subject to regulatory risk. Contrary to Item 105's directive, M&T's explanation of the regulatory review process offered no details and no more than '[g]eneric or boilerplate discussions [that] do not [explain] . . . the risks.'" *Id.* at *9 (internal citations omitted). The Court observed that "M&T should have 'specifically link[ed]' its general statements to 'each risk to [its] industry, company, or investment' using details that connected the pending merger review to its existing and anticipated business lines." *Id.* (citing Legal Bulletin No. 7 at *6).

The Third Circuit similarly held that M&T's disclosure about the problems surrounding its consumer checking practice were deficient under Item 105. *Id.* The Court stated that it is reasonable to infer that "the consumer checking practices cast doubt on M&T's controls and compliance systems, and posed an independent regulatory risk to the merger material enough that a reasonable shareholder would consider it important in deciding how to vote." *Id.* While not "hold[ing] that the regulatory enforcement actions by themselves required M&T to disclose these issues," M&T had an obligation to disclose because "M&T knew the regulators would be looking into its compliance program, and specifically its BSA/AML effectiveness. They said so themselves. And they knew the failure to obtain regulatory approval would be significant, possibly fatal, to the merger. Yet, . . . M&T offered little more than generic statements about the process of regulatory review." *Id.* at *10.

Regarding the misleading opinion claims, the Court agreed with the district court's dismissal. The Court stated that, "'to avoid exposure for admissions,' a speaker 'need only divulge an opinion's basis, or else make clear the real tentativeness of its belief.' Thus, even if a reasonable investor would have expected the banks to conduct diligence over a longer period, the Joint Proxy provided enough information to understand what the banks did, information enough to decide how to vote." *Id.* at *11 (citing *Omnicare*, 575 U.S. at 195). The Court observed that "the opinions flowed from the Joint Proxy's description of the increased scrutiny across the industry. Cautionary language surrounds the opinions, warning of the uncertainty of projections about regulatory approval. Under *Omnicare*, these opinions inform, rather than mislead, a reasonable investor." *Id.* at *11.

III. Implications

The Third Circuit's decision in *Jaroslawicz* clarifies that Item 105 requires more than mere boilerplate or generally applicable language to describe risk factors. In reaching this conclusion, the court cited to written SEC Legal Bulletins as providing support that the risk factors must each be "specifically link[ed]" to the particular industry, company, or investment being discussed. Companies drafting disclosures post-*Jaroslawicz* should ensure that their practices conform with the SEC's written guidance as articulated by the Third Circuit, as failure to fully discuss the relevant risk factors could result in a court finding—in the words of the Third Circuit—that the disclosures "fell short." This appears to be the case where, as in *Jaroslawicz*, the company possesses sufficient knowledge that a regulatory investigation is likely.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Peter J. Linken at 212.701.3715 or plinken@cahill.com; or G. Kevin Judy II at 212.701.3499 or kjudy@cahill.com; or email publications@cahill.com.

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