Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Look Before You Leap Into A Securities Litigation Trap

Law360, New York (October 31, 2012, 11:18 AM ET) -- The possibility of expiring tax cuts combined with mandatory reductions in federal spending at year end have prompted observers to warn that the U.S. faces a “fiscal cliff” over which the economy might well plunge into another recession. If Congress fails to reach an agreement that avoids the cliff, corporations could see recent stock price improvements wiped out, and plaintiffs’ lawyers are sure to bring shareholder claims alleging that companies did not adequately disclose or otherwise account for this risk.

Absent congressional intervention, automatic tax and spending cuts taking effect in late 2012 and early 2013 are expected to cut the federal budget deficit by $607 billion, or approximately 4 percent of Gross Domestic Product between FY 2012 and FY 2013.

First, the so-called “Bush era” tax cuts are scheduled to expire on Dec. 31, 2012, raising all income tax rates, with the top rate climbing from 35 percent to 39.6 percent. In addition, rates on estate and capital gains taxes are scheduled to rise. Also, millions more taxpayers will be subject to the alternative minimum tax. The Social Security payroll tax holiday will also expire at year end, hiking that rate from 4.2 percent to 6.2 percent.

Second, big spending cuts are on the horizon. The Budget Control Act of 2011, or “sequestration,” will kick in on Jan. 2, 2013, because a congressional budget “supercommittee” failed to agree on a deficit reduction plan. The Budget Control Act mandates annual cuts of $109 billion per year from 2013 to 2021, with half coming from the national defense budget (approximately 70 percent of mandatory spending is exempt). Eligibility for federal unemployment benefits, last extended in February 2012, will expire. And the federal government will cut the rates at which Medicare pays physicians by nearly 30 percent on Dec. 31, 2012.

Finally, the federal government may hit the debt limit sometime in early 2013, which could further alarm investors and raise the government’s borrowing costs.

The Congressional Budget Office has warned that a $607 billion budget contraction would likely result in another recession in the first half of 2013. Other observers have noted that the consequences of a fiscal cliff scenario would not be limited to the U.S., but would be felt around the world.

While it remains possible that Congress will take action to steer the government away from the cliff, the uncertainty about whether and when such action will be taken is already prompting some companies to take precautionary business measures. A third quarter survey published by the Business Roundtable reported that more CEOs now expect their firms to cut jobs rather than add them in the next six months; and fewer CEOs expect sales and capital investment to increase in the near future than in June.

Similarly, increasing numbers of investors are reportedly using options trading, including put contracts, to hedge the risks of a downturn, which could add to volatility in the market. The implications of these trends have broad ramifications for companies in many sectors, including health care and life sciences, defense, capital equipment and consumer goods.

Minimizing the Likelihood of Cliff-Related Lawsuits

Public companies can be sure that plaintiffs' lawyers will be on the lookout for targets of "stock drop" securities fraud class action litigation in this climate. Companies that experience unexpected earnings slowdowns prompted by uncertainty between now and the New Year, as well as companies adversely affected if the fiscal cliff is not avoided, are at risk. Plaintiffs' securities lawyers are likely to characterize such stock price declines as the result of a company's misrepresentation with respect to, or failure to adequately disclose, these risks.

However, the securities laws are not without protection for companies that assess these risks and disclose them if they are material. The Private Securities Litigation Reform Act of 1995 includes a "safe harbor" for forward-looking statements accompanied by meaningful cautionary language. A common law principle called the "bespeaks caution" doctrine also provides similar protection. As a result, a company that warns with sufficient detail that its forecasts are subject to uncertainty because of fiscal cliff events may both discourage litigation before it starts and have a better chance of prevailing should it be targeted nonetheless.

In order to take advantage of these protective principles, companies should pay particular attention to three aspects of their public disclosure:

- Earnings Guidance — In the case of earnings releases, analyst conference calls and forward-looking earnings guidance, companies should reflect potential cliff-related business and financial risks in their oral and written public statements. A review of prior public statements should be undertaken to determine whether there is a need to correct earlier disclosures in light of new developments. In certain cases, companies may need to consider revising prior earnings guidance or "pre-releasing" results outside of the normal quarterly reporting cycle either due to a legal obligation to correct prior statements or a desire to avoid last-minute earnings surprises for the analyst community. Finally, discussions with investors or analysts of the company-specific impact of cliff-related issues should be carefully conducted in order to avoid selective disclosure of material nonpublic information, particularly information that affects previously published guidance, in violation of Regulation FD.

- Risk Factor Disclosures — Because many of the developments that underlie cliff-related concerns have occurred during the past six months, it is likely that published Form 10-K and 10-Q risk factor disclosures covering earlier periods need to be updated to reflect material changes that have occurred in the intervening periods. For companies that restate all risk factor disclosures in each quarterly Form 10-Q, as well as for issuers with a Sept. 30 year end, this should occur in the ordinary course of preparing their next 1934 Act filings; and in the case of companies who follow a practice of incorporating risk factors by reference from their most recent Form 10-K, the updating process may result in adding new risk factor disclosures to their September quarter Form 10-Q. In each case, however, companies will obtain the maximum benefit from their risk factor disclosures by going beyond boilerplate language to describe with specificity the risks that the fiscal cliff poses for their particular business. Also, companies should make sure that they revise their standard forward-looking information disclaimers in press releases, investor presentations, etc., to conform to any revised risk factor disclosures.

- Management's Discussion and Analysis of Results of Operations and Financial Condition — Companies should consider the implications of the fiscal cliff in addressing the Form 10-K and Form 10-Q MD&A requirement to discuss known trends and uncertainties that are reasonably likely to affect the company's financial results in a material way, even if these factors are prospective in nature and did not impact the historical periods being reported upon. Although the most immediate effect of cliff-related issues is likely to be on the revenue line of the income statement, companies should also take into account any defensive cost-related actions they may take in response to weak revenues, including headcount reductions, lowering capital expenditures, exiting lines of business, etc. MD&A disclosure should be coordinated with risk factor disclosure included elsewhere in the filing.

As noted, generic disclosure of cliff-related risks may not be sufficient to ward off or to successfully defend a shareholder lawsuit. Instead, companies should make substantive and meaningful disclosures tailored to the cliff-related risks they face and the potential impact of such risks on their operations.

For example, companies in the defense industry should consider the possible effects of sequestration on particular programs in which they are involved or on which they are bidding and assess the materiality of those programs to future results. Health care companies have a unique challenge in factoring fiscal cliff issues on top of the implications of the phase-in of the Affordable Care Act. And technology companies, who may not be dependent upon federal government revenues, nevertheless should anticipate the potential effects of cutbacks in spending for capital equipment among their customers in response to the fiscal cliff and disclose with particularity any market segments that may be adversely affected.

Regardless of industry, it is important that public companies assess their exposure to the fiscal cliff and, if it is deemed to be a material risk, factor in relevant trends and uncertainties in a meaningful way for the current quarterly reporting season.

--By Michael R. Dube, Michael T. Gass and William B. Asher Jr., Choate Hall & Stewart LLP

Michael Dube is a partner in the securities litigation & corporate governance group and major commercial litigation group at Choate Hall & Stewart in Boston. Michael Gass chairs the firm's securities litigation & corporate governance group and co-chairs the major commercial litigation group. William Asher is co-chairman of Choate's business & technology group.