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Practical Insights for Public Company Counsel

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King & Spalding's Public Company Practice Group periodically publishes the Public Company Advisor *to provide practical insights into current corporate governance, securities compliance and other topics of interest to public company counsel.*

Second Circuit's *Ikanos* Decision Illustrates Pitfalls Surrounding MD&A "Trends and Uncertainties" Disclosure

Overview

Item 303 of Regulation S-K requires the disclosure, in a company's MD&A, of "any known trends or uncertainties…that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." A company's failure to correctly anticipate *which* known "trends or uncertainties" ultimately will have a material impact and make corresponding disclosures may give rise to litigation in which nondisclosure will be judged in hindsight and with the benefit of knowledge of subsequent events that may not have been foreseen at the time of disclosure.

The Second Circuit Court of Appeals' recent decision in *Panther Partners Inc. v. Ikanos Communications, Inc.* threatens to expand the litigation risk posed by Item 303. Although Item 303 requires disclosure only of known uncertainties that an issuer "reasonably expects will have" a material impact, in *Ikanos*, the Second Circuit held that the plaintiff adequately alleged a claim based on the company's failure to disclose an "uncertainty" that the court determined "*might* reasonably" have been expected to materially impact future revenues.

The *Ikanos* Decision

Ikanos is a developer of semiconductor chips and related software. In 2005, two main customers provided Ikanos with 72% of its revenues. According to the complaint, Ikanos learned in January 2006 about quality issues in some sets of chips sold to those two customers. Plaintiff alleged that, in the weeks leading up to a March 2006 secondary offering, Ikanos received increasing numbers of complaints about chip defects from the two primary customers and that the Ikanos board was aware of the complaints. Although the March 2006 offering materials included general warnings to the effect that semiconductor chips "frequently contain defects and bugs" and that Ikanos chips had in the past and could in the future have such defects, Ikanos did not specifically disclose the alleged customer complaints.

Plaintiff alleged that Ikanos eventually determined that between 25% and 30% of the chips sold to the two customers were defective, but did not allege *when* that determination was made,

much less that it was made *prior to* the secondary offering. The complaint further alleged that in June 2006, three months after the secondary offering, Ikanos agreed to replace all of the chips sold to its two primary customers — not just those chips that had defects. Ikanos ultimately recalled hundreds of thousands of chips, the cost of which was written off. In July 2006, Ikanos reported a $2.2 million net loss for the second quarter of 2006 and its stock dropped 25%.

Shareholder lawsuits followed, alleging claims under Sections 11 and 12(a)(2) of the Securities Act of 1933 for failure to disclose the reports of chip defects. The trial court granted Ikanos' motions to dismiss the original and amended complaints, focusing on the lack of allegations stating whether Ikanos knew the chip defect rate was abnormally high prior to the secondary offering. On appeal, however, the Second Circuit reversed that ruling. The appellate court held that plaintiff's allegations gave rise to a "plausible inference" that Ikanos "was aware of the 'uncertainty' that it might have to accept returns of a substantial volume, if not all, of the chips it had delivered to its major customers." Because that "known uncertainty" "might reasonably be expected to have a material impact on future revenues," the court held plaintiff had alleged a claim sufficiently to avoid dismissal at the pleading stage.

Impact of the *Ikanos* Decision

The *Ikanos* decision can be expected to invite additional claims alleging failures to disclose known trends and uncertainties under Item 303. Management teams preparing and evaluating MD&A disclosures should follow the SEC's interpretive guidance contained in Securities Act Release No. 6835 (1989), which the Second Circuit directly quoted in *Ikanos*. That guidance sets forth the following criteria that management teams evaluating disclosure obligations under Item 303 should consider:

> Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:
>
> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
>
> (2) If management cannot make that determination, it must evaluate objectively, the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition is not reasonably likely to occur.

Unfortunately, adherence to the above guidance will not entirely eliminate the risk of claims. The Ikanos management team may well have determined that the limited information regarding chip defects available at the time of the offering did not suggest that a material recall was "reasonably likely to occur." Nevertheless, the court allowed the claim to proceed under the minimal pleading threshold applicable to Section 11 and 12 claims. In light of *Ikanos*, public company management teams and their advisors are therefore forced to consider "defensive" disclosures of trends or uncertainties that "*might*" occur and be material, rather than just those determined to be "reasonably likely" to occur.

Management teams should also bear in mind Item 303's potential to create disclosure issues in quarterly and annual filings, which could lead to claims under Section 10(b) of the Securities

Exchange Act of 1934 and SEC Rule 10b-5. Unlike Section 11 and 12 claims such as those in *Ikanos*, complaints alleging 10b-5 "fraud" claims will be subject to the heightened pleading standards of Rule 9(b) and the Private Securities Litigation Reform Act, which will give defendants a greater chance at dismissal on the pleadings. Nevertheless, public companies should be wary of Item 303's thorny disclosure requirements, and the Second Circuit's worrisome reading of those requirements in *Ikanos*, when preparing MD&A in periodic reports and offering documents.

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About King & Spalding

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