

## The Disclosure Process Defense to Securities Fraud Claims, Part I: Key Steps for Litigation Preparedness

*One of the most effective—but underutilized—defenses against claim of securities fraud is a disclosure process defense: that the defendants reasonably relied on a robust process for drafting, reviewing, and approving the public disclosures at issue.*

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It will come as no surprise to corporate counsel that public companies should be prepared to face allegations of securities fraud. Private securities class actions are filed after nearly any sharp stock-price decline, and government enforcement actions are on the rise and are increasingly aggressive. One of the most effective—but underutilized—defenses against such claims is a disclosure process defense: that the defendants reasonably relied on a robust process for drafting, reviewing, and approving the public disclosures at issue.

This two-part article describes how public companies can ensure that their disclosure process provides a strong defense against claims of securities fraud, if and when they arise. Part One outlines the nature of the defense and identifies key prophylactic steps that corporate counsel can take to strengthen a potential defense. Part Two will address privilege issues that arise from the involvement of in-house counsel in the disclosure process.

### The Disclosure Process Defense Negates Scienter

In the typical case, securities fraud under Section 10(b) of the Securities Exchange Act of 1934 requires proof that a public statement was made with scienter, i.e., fraudulent intent. Scienter is generally established if it is more likely than not that the speaker made the statement with actual knowledge it was false or with reckless disregard to a substantial risk it was false.

A disclosure process defense seeks to negate scienter by demonstrating that the statement at issue was the product of a regular process involving multiple people—often one or more committees comprised of executives, senior management, business leaders, and finance professionals who draft, review, and approve public disclosures—and the speaker reasonably relied on that process when making the statement. The fundamental premise is that the involvement and approval of multiple other people, within a framework of specified procedures and controls, shows good faith and renders any inference of fraudulent intent by the speaker unreasonable.

### Building the Foundation for a Persuasive Disclosure Process Defense

There is no single “right” way to structure a disclosure process, and public companies employ a variety of procedures and controls to comply with regulatory and corporate governance standards. In the context of securities fraud litigation, the specific facts and circumstances matter: courts across the country have sometimes granted summary judgment for defendants and other times found the defense insufficient. Similarly, government enforcement agencies put more weight on a disclosure process defense in some cases than in others. Regardless of the forum, there are three key steps that govern any strong disclosure process and that can maximize the defense’s effectiveness if and when fraud is alleged.

- **Gather the right people and information.** A disclosure process defense is most likely to be successful when a broad range of stakeholders with different roles, perspectives, and knowledge bases participate in the process. In addition to traditional participants like accounting, legal, and investor relations, the involvement, when appropriate, of additional departments and internal subject matter experts can ensure that the best and most on-point information is taken into

account. This is particularly important for public statements about non-financial topics like scientific, business environment, safety, or technology issues. Of course, a balance between rigorous process and business efficiency must be struck, and there are a variety of ways to involve different stakeholders at various stages of the process, from formal membership of committees, to informal participation in cross-functional working groups, to written review and comment on draft disclosure documents, to targeted ad hoc consultations.

- **Encourage open dialogue and consensus-based decision-making.** To be an effective defense to fraud claims, a disclosure process cannot be—and cannot be perceived to have been—a rubber stamp. A strong and consistent tone at the top can thus be critical to undermining claims of an intent to defraud. Senior management should foster open discussion and debate of proposed disclosures throughout the process, and encourage input from all participants, especially financial and business personnel with on-the-ground knowledge of the company's opportunities and challenges. Additionally, a consensus-based approval model can ensure that the final disclosures reflect the collective best judgment and good faith of those involved in the process.
- **Create and preserve appropriate documentation.** The best-designed and -executed disclosure process is of little help in litigation if there is no evidence of its operation. Indeed, at least one court has refused to grant summary judgment, despite acknowledging that the defendants used a robust disclosure process that entailed multiple levels of review by management, the board, and external auditors, because the evidence did not definitively show that the precise statements at issue were actually evaluated by that process. To get the benefit of a robust disclosure process in litigation, it is thus imperative that companies appropriately document the process, with an eye toward later discoverability. This includes: maintaining up-to-date committee charters and policies and procedures that accurately describe the process; preparing agendas and attendee lists for disclosure-related meetings; taking appropriately detailed minutes of those meetings; and preserving drafts and final versions of disclosure documents such as scripts, Q&As, slide decks, and press releases. A central depository of such documentation, subject to an appropriate retention policy, can provide a strong evidentiary foundation to assert the defense.

## A Final Note

A well-designed and well-documented disclosure process can be a potent defense to allegations of securities fraud. But because in-house counsel commonly participates in the process and offers legal advice regarding disclosures, the invocation of such a defense raises the possibility of a waiver of privilege. Part Two of this article will address how to handle these privilege issues.

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