

Southern District of New York: Plaintiffs Adequately Pled a Securities Fraud Claim Based on an Alleged Violation of Item 303 of Regulation S-K

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On April 14, 2020, the Southern District of New York held that plaintiffs “alleged a plausible securities fraud claim premised on a violation of Item 303” of Regulation S-K. *Plumbers & Pipefitters Nat’l Pension Fund v. Davis*, 2020 WL 1877821 (S.D.N.Y. 2020) (Woods, J.). “Item 303 requires a public company to describe in its Forms 10-K or 10-Q ‘known trends or uncertainties’ that the company ‘reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.’” *Id.* (quoting 17 C.F.R. § 229.303(a)(3)(ii)). The court stated that if a violation of Item 303 “is adequately alleged, it can give rise to liability under Section 10(b) because Item 303 creates a legal disclosure obligation with which a regulated company must comply.”^[1]

In the case before it, plaintiffs alleged that a manufacturer of sports equipment and apparel “flooded the market with discounted inventory to increase its short-run sales figures.” Plaintiffs further alleged that “partially as a result of [d]efendants’ sales practices, there was a marked increase in inventory of unsold [] goods at [the company’s] retailers.” Plaintiffs “argue[d] that [the company’s] practice of flooding the market with inventory far in excess of demand was a trend that required disclosure” under Item 303.

The court found plaintiffs “adequately alleged that [the company’s] sales practices created a trend of increasing inventory,” and determined that “[i]t was both reasonably foreseeable and material to [the company’s] future performance that a buildup of inventory would lead to a decline in [the company’s] future sales.” The court further held that plaintiffs’ allegations “create[d] a plausible inference that [d]efendants had actual knowledge of this trend because they received repeated warnings that [the company’s] sales tactics were cannibalizing future sales.” The court concluded that plaintiffs “adequately pleaded” a securities fraud claim based on a violation of Item 303.

The court further held that plaintiffs adequately alleged misstatements regarding the sources and nature of the company’s sales growth, as well as potential risks to the company. The court found that “[b]ecause [d]efendants specifically cited their strategy as a source of their success, they were obligated to tell the whole truth with respect to that strategy by disclosing that their sales growth was, at least in part, the result of short-run sales tactics that led to a buildup of inventory at [the company’s] customers.” The court further found that defendants’ disclosures regarding the risk of “inventory levels in excess of consumer demand” were false or misleading because defendants allegedly “had actual knowledge that [the company’s] customers already had excessive levels of inventory” at the time they made those statements.

[1] The court cited to *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015). In *Stratte-McClure*, the Second Circuit held that “a violation of Item 303’s disclosure requirements can only sustain a claim under Section 10(b) and Rule 10b-5 if the allegedly omitted information satisfies *Basic*’s test for materiality.” Please [click here](#) to read our discussion of the Second Circuit’s decision in *Stratte-McClure*.

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