MEMO TO THE PARTNER

CLIENT LITIGATION DISCLOSURE

KEITH E. THOMPSON[1]

TO: Law Firm Partner
FROM: Keith Thompson
RE: Client Litigation Disclosure

Mallard Enterprises, Inc., a public company based in Maryville, Tennessee, is in the process of preparing a Registration Statement on Form S-1 for filing with the Securities and Exchange Commission. The company recently terminated the employment of its Executive Vice President of Operations, Ward Horton, because of repeated substance abuse. Mr. Horton then sued Mallard Enterprises in Federal District Court, alleging violations of the Americans with Disabilities Act of 1990. Mallard's Chief Executive Officer contacted our firm for guidance as to whether or not the company needs to disclose the lawsuit in the Form S-1. For the reasons set out below, Mallard Enterprises should disclose its present litigation with Ward Horton in its Form S-1 Registration Statement.

Section 7 of the Securities Act of 1933 addresses the information that a registrant is required to include in its Registration Statement.[2] It states that the Registration Statement must contain the information specified in Schedule A.[3] Schedule A, however, does not mention litigation disclosure.

Along with Section 7 and Schedule A, the SEC's Regulation S-K provides for mandatory disclosure requirements with regard to Registration Statements authorized in Section 7(a). Specifically, Item 103 of Regulation S-K addresses "Legal Proceedings."[4] It requires a company to disclose and describe any material pending legal proceedings, subject to certain instructions and exceptions.[5] Two particular

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[2] 15 U.S.C. § 77g(a) (2005).

[3] *Id.*

[4] 17 C.F.R. 229.103 (2005).

[5] *Id.*

instructions are of note in this instance. Instruction two states that the registrant does not need to provide information if the potential damages do not exceed ten percent of the registrant's current assets.[6] Here, Mallard's potential damages of $1,500,000 slightly exceed the 10 percent threshold, as the company has current assets of $14,000,000. Therefore, it is unlikely that an exception is available under instruction two. In addition, instruction four requires a registrant to disclose legal proceedings in which an officer of the company is an adverse party to the registrant.[7] While technically Mr. Horton is no longer an officer of Mallard Enterprises, he was a high-level executive prior to his termination, so it would be unwise for the company to contend that it does not need to disclose the litigation based on this exception.

In addition to the SEC's line-item disclosure requirements set out in Regulation S-K, Rule 408 compels registrants to disclose "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."[8] Rule 405 defines "material" as information "to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[9] Moreover, the Supreme Court in *Basic Inc. v. Levinson*[10] adopted the two standards of materiality stated in *TSC Industries, Inc. v. Northway, Inc.*,[11] and held that a factor test was appropriate in determining said materiality.[12]

Applying a factor analysis here, we know from a recent newspaper article that Mr. Horton was a prominent citizen of Maryville. In addition, we know that 60 percent of Mallard's stockholders are residents of Maryville. It follows that disclosure of a lawsuit involving the company and a prominent former executive in a town where the majority of Mallard Enterprise's shareholders reside would seem to

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[6] *Id.*

[7] *Id.*

[8] 17 C.F.R. § 230.408 (2005).

[9] 17 C.F.R. § 230.405 (2005).

[10] 485 U.S. 224 (1988). The Court offered two standards: (1) whether "there is a substantial likelihood that a reasonable shareholder would consider [the information] important;" and (2) whether there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information." *Id.* at 231.

[11] 426 U.S. 438 (1976).

[12] Basic Inc., 485 U.S. at 239.

be important to the reasonable investor and could alter the "total mix" of available information. Mallard may counter that the $1,500,000 in potential damages is merely a drop in the bucket compared to the company's $100,000,000 annual profits. However, as discussed above, Item 103 specifically mentions "current assets" as opposed to profits. Moreover, *SEC v. Jos. Schlitz Brewing Co.*[13] indicates that the SEC looks beyond mere percentage of profits to the overarching ramifications that an incident may have on a registrant's business.[14] Given the recent performance of Mallard's stock, it is conceivable that those stockholders who support Mr. Horton might dump their Mallard shares as this litigation becomes public. Surely this information would be important to the "reasonable investor."

In summary, while the 1933 Act does not specifically require disclosure of legal proceedings, Item 103 of Regulation S-K requires disclosure of certain classes of pending litigation. The Horton litigation arguably falls into one of those classes. Even if Item 103 does not mandate disclosure of the lawsuit, Rule 408 requires disclosure of "material" information, and the case law interpreting materiality and disclosure suggests that disclosure is proper in this instance. Finally, if Mallard fails to disclose the Horton litigation, it could open itself up to securities fraud allegations down the road. In light of these considerations, it behooves the company to disclose the Horton litigation.

Possible Lawsuit Disclosure Statement:

On January 31, 2005, Mr. Ward Horton, former Executive Vice President of Operations for Mallard Enterprises, Inc., filed suit against the company in the federal District Court for the Eastern District of Maryville. Mallard terminated the employment of Mr. Horton for cause in mid-January 2005. Mr. Horton alleges that Mallard wrongfully terminated his employment and violated the American Disabilities Act of 1990. He seeks $1,500,000 in damages. The company answered Mr. Horton's complaint and denied all of the allegations contained therein. The litigation is in its preliminary stages, and discovery has not yet commenced. Although the company has reason to believe that it will prevail on the merits, the litigation could have a lengthy duration, and the ultimate outcome cannot be predicted at this time.

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[13] 452 F. Supp. 824 (E.D. Wis. 1978).

[14] *Id.* at 830.