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Second Circuit Rejects First Circuit's "Extreme Departure" Test for Assessing Materiality of an Alleged Omission of Interim Financial Information From Registration Statement

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In *Stadnick v. Vivint Solar, Inc.*, 2017 WL 2661597 (2d Cir. June 21, 2017), the United States Court of Appeals for the Second Circuit affirmed the dismissal of claims for violations of Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, arising out of Vivint Solar, Inc.'s ("Vivint") 2014 initial public offering ("IPO"). Plaintiffs, citing *Shaw v. Digital Equipment Corp*., 83 F.3d 1194 (1st Cir. 1996), alleged that Vivint was obligated to disclose in its registration statement financial information for the quarter ending one day before the IPO because the company's performance in that quarter constituted an "extreme departure" from previous performance, even though Securities & Exchange Commission ("SEC") Regulation S-X, 17 C.F.R. § 210.3-12(a), (g), requires a registrant to update financial statements only if they are more than 135 days old from the effective date of the IPO. The Second Circuit declined to adopt the First Circuit's "extreme departure" test, and instead followed its own "long-standing test for assessing the materiality of an omission of interim financial information . . . set forth in *DeMaria v. Andersen*," 318 F.3d 170 (2d Cir. 2003), to hold that a reasonable investor would not view the omission of the quarterly financial information at issue as significantly altering the "total mix" of information made available. This decision reflects a split in the Circuits regarding the duty to disclose interim financial information in IPO registration statements.

Plaintiffs were a putative class of investors in Vivint's IPO. Plaintiffs' Section 11 claims centered on the registration statement issued by Vivint to accompany its IPO on October 1, 2014. This registration statement disclosed financial information for six consecutive quarters, but did not include information from the third quarter of 2014. The structure of Vivint's business required income to be split between shareholders and non-controlling interests ("NCIs"), made up of outside investors essential to Vivint's business model. These NCIs finance Vivint's purchase and installation of solar energy systems through the creation of investment funds, and in return receive tax credits and monthly payments until a targeted rate of return is reached. Vivint uses an equity accounting method called Hypothetical Liquidation at Book value which affects the allocation of income. The registration statement accompanying the IPO disclosed this information, and warned that this business model and accounting practice could have an impact on the allocation of income between shareholders and NCIs.

On October 1, 2014 Vivint held its IPO and sold 20,600,000 shares at $16 per share. Six weeks later, on November 10, 2014, Vivint released a press release with financial information from the third quarter of 2014. The third quarter ended the day before the IPO. This press release revealed that net income for shareholders had decreased by $40.8 million between the second quarter and third quarter. The financial results published from the second quarter, the final results included in the registration statement, indicated $5.5 million in net income for shareholders. In the third quarter results, which were not published prior to the IPO, the net income for shareholders was negative $35.5 million. On November 12, 2014, Vivint released its Form 10-Q for the third quarter of 2014, in which it explained that the shift was attributable to a reallocation of income from shareholders to NCIs due to the timing of an installation of solar systems.

Despite this shift in allocation of income, Vivint reported that its third quarter financial results were surpassing expectations, measured by “key operating metrics” identified in the registration statement. Additionally, Vivint’s overall market share increased by 7% from the first quarter to the third quarter of 2014.

From November 10 to November 11, 2014, after Vivint released the press release, Vivint stock price dropped from $14.74 to $11.42 per share. On November 13, 2014, following the release of the 10-Q, Vivint stock declined again from $12.33 to $11.70 per share. Three months later, on February 13, 2014, the first shareholder complaint was filed against Vivint.

Plaintiffs alleged that the omission of the third quarter financial information by Vivint rendered the registration statement misleading in violation of Section 11. As noted above, SEC Regulation S-X requires a registrant to update financial statements in a registration statement only if they are more than 135 days old from the effective date of the IPO. Plaintiffs argued that because the third quarter performance of Vivint was an “extreme departure” from previous performance, the interim information from the third quarter was required to be disclosed under *Shaw* rather than pursuant to Regulation S-X. The United States District Court for the Southern District of New York applied the First Circuit’s “extreme departure” test, but held that there was no such departure in this case, and dismissed plaintiffs’ claims.

The Second Circuit affirmed, though on a different ground. The Court rejected the district court’s application of the *Shaw* “extreme departure” test, holding that the test set forth in *DeMaria* is the controlling test in the Second Circuit. Under *DeMaria* a duty to disclose interim financial information arises where a reasonable investor would find that omission of this information significantly alters the “total mix” of information made available. The Court reasoned that the *DeMaria* test is clearer and easier to apply as it is built upon the classic standard for materiality in the omission context, whereas the “extreme departure” test is vague and can confuse the analysis by allowing a focus on only one or two traditional metrics rather than focusing on the total mix of available investor information.

Applying the *DeMaria* test, the Court held that there was no duty to disclose because the omission of the third quarter financial information did not significantly alter the total mix of available investor information. The materiality of omissions was assessed by taking into account all information disclosed, including all metrics disclosed by Vivint and Vivint’s disclosure of its unique business plan (including the existence of NCIs) and accounting method. The Court held that Vivint’s *total* revenue and income are the more accurate indicator of the company’s performance, rather than assessing performance solely on income available to shareholders and earnings-per-share; these metrics remained consistent with previous performance.

Additionally, the Court held that, considering all of the information disclosed, there was a consistent pattern of fluctuation in income available to shareholders and earnings-per-share; this, the Court held, would prevent a reasonable investor from having solid expectations of performance as measured by these two metrics. The Court noted that it was also critical that Vivint’s registration statement contained ample warnings and disclosures explaining the fluctuations in shareholder revenue.

While the *Stadnick* decision illustrates the development of a split between the First and Second Circuits, the outcome in this case was the same under both tests. It remains to be seen whether the different tests will lead to materially differing results in these two Circuits and whether plaintiffs will seek *certiorari* from the United States Supreme Court to resolve this Circuit split.