

Merit, or no merit? That is the (disclosure) question

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The U.S. District Court for the District of Massachusetts recently denied a motion to dismiss securities fraud claims in *The City of Fort Lauderdale Police and Firefighters' Retirement System v. Pegasystems Inc.*¹. The putative class action lawsuit accused Pegasystems of failing to properly disclose whether an earlier-filed lawsuit against the company had “merit”. The Court held Pegasystems indeed misled investors in its U.S. Securities and Exchange Commission (SEC) disclosures.

What you need to know

- The motion to dismiss was denied because statements in SEC filings describing litigation as “without merit” can be “false and misleading” under U.S. federal securities law, if the issuer is aware of viable legal arguments against it.
- While the decision is subject to appeal and is non-binding in other U.S. federal district courts, practitioners believe it may have significant precedential value and is relevant to U.S.-listed Canadian companies, and other Canadian companies offering securities in the United States, when describing litigation in SEC filings and other disclosure documents.
- Canadian securities law does not have a developed, general framework for the disclosure of opinions—including opinions about litigation risk—and little guidance as to when opinion evidence in general may constitute an actionable misrepresentation. Cases like *Pegasystems* (decided under *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*²) provide some indication as to how a Canadian court or securities regulator may approach allegations about opinion disclosure.

Background

The lead plaintiff in *Pegasystems* was a U.S. investor who purchased common stock of the defendant, Pegasystems Inc. Pegasystems is a Massachusetts-incorporated company listed on Nasdaq and an SEC-reporting company, making it subject to U.S. federal securities law claims under the U.S. Securities Exchange Act of 1934, as amended (Exchange Act), and the rules and regulations thereunder, including Rule 10b-5 (the U.S. general antifraud rule). The plaintiff filed this putative securities fraud class action after the company’s stock price tumbled on the Nasdaq after entry of a civil \$2 billion trade-secret verdict against the company. The lawsuit alleged Pegasystems previously made fraudulent statements in its SEC filings because the company had stated the trade-secret litigation was “without merit”.

Specifically, the complaint alleged violations of Sections 10(b) and 20 of the Exchange Act. Those sections make it unlawful for a person or “controlling person” to make an untrue statement of material fact or to omit to state a material fact necessary to make the statements—in light of the circumstances under which they were made—not misleading. For the sections to apply, the statements must be made in connection with the use of interstate commerce, mail, or any national security exchange (including the Nasdaq) for offers and sales of securities in the United States.

Timeline of previous litigation and subsequent class action

The complaint claimed senior management at Pegasystems was involved in hiring a third party to spy on its competitor, Appian, between 2012 and 2014 to improve its products and expand its customer base. When the third party ultimately lost access to Appian’s systems, Pegasystems’ senior management then directed members of its own team to create fake companies to act as customers to access Appian’s systems. Instead of disciplining the members responsible for devising the spying plan, the company rewarded them with bonuses.

In May 2020, Appian filed a trade-secrets suit against Pegasystems in Virginia state court seeking \$90 million in compensatory damages plus punitive and treble damages, as well as injunctive relief. In February 2022, Appian amended its complaint and increased its damages demand to \$3 billion.

In February 2022, Pegasystems included disclosure regarding this litigation in its annual report on Form 10-K, which stated the claims in the Appian litigation were “without merit”, the company had “strong defenses”, and “any alleged damages [were] not supported by the necessary legal standard of proximate cause”³. Despite these relatively optimistic disclosures, Pegasystems’ stock price dropped the next day by nearly 16%.

In September 2022, the Virginia jury in the Appian matter held that Pegasystems willfully and maliciously misappropriated Appian's trade secrets and awarded Appian \$2 billion in compensatory damages plus attorney’s fees and post-judgment interest. After the public announcement of the verdict (reported on a Current Report on Form 8-K), Pegasystems’ stock price fell again by approximately 28%.

As a result of the substantial decline in stock price, lead plaintiff commenced this putative securities fraud class action against Pegasystems in Massachusetts federal district court.

Decision on motion to dismiss

Defendants, the company and its CEO, moved to dismiss, in part, because they alleged none of their statements were false or misleading. The court denied that part of defendants’ motion to dismiss because defendants had “misleadingly reassured investors” in their Form 10-K filing, which reported that the claims in the Virginia action were “without merit”⁴.

The court held this language was an “actionable opinion statement” under *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*⁵, a 2015 U.S. Supreme Court decision that lays the general framework whereby statements of opinion by a company could give rise to liability under U.S. federal securities laws if the statement later proves to be untrue. Under *Omnicare*, company statements of opinion or belief may not give rise to an actionable U.S. securities law claim if the company has a reasonable belief that the opinion is true. However, liability can attach if a statement “omits material facts about the issuer’s inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself”⁶. This is because a reasonable investor “expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer’s possession at the time”⁷.

The *Pegasystems* court, in applying the *Omnicare* standard, found that the company’s statement regarding the Appian litigation was at odds with the information available to the company at the time the statement was made. The principal concern was that defendants’ disclosure “categorically denied that Appian’s claims had any merit—despite possessing substantial information about the viability of those claims”⁸.

The *Pegasystems* court explained further that

[a]n issuer may legitimately oppose a claim against it, even when it possesses subjective knowledge that the facts underlying the complaint are true. When it decides to do so, however, it must do so with exceptional care, so as not to mislead investors. For example, an issuer may validly assert its intention to oppose the lawsuit. It also may state that it has “substantial defenses” against it if it reasonably believes that to be true. An issuer may not, however, make misleading substantive declarations regarding its beliefs about the merits of the litigation.

Although defendants have noticed an appeal, and the decision is technically only binding within the Massachusetts federal district, the foregoing interpretation of *Omnicare* in the context of U.S. public disclosures regarding the merits of litigation should be cautionary to SEC-reporting companies making similar disclosures.

Key takeaways

- U.S. and Canadian issuers that offer securities in the United States should exercise “exceptional care” when describing litigation or threatened claims as being “without merit” in SEC and other disclosures made to U.S. investors.
- Such issuers can validly assert an intention to oppose a lawsuit or note substantial defenses, but only if they reasonably believe such statements to be true.
- Issuers should also be sure to consult pertinent directors and officers about the veracity of the allegations asserted in connection with threatened claims or actual litigation when preparing SEC and other disclosures made to U.S. investors.

FOOTNOTES

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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