

# Northern District of California Delineates When Affirmative Statements Can Create a Duty to Disclose

## Securities Litigation Quick Read

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In a decision likely to cause some consternation for companies defending against federal securities claims, the U.S. District Court for the Northern District of California issued an unpublished decision on March 22, sustaining an extremely narrow omissions theory of liability alleged in *City of Sunrise Firefighters' Pension Fund v. Oracle Corp.*<sup>[1]</sup> The court dismissed most of the stockholder plaintiffs' claims against Oracle Corporation (Oracle) and its officers for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, but the claim that survived illustrates a pitfall of sometimes providing "too much information." The court expressly found that Oracle would have had no duty to disclose the allegedly omitted information but decided that it should have been disclosed after Oracle made affirmative statements that rendered the omitted information materially "interesting" to investors. Specifically, Oracle publicly identified several "reasons for cloud revenue growth and explanations for the subsequent slowing of that growth."<sup>[2]</sup> The plaintiffs went to work and ferreted out allegations from confidential witnesses that purportedly "coercive" and unsustainable sales practices were a "material driver" of the cloud revenue growth rates, which Oracle had failed to mention among the reasons for growth in its public statements.<sup>[3]</sup>

According to the complaint's narrative, Oracle began to shift the sales emphasis for its software products in 2016 from its traditional model of local licenses to a new model of cloud-based subscriptions. As part of this shift, Oracle allegedly engaged in "coercive" sales practices to increase revenue in the cloud sector, such as threatening to charge penalties for exceeding existing license agreement usages unless the customers agreed to pay for short-term cloud subscriptions, and allegedly offering discounts on existing licenses in exchange for signing up for otherwise unwanted short-term cloud subscriptions. The plaintiffs alleged that these sales strategies led to rapid growth in cloud subscription revenue but that, by late 2017 and early 2018, many of the cloud subscriptions expired and were not renewed, leading to Oracle's announcement that its cloud revenue growth was slowing. The plaintiffs sued Oracle and its officers, claiming, among other things, that the defendants failed to disclose the allegedly "coercive" and unsustainable sales practices that had driven cloud subscription growth and, by omission, had thereby misrepresented that growth and its subsequent slowdown.

In their amended complaint, the plaintiffs alleged over 50 false and misleading statements across a variety of topics, including, for example, statements about the technical adequacy of Oracle's cloud products, statements about the revenue growth of Oracle's cloud-based products, and statements about Oracle's accounting that allegedly violated Generally Accepted Accounting Principles (GAAP). The court found that the vast majority of the statements were mere puffery or were not sufficiently alleged to be false, and that any forward-looking statements were not actionable under the safe harbor provisions of the Private Securities Litigation Reform Act (PSLRA).

But, when it came to statements about the drivers of growth in Oracle's cloud revenues and the reasons for a slowdown in the growth, the court found that while the statements themselves were facially accurate, they might not paint a complete picture. The court had previously dismissed these claims without prejudice, but the amended complaint supplied additional allegations from 11 confidential witnesses and industry experts. The court found these new allegations sufficient to plausibly establish that the revenue generated from Oracle's allegedly coercive sales tactics could be material. In particular, the court was swayed by new allegations from confidential witnesses that "90-95%" of Oracle's cloud revenue growth during the class period "did not have use cases associated with them,"[4] and that it was a "regular practice" for Oracle's customers to purchase cloud subscriptions to avoid penalties after site use audits.[5] Ultimately, "more than 75%" of cloud revenue came from allegedly coercive sales practices.[6] Furthermore, one confidential witness estimated that less than 10% of his clients renewed their cloud subscriptions at the same level as initial sales.[7] The court was persuaded that these allegations from confidential witnesses indicated that a material portion of cloud revenue was derived from allegedly coercive and unsustainable sales practices, and permitted the case to proceed solely on a "narrow omission theory of securities fraud." [8]

While emphasizing that Oracle did not have "an independent duty to disclose its sales tactics," the court determined that, "once Defendants made statements about the drivers of cloud revenue growth, investors would have been **interested to know** that Oracle's allegedly coercive sales practices were 'a material driver' of cloud sales." [9] Investor "interest" is not the legal standard of materiality, however, so the court's evaluation of the issue is problematic in that respect. Nonetheless, the court concluded that Oracle's affirmative public statements about its cloud growth performance "created an impression of a state of affairs that differs in a material way from the one that actually existed." [10] The court also noted that Oracle's alleged omissions occurred during a time when "the nascent cloud market exploded," and Oracle's competitors experienced robust growth. [11] The court found that by failing to disclose that its cloud growth stemmed from sales practices unlikely to create long-term revenue streams, Oracle and certain of its officers affirmatively created the misimpression that Oracle's revenue stream in that sector was stable. In short, once Oracle and its officers made statements touting the robustness of its cloud growth, Oracle had a duty to disclose additional information about its sales practices to avoid misleading investors.

This case provides insights into how a court may evaluate the extent of a public company's duty to disclose once it decides to speak on a particular topic related to its business. While it is a fundamental principle of securities law that nondisclosure of material information will not give rise to liability under Rule 10b-5 unless the defendant had an affirmative duty to disclose that information, [12] making an otherwise truthful, but incomplete, statement relating to the relevant subject matter may lead to such a duty. In practice, determining when such a duty will arise can be difficult to ascertain. The closely drawn illustration provided by the court's decision in this case can provide useful guidance for those evaluating when disclosure may be needed.

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[1] No. 18-cv-04844-BLF, 2021 WL 1091891, at \*21 (N.D. Cal. Mar. 22, 2021).

[2] *Id.* at \*31.

[3] *Id.* at \*7, \*10.

[4] *Id.* at \*3.

[5] *Id.* at \*4.

[6] *Id.* at \*5.

[7] *Id.*

[8] *Id.* at \*21.

[9] *Id.* at \*19 (emphasis added).

[10] *Id.* at \*21 (quoting *Brody v. Transitional Hospitals Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002)).

[11] *Id.*

[12] “Silence, absent a duty to disclose, is not misleading under Rule 10b-5.” *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n. 17 (1988).

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