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Securities Law Alert

KEY DEVELOPMENT IN SHAREHOLDER LITIGATION

Ninth Circuit: Reverses Dismissal Finding "Rare Circumstances" Where Core Operations Doctrine Applies

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The Ninth Circuit recently reversed in part dismissal in a putative securities fraud class action alleging that a toy manufacturer and two of its officers misrepresented the status of its inventory management, distribution capabilities, and IT system use. *Constr. Laborers Pen. Tr. of Greater St. Louis v. Funko, Inc.*, 2026 U.S. App. LEXIS 3476 (9th Cir. 2026) (Mendoza, J.). After holding that plaintiffs plausibly alleged that Funko's inventory-related risk disclosures were misleading, the Ninth Circuit concluded that the scienter allegations presented one of the "rare circumstances" where the third prong of the core operations doctrine[1] applies, such that even if the allegations are not particularized, "the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter."

Background and Procedural History

The defendant company specializes in trendy toys, which carry the risk of becoming "dead inventory," meaning that they are unsellable, for example, if tastes change or a product fails to catch on. Before the litigation commenced, the company began exploring switching to a new inventory management software system and leased a new distribution center. The software was intended to allow products to be scanned when they arrived and placed in exact distribution center locations, facilitating easy order fulfillment. However, in November 2022, the company's CEO stated that the company was experiencing "higher-than-expected short-term operating expenses" and the company experienced a 59% stock drop a day later. The company also announced around this time that it was writing down between $30 and $36 million in inventory. Following this, plaintiff stockholders sued alleging that defendants had made a variety of misrepresentations in violation of Section 10(b) of the Exchange Act and Rule 10b-5(b). Among other things, plaintiffs alleged that the company's various risk disclosures in its 2022 SEC

[1] Citing *Prodanova v. H.C. Wainwright & Co., LLC,* 993 F.3d 1097 (9th Cir. 2021), the Ninth Circuit explained that "[c]ore operations allegations support a strong inference of scienter in three circumstances: (1) when they, along with other allegations, support a cogent and compelling inference of scienter as part of a court's holistic review of a plaintiff's allegation; (2) when the allegations are themselves particular and suggest that the defendants had actual access to the disputed information; and (3) in the rare circumstances when the allegations are not particularized, but the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter."

filings concerning its inventory management concealed that the company had already failed to manage its inventory and that its business, financial condition, and operations had already been adversely affected. The district court dismissed, concluding that plaintiffs failed to sufficiently allege falsity and scienter, finding that the risk disclosures were protected by the PSLRA's safe harbor provision as "forward-looking statements." Plaintiffs argued on appeal that the risk disclosures misled investors into thinking that, at the time they were made, the risks identified had not yet occurred.

Risk Disclosures Could Have Allayed Concerns Over Inventory Management

The Ninth Circuit noted that it had previously endorsed the theory that risk disclosures in an SEC filing can give rise to Exchange Act liability where the disclosures warn that risks could occur when, in fact, those risks had already materialized.[2] Noting plaintiffs' allegations that, among other things, dead inventory was piling up in spring of 2022, that between 300 to 500 shipping containers' worth of inventory could not be sent to customers as of July 2022 and that the company had to rent additional warehouses to store excess inventory by October 2022, the Ninth Circuit concluded that the company implied that it was not presently experiencing those issues when it told investors that the company "must also avoid accumulating excess inventory," that "there is a risk of having excess inventory," and that "if we are not successful in managing our inventory, our business, financial condition and results of operations could be adversely affected." The Ninth Circuit further stated that when the company's disclosures identified a previous write-down in 2019,[3] that the company "gave investors the impression that the current state of affairs was not similar to those in 2019." The Ninth Circuit concluded that "the repeated risk disclosures could have allayed concerns over inventory management while serious inventory problems bloomed, culminating in a massive write-off reminiscent of the 2019 incident."

The Allegations Meet the "Rare Circumstances" Where It Is "Absurd to Suggest That Management Was Without Knowledge"

As to scienter, plaintiffs argued that they satisfied the PSLRA's pleading requirements under the core operations doctrine. Plaintiffs asserted that they adequately alleged that the company's inventory management and IT use were so critical to its business operations that a reasonable trier of fact could find that its CEO and CFO "must have known about the chaos that was ensuing" at the company's new distribution center as it was rapidly accumulating excess inventory and had failed to onboard the new software system that was supposed to organize incoming inventory and speed order fulfillment. Defendants responded that plaintiffs did not plausibly allege that

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[2] *See In re Alphabet, Inc. Sec. Litig.*, 1 F.4th 687 (9th Cir. 2021) (holding that plaintiffs plausibly alleged that warning of risks that "could" or "may" occur was misleading when the company knew that those risks had materialized); *In re Facebook, Inc. Sec. Litig.*, 87 F.4th 934 (9th Cir. 2023) (holding that when defendants presented the risk of third parties improperly accessing and using the company's user data as purely hypothetical that it misrepresented the current state of affairs as defendants knew that a third party had accessed user data). By contrast, the Sixth Circuit recently held that "risk disclosures in SEC filings are inherently prospective in nature" and therefore courts will "not deem cautionary statements . . . actionable in instances where a plaintiff claims that defendants should have disclosed risk factors *are* affecting financial results rather than *may* affect financial results." *Newtyn Partners, LP v. All. Data Sys. Corp.*, 165 F.4th 947, 964 (6th Cir. 2026) (quotations omitted).

[3] The disclosures identified the "fourth quarter of 2019," during which the company "wrote-down $16.8 million of inventory . . . to dispose of slower moving inventory to increase operational capacity which contributed to the Company's net loss for the period."

it would be "absurd" to suggest that the CEO and CFO did not know about the issues with inventory management or the new software.

The Ninth Circuit agreed with plaintiffs that this is one of the "rare circumstances" where the third prong of the core operations doctrine applies, such that even if the allegations are not particularized, "the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter." In connection with this, the Ninth Circuit discussed its decision in *Berson v. Applied Signal Technology, Inc.,* 527 F.3d 982 (9th Cir. 2008), holding "that because the stop-work orders were prominent enough that it would be absurd to suggest that top management was unaware of them," noting that in the case the CEO and CFO were directly responsible for day-to-day operations, the stop-work orders allegedly halted tens of millions of dollars of work, and one stop-work order related to the company's largest contract with one of its most important customers. Similarly, the Ninth Circuit also noted its decision concluding that given the importance of an airline's maintenance problems and the FAA's investigations into them, it was absurd to suggest that the airline's board of directors would not discuss and be aware of these issues. *See No. 84 Emp.-Teamster Joint Council Pension Tr. Fund v. Am. W. Holding Corp.,* 320 F.3d 920 (9th Cir. 2003).

Here, the Ninth Circuit concluded that given how "critical" the company's management of its inventory, its IT use, and its new distribution center upgrade were for its operations that it was strongly likely that the COO would have shared information with the CEO and CFO about the issues he had seen at the new distribution center. The Ninth Circuit further stated that given the company's "business model, its ability to effectively manage inventory was critical to its business operations" and that a rational fact finder could find that it would be absurd for the CEO or CFO not to have closely monitored the company's management of its inventory, especially in its "highly touted" new distribution center.

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