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EXPERT ANALYSIS

Supreme Court to Tackle Omissions Fraud Liability

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The United States Supreme Court has granted certiorari in a case that could have a significant impact on the law under Section 10(b) of the Securities Exchange Act of 1934 and accompanying Rule 10b-5 as they relate to matters omitted from public disclosures.

In *Leidos, Inc. v. Indiana Public Retirement System*, No. 16-581, the Supreme Court will take up the question of whether the Second Circuit erred in holding — in direct conflict with the decisions of the Third and Ninth Circuits — that *Item 303 of SEC Regulation S-K creates a duty to disclose that is actionable under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5*. (Emphasis added).

Thus, the petition raises the momentous question of whether a Section 10(b) claim can be premised upon the failure to comply with an SEC disclosure regulation (or, possibly, any other regulatory rule).

Suits premised upon failures to comply with Item 303 present a particular hazard for public companies because Item 303's requirement that management discuss trends and uncertainties that may affect the company going forward will inevitably involve judgment calls that are difficult to make and are easily second-guessed in hindsight.

The Second Circuit, in the 2015 *Stratte-McClure* case, held that violations of Item 303 could give rise to a Section 10(b) violation so long as the undisclosed fact was material. As the court described its test:

> [W]e have consistently held that an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts. ... Such a duty may arise when there is a corporate insider trading on confidential information, a statute or regulation requiring disclosure, or a corporate statement that would otherwise be inaccurate, incomplete, or misleading.

776 F.3d 94, 100-01 (2d Cir. 2015) (quotations and citations omitted).

Permitting a private Section 10(b) claim to be asserted for violation of Item 303 opened a split with the Ninth Circuit and, at least arguably, with the Third Circuit. *See In re NVIDIA Corp. Securities Litigation,* 768 F.3d 1046 (9th Cir. 2014); *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (Alito, J.).

The court in *Stratte-McClure* nonetheless dismissed the complaint in that case for failure to plead facts showing that the violation in question, involving a financial institution's exposure to the mortgage market, was reckless. *See Stratte-McClure*, 776 F.3d at 106-07.

As a result, the Circuit split had to await a live case to bring to the Supreme Court.

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However, in *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 95 (2d Cir. 2016) (*SAIC*), the Second Circuit allowed such a claim to go forward, albeit with a heightened state of mind requirement derived from Item 303's own language: "Item 303 requires the registrant to disclose only those trends, events, or uncertainties that it actually knows of when it files the relevant report with the SEC. It is not enough that it should have known of the existing trend, event, or uncertainty."

The petition in *Leidos* appealed from that decision.

THE SECOND CIRCUIT'S OPINION

The complaint in *Leidos* alleges a kickback scheme between the defendant company and a subcontractor, which allegedly produced cost overruns in a government contract and led, in successive stages, to an internal audit report in early March 2011, and thereafter to repayment of overcharges, a federal investigation and deferred prosecution agreement (and the indictment of a company officer and the subcontractor), and ultimately cancellation of the contract by the City of New York. *SAIC*, 818 F.3d at 89-90.

The complaint challenged a March 2011 Form 10-K, alleging, among other things, that it (1) failed to disclose the scheme's impact as a known trend or uncertainty under Item 303; and (2) violated Generally Accepted Accounting Practices (GAAP) by failing to disclose the scheme's impact as a loss contingency under Financial Accounting Standards (FAS) number 5.

Although the Second Circuit reinstated both the Item 303 and FAS 5 claims, the petition for certiorari only challenged the Second Circuit's ruling on Item 303.

After adhering to its *Stratte-McClure* rule, the Second Circuit in *SAIC* held that Item 303 requires management's actual knowledge of a trend or uncertainty in order to create a duty to disclose it.

While the question presented does not explicitly address this ruling, the issue of *how* to find that a corporation violated Item 303's disclosure requirements is likely to inform the Court's consideration of the practical effects of allowing suits to be based on such non-disclosures:

> We have never directly addressed whether Item 303 requires that a company actually know or merely should have known of the relevant trend, event, or uncertainty in order to be liable for failing to disclose it. Instead, we appear to have assumed, without deciding, that Item 303 required an allegation or showing of actual knowledge rather than a lesser standard of recklessness or negligence.
>
> *The plain language of Item 303 confirms our previous assumption that it requires the registrant's actual knowledge of the relevant trend or uncertainty.* Item 303 demands that the registrant "[d]escribe any known trends or uncertainties" and also requires disclosure where "the registrant knows of events that will cause a material change in the relationship between costs and revenues," such as a "known future increase in costs of labor." ... *The SEC's interpretation of Item 303 further confirms this "plain language" reading of Item 303, insofar as it advises that the trends or uncertainties must be "presently known to management*."

Id. at 95 (italics added; underlining in original; citations omitted).

Because the Second Circuit's reading of the disclosure duty is tied to the language of Item 303 itself, it is likely not limited to Section 10(b) cases but would apply as well in cases under Section 11 or 12 of the Securities Act of 1933 or SEC proceedings under Section 17 of the Securities Act.

The Second Circuit in *SAIC* found the actual knowledge satisfied by the accumulation of factual allegations of internal and external investigative developments:

> This was not an "uncertainty" arising out of a run-of-the-mill civil enforcement investigation by the SEC. *See In re Lions Gate Entm't Corp. Sec. Litig.*, No. 14-CV-5197 (JGK), 2016 WL 297722, at *14 (S.D.N.Y. Jan. 22, 2016). Rather, as alleged in the [amended complaint], by early March 2011 [the defendant] was aware that it faced serious, ongoing criminal and civil investigations that exposed it to potential criminal and civil liability and that ultimately did result in criminal charges and substantial liability.

Id. at 95 n. 8 (emphasis added).

POTENTIAL IMPACT

While the courts have held for years that a violation of Section 10(b) and Rule 10b-5 may be premised upon an omission of material information that the defendant had a duty to disclose, neither the statute nor the rule says anything about either omissions or duties to disclose other than omissions that render affirmative statements misleading.

This stands in contrast to Section 11 of the Securities Act, which explicitly creates liability when a registration statement "contained an untrue statement of a material fact or omitted to state a material fact *required to be stated therein* or necessary to make the statements therein not misleading."

The Court thus may need to examine the sources of omissions liability under Section 10(b), which it has often assumed to be based on fiduciary or similar duties of trust and confidence created by common law.

Depending upon the extent to which the Court re-examines those assumptions, its decision in *Leidos* could have far-reaching consequences not only for private Rule 10b-5 class actions but also for criminal and civil enforcement proceedings under Section 10(b), which are often based on theories of omission and duties to disclose.

Public companies face a broad array of regulatory disclosure requirements under SEC regulations as well as other federal and state rules and regulations.

Leidos could potentially decide the extent to which those myriad disclosure rules give rise to federal securities fraud liability.

How the Court resolves those questions could thus have a significant impact well beyond the narrow question of Item 303 disclosures.

Permitting a private Section 10(b) claim to be asserted for violation of Item 303 opened a split with the Ninth Circuit and, at least arguably, with the Third Circuit.






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