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The Supreme Court Agrees to Decide Whether a Failure to Disclose Known Trends and Uncertainties Under Item 303 of SEC Regulation S-K Can Give Rise to a Private Cause of Action Under Section 10(b) and Rule 10b-5

By Susan E. Hurd and Tim Fitzmaurice

On March 27, 2017, the U.S. Supreme Court granted a petition for writ of certiorari in *Leidos v. Indiana Public Retirement System, et al.*, No. 16-581, and agreed to review the Second Circuit's decision that Item 303 of SEC Regulation S-K ("Item 303") creates a disclosure duty that is actionable under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5.[1] That issue has divided the Second and Ninth Circuit Courts of Appeal because the Ninth Circuit has adopted the view that Item 303 does *not* create a duty that could form the basis of private liability under Section 10(b) and Rule 10b-5.[2]

Overview of the Rule 10b-5 Liability and the Duty to Disclose

Section 10(b) of the Exchange Act prohibits the use of any "manipulative or deceptive device" in connection with the purchase or sale of any security.[3] SEC Rule 10b-5, which was promulgated pursuant to Section 10(b), contains three subparts that describe the conduct in connection with the purchase or sale of a security that is prohibited by Section 10(b). Rules 10b5(a) and (c) make it unlawful "[t]o employ any device, scheme, or artifice to defraud" or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person…."[4] Rule 10b-5(b) prohibits any person from "mak[ing] any untrue statement of a material fact or … omit[ting] to state a material fact necessary … to make the statements made, in the light of the circumstances under which they were made, not misleading…."[5]

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1 *Indiana Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85, 94-96 (2d Cir. 2016). The Supreme Court case is captioned *Leidos v. Indiana Pub. Ret. Sys., et al.*, because SAIC, Inc. is now known as Leidos Holdings, Inc.

2 *Compare In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014) *with SAIC*, 818 F.3d at 94-96.

3 15 U.S.C. § 78j(b).

4 17 C.F.R. § 240.10b-5(a), (c).

5 17 C.F.R. § 240.10b-5(b).

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Importantly, however, neither Section 10(b) nor Rule 10b-5 "create[s] an affirmative duty to disclose any and all material information" to the market.[6] Instead, as noted above, disclosure is required under Rule 10b-5(b) only when necessary to avoid creating a misleading impression via other statements.[7] Thus, the long-standing rule has been that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[8]

Summary of the *Leidos* Case and the Circuit Split

In March 2016, the Second Circuit issued its decision in *Leidos* and held that Item 303 creates a duty to disclose that can be actionable under Section 10(b) and Rule 10b-5.[9] In reaching that conclusion, the Second Circuit relied on its prior decision in *Stratte-McClure v. Morgan Stanley*,[10] where the Second Circuit held for the first time that Item 303 creates an affirmative disclosure duty.

Item 303, in relevant part, requires companies filing SEC-mandated reports (e.g., annual reports (Form 10Ks) and quarterly reports (Form 10-Qs)) to disclose "known trends or uncertainties … that the registrant reasonably expects will have a material … unfavorable impact on … revenues or income."[11] In *Morgan Stanley*, the Second Circuit reasoned that if a company violates Item 303 and fails to disclose a known, unfavorable trend or uncertainty, "a reasonable investor would interpret the absence of an Item 303 disclosure to imply the nonexistence" of unfavorable trends or uncertainties.[12] Accordingly, the Second Circuit held that "Item 303 imposes the type of duty to speak that can, in appropriate cases, give rise to liability under Section 10(b)."[13]

In *Leidos*, the Second Circuit held that the plaintiffs adequately pled that Leidos violated Item 303 by failing to disclose in its March 25, 2011, Form 10-K that, as a result of a kickback scheme that caused Leidos to overbill the city of New York, the company was subject to numerous undisclosed risks.[14] As a result, the Second Circuit held that the plaintiffs adequately alleged an actionable omission under Section 10(b) and Rule 10b-5 and reversed the district court's dismissal of the plaintiffs' claims.[15]

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[6] *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321 (2011).

[7] *Id.* at 1321-22 (quoting 17 C.F.R. § 240.10b-5).

[8] *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *see also Chiarella v. United States*, 445 U.S. 222, 235 (1980).

[9] *See SAIC*, 818 F.3d at 94-96.

[10] 776 F.3d 94 (2d Cir. 2015).

[11] 17 C.F.R. § 229.303(a)(3)(iii).

[12] *Morgan Stanley*, 776 F.3d at 102.

[13] *Id.*

[14] *SAIC*, 818 F.3d at 94.

[15] *Id.* at 94-96.

The Second Circuit's decisions in *Morgan Stanley* and *Leidos*, however, directly conflict with the Ninth Circuit's decision in *In re NVIDIA Securities Litigation*.[16] In that case, the Ninth Circuit held that "Item 303 does *not* create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."[17] The Ninth Circuit reached this conclusion, relying in large part on then-Judge Alito's decision in *Oran v. Stafford*,[18] because the materiality standards of Item 303 and Rule 10b5 "differ considerably."[19] As the Ninth Circuit explained, "[m]anagement's duty to disclose under Item 303 is much broader than what is required under" the materiality standard for Rule 10b-5 liability set forth in the Supreme Court's decision in *Basic*.[20] Accordingly, "'the demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5.'"[21]

In *Morgan Stanley*, the Second Circuit addressed *NVIDIA* and suggested that the Ninth Circuit misinterpreted the Third Circuit's decision in *Oran*. Rather than "*compel[ling]* a conclusion that Item 303 violations are never actionable under Rule 10b-5," the Second Circuit stated that "*Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material Rule 10b-5 omission … so long as the omission is material under *Basic*, and the other elements of Rule 10b-5 have been established."[22]

The *Leidos* case will be heard during the Supreme Court's October 2017 term. Oral argument will likely be scheduled for the fall of 2017, and the Supreme Court's decision will likely be issued in late 2017 or early 2018.

Analysis of the Issues and Potential Impact of the Court's Ruling

It seems unlikely that the Supreme Court will embrace the Second Circuit's view of the world—that the failure to disclose known trends and uncertainties in the MD&A section of a 10K or 10-Q automatically gives rise to an actionable omission under Section 10(b) and Rule 10b-5. This is so because the text of Rule 10b-5(b) specifically directs that an omission is actionable only in relation to other statements that the company affirmatively made. In other words, an omission is only actionable under express terms of Rule 10b-5(b) to the extent that it "necessarily" renders some other affirmative statement made by the company false or misleading. Over 37 years ago, the Supreme Court held on

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[16] 768 F.3d 1046 (9th Cir. 2014). The Second Circuit's decisions also arguably conflict with the Third Circuit's decision in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), which was written by then-Judge Alito. As explained further, however, the Second Circuit has construed *Oran* as "suggest[ing], without deciding, that in certain instances, a violation of Item 303 *could* give rise to a material 10b-5 omission." *Morgan Stanley*, 776 F.3d at 103-104. Accordingly, the Second Circuit has stated that "*Oran* is consistent with our decision that failure to comply with Item 303 in a Form 10-Q can give rise to liability under Rule 10b-5 so long as the omission is material under *Basic*, and the other elements of Rule 10b-5 have been established." *Id.*

[17] *NVIDIA*, 768 F.3d at 1055 (emphasis added).

[18] 226 F.3d 275 (3d Cir. 2000).

[19] *NVIDIA*, 768 F.3d at 1055.

[20] *Id*.

[21] *Id.* (quoting *Oran*, 226 F.3d at 288).

[22] *Morgan Stanley*, 776 F.3d at 103-104 (emphasis in original).

the basis of this language that mere silence is not actionable under Section 10(b).[23] The Supreme Court would have to reverse its own prior pronouncements on this topic to adopt the Second Circuit's view, which seems unlikely.[24]

But even if the Court should embrace the Second Circuit's position, it is hard to imagine a situation where such a ruling would have a significant impact on how securities cases are litigated. Both the Second and Ninth Circuits agree that there can be no liability under Section 10(b) and Rule 10b-5 unless all of the requirements for stating a claim under these provisions are met.[25] Thus, at the most, the adoption of the Second Circuit's view would mean that a litigant can satisfy only one of the six requirements for pleading securities fraud (e.g., a false or misleading statement) and only for statements made in the MD&A sections of quarterly and annual filings. In most securities cases, the 10-K or 10-Q is only one of many statements made during the course of the alleged class period that the plaintiffs contend were false or misleading. It seems unlikely that the plaintiffs would claim that some undisclosed trend or uncertainty gave rise to an actionable omission in a 10-K or 10-Q, but the subject matter at issue was not something about which the company also affirmatively spoke. Accordingly, we do not anticipate that the Supreme Court's ruling on this appeal will impact the number of securities suits filed or the number of such suits that survive motions to dismiss.

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[23] *See Chiarella,* 445 U.S. at 234-35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

[24] The Supreme Court has previously held that a material omission is actionable under Rule 10b5 without an affirmative alleged misstatement when there is a relationship of trust and confidence between the parties to a securities transaction. *See id*. at 230. For example, in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), a corporation issued stock to its Native American shareholders and designated a local bank as the transfer agent. 406 U.S. at 145-46. The corporation requested that the bank advise the shareholders not to sell their shares and to impress upon the shareholders that the market value of the shares cannot be determined. *Id*. Two employees of the bank, however, proceeded to create a market for the sale of the shares and facilitate the sale of shares in that market, without disclosing that (1) the shares could be sold for considerably more in another market and (2) that the defendants would profit from the sale of the shares in the market they created. *Id*. at 152-53. The Supreme Court held that, under those very unique facts, the defendants' omissions were actionable under Rule 10b-5 without an affirmative alleged misstatement. *Id*. This fact pattern is not often replicated because the overwhelming majority of Rule 10b-5 cases concern securities purchased and sold at arm's length on public stock exchanges.

[25] *See SAIC*, 818 F.3d at 92, 94 n.7 (explaining that "failure to comply with Item 303 … can give rise to liability under Rule 10b-5 so long as the other elements of Rule 10b-5 have been established" and that "[t]o succeed on a claim under Section 10(b) of the Exchange Act and Rule 10b-5, a plaintiff must allege that [each] defendant (1) made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) upon which the plaintiff relied, and (5) that the plaintiff's reliance was the proximate cause of its injury" (quotations and citations omitted)); *see also NVIDIA*, 768 F.3d at 1052 ("[T]o prevail on a claim for violations of either Section 10(b) or Rule 10b-5, a plaintiff must prove six elements: '(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.'" (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008))).

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