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Legal Sidebar

UPDATE: When Silence Isn't Golden: Omissions Liability under Securities Laws

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UPDATE: On October 17, the Court granted a joint motion of the parties to remove the case from its argument calendar in light of the parties' reported agreement in principle to settle the dispute.

The original post from October 3, 2017, appears below.

In its upcoming term, the Supreme Court is scheduled to hear oral arguments in *Leidos, Inc. v. Indiana Public Retirement System*, a case involving a circuit split between the Second and Ninth Circuits (which together see more securities cases than the rest of the federal circuits combined) on a question concerning the principal anti-fraud provision of the Securities and Exchange Act of 1934 (the Exchange Act). The case raises the question of whether violations of a Securities and Exchange Commission (SEC) regulation requiring public companies to disclose "known trends or uncertainties" that a company "reasonably expects will have a material . . . impact" on revenues are actionable under Section 10(b) of the Exchange Act, which prohibits fraudulent misstatements and omissions in connection with the purchase and sale of securities. This Sidebar discusses the legal issues involved in *Leidos*, the circuit split, and the implications of the Court's decision for securities law in general.

Section 10(b), Rule 10b-5, and Item 303

The *Leidos* case involves the interaction of Section 10(b), SEC Rule 10b-5, which implements Section 10(b), and Item 303 of SEC Regulation S-K, which imposes certain disclosure requirements on public companies.

Section 10(b) of the Exchange Act makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance" prohibited by rules adopted by the SEC. SEC Rule 10b-5, in turn, makes it unlawful to, "in connection with the purchase or sale of any security," (1) "employ any device, scheme, or artifice to defraud;" (2) "make any untrue statement of a material fact or . . . omit to state a material fact necessary in order to make the statements made . . . not misleading;" or (3) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." To state a claim under these provisions, a plaintiff must show that a defendant (1) made a *material* misrepresentation or omission (*i.e.*, that there is a substantial likelihood that a reasonable investor would view a misrepresented or omitted fact as significant); (2) with *scienter* (*i.e.*, that the defendant made the misstatement or omission intentionally or

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recklessly); (3) in connection with the purchase or sale of securities; (4) upon which the plaintiff *relied*; and (5) the misrepresentation or omission *caused* the plaintiff *economic loss*.

In interpreting the scope of omissions liability under these provisions, the Supreme Court has held that a company's failure to disclose a fact is not "misleading" unless a company has an affirmative "duty to disclose" that fact. Courts have held that such a "duty to disclose" arises in three general types of circumstances: when (1) a defendant has a fiduciary-type relationship with the plaintiff (*e.g.*, where a corporate insider trades securities on the basis of inside information); (2) an omission renders a company's affirmative statements misleading; or (3) a statute or regulation obligates a defendant to speak. While the existence of a "duty to disclose" is fairly well established in the first two categories of cases, the Supreme Court has not squarely addressed the third category of disclosure duties under Rule 10b-5.

Leidos raises the question of whether the disclosure requirements in Item 303 of SEC Regulation S-K impose a "duty to disclose," such that violations of those requirements are actionable under Rule 10b-5. Item 303 requires public companies to include in their annual reports management's discussion and analysis of their financial condition and results of operations—frequently referred to as the "MD&A." Under Item 303, the MD&A section of a company's annual report must, among other things, "[d]escribe any known trends or uncertainties . . . that the [company] reasonably expects will have a material ... unfavorable impact on . . . revenues or income from continuing operations."

The Leidos *Litigation and the Circuit Split*

The *Leidos* litigation arises out of what has been described as "the largest city corruption scandal in decades"—an elaborate kickback scheme orchestrated by employees of Science Applications International Corporation (SAIC, later spun off and renamed "Leidos"), the prime contractor for New York City's "CityTime" workforce management system. The scheme allegedly resulted in hundreds of millions of dollars in fraudulent charges to the city and ultimately led to a criminal investigation.

A putative class of investors in SAIC common stock sued SAIC for violations of Section 10(b) and Rule 10b-5, based on a number of alleged misstatements and omissions. In particular, the plaintiffs allege that SAIC accumulated information regarding its employees' role in the kickback scheme in the months following the announcement of the criminal investigation. Despite this knowledge, the plaintiffs allege, among other things, that SAIC omitted discussion of the CityTime scandal from the MD&A section of its March 2011 annual report, in violation of Item 303's requirement that companies disclose known trends or uncertainties reasonably expected to materially impact revenue.

After the district court dismissed the plaintiffs' claims, the Second Circuit reversed as to the plaintiffs' claims based on the alleged omissions from SAIC's March 2011 annual report. In reversing the district court, the Second Circuit relied on its decision several months earlier in *Stratte-McClure v. Morgan Stanley*, which held that Item 303 imposes an "affirmative duty to disclose . . . [that] can serve as the basis for a securities fraud claim under Section 10(b)" when a plaintiff can also establish the other elements of a Section 10(b) claim discussed above, including materiality.

The Second Circuit's conclusion in *Stratte-McClure* and *Leidos* conflicts with case law from the Third and Ninth Circuits. In *Oran v. Stafford*, then-Judge Alito wrote for the Third Circuit and concluded that Item 303 does not create a "duty to disclose" under Section 10(b). Judge Alito reasoned that the general test for securities fraud materiality (whether there is a *substantial likelihood* that a reasonable investor would view a misrepresented or omitted fact as significant) is considerably more demanding than Item 303's requirement that management disclose known trends or uncertainties *reasonably expected* to materially impact revenue, citing SEC guidance indicating the differences between those standards. The Ninth Circuit relied heavily on *Oran* when it came to the same conclusion in *In re NVIDIA Corp. Securities Litigation*.

Implications of the Court's Decision

The petitioners in *Leidos* and certain commentators have suggested that a decision affirming the Second Circuit would represent a "vast" expansion of Section 10(b) liability. Indeed, the petitioners argue that the Second Circuit's conclusion lacks a limiting principle, and that if private plaintiffs can enforce Item 303 via Section 10(b), there is no reason why they cannot also "enforce the SEC's entire disclosure regime." Accordingly, if the Court affirms the Second Circuit, the extent to which it qualifies its holding will be critical in assessing the decision's impact on securities litigation more generally. A decision wholly adopting the Second Circuit's reasoning could be read to support Section 10(b) liability for violations of a wide variety of SEC disclosure rules.

A decision reversing the Second Circuit would also be significant. The respondents contend that the conclusions of the Third and Ninth Circuits "ha[ve] no limiting principle that would restrict [their] impact on the [SEC's] enforcement prerogatives to Item 303 cases." Because the SEC, like private plaintiffs, must allege breach of a "duty to disclose" to bring a Section 10(b) claim based on an omission, the respondents and certain amici argue that a decision reversing the Second Circuit could seriously undermine the SEC's enforcement capabilities. Whether the Court chooses to distinguish between the SEC and private litigants could accordingly prove important if the Court reverses the Second Circuit.

The case is scheduled for oral argument on November 6, 2017.

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