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Securities Litigation

U.S. Supreme Court Grants Certiorari to Decide Issue That Might Have Significant Impact on Registrants' Exposure for Non-Disclosure of "Known Trends or Uncertainties" in SEC Filings

SUMMARY

Earlier today, the U.S. Supreme Court granted *certiorari* in *Leidos, Inc.* v. *Indiana Public Retirement System*, No. 16-581. This appeal, which likely will not be decided until the first half of 2018, at the earliest, presents the question of whether non-disclosure of "known trends or uncertainties" under Item 303 of Regulation S-K may give rise to private liability for securities fraud under Section 10(b) of the Securities Exchange Act of 1934. The U.S. Supreme Court will address a split between the Second Circuit, which has held that, under some circumstances, non-disclosure under Item 303 of Regulation S-K could give rise to private securities fraud liability, and the Third and Ninth Circuits, which held that such non-disclosure does not create a private securities fraud claim. Although the Supreme Court's decision will not affect the obligation of registrants to comply with Item 303, it may have a significant impact on their potential exposure to securities fraud claims.

BACKGROUND

The Supreme Court has long held that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 239 n.17 (1988). To establish a securities fraud claim based on a registrant's alleged omission of material fact, a shareholder plaintiff must therefore show, among other things, that the registrant had a duty to disclose the omitted information.

The Supreme Court has granted *certiorari* to address whether Item 303 of Regulation S-K creates a duty to disclose that could give rise to a securities fraud claim. Item 303 requires a registered public company to disclose in its annual and quarterly reports "known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or

revenues or income from continuing operations." 17 C.F.R. § 229.303. In an interpretative release, the Securities and Exchange Commission ("SEC") provided registrants with guidance for making Item 303 disclosures:

> Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:
>
> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
>
> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22427, 22430 (May 24, 1989).

Three federal courts of appeal have addressed whether non-disclosure of information under Item 303 may give rise to a Section 10(b) securities fraud claim. Two out of three of those courts held that such non-disclosure is not an actionable basis for securities fraud liability.

In 2000, in a decision authored by now-U.S. Supreme Court Justice Samuel Alito, the Third Circuit held that a pharmaceutical company's non-disclosure under Item 303 of a link between its weight-loss drugs and certain heart disorders did not give rise to a securities fraud claim. *See Oran* v. *Stafford*, 226 F.3d 275 (3d Cir. 2000). In *Oran*, the Third Circuit held that Item 303 does not independently "establish a private cause of action," or create a "duty of disclosure" that, if violated, would "automatically give rise to a material omission under Rule 10b-5." *Id.* at 287, 288. The Third Circuit explained that non-disclosure under Item 303 could not be the predicate of Section 10(b) securities fraud liability because the SEC's guidance for "disclosure obligations under [Item] 303" "varies considerably from the general test for securities fraud materiality" and imposes "disclosure obligations [that] extend considerably beyond those required by Rule 10b-5." *Id.*

The Ninth Circuit Court of Appeals in 2014 expressly followed the reasoning of the Third Circuit's *Oram* decision and likewise held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1056 (9th Cir. 2014).

Less than a year later, in a decision that it recognized was "at odds" with the Ninth Circuit, the Second Circuit held that "a failure to make a required Item 303 disclosure . . . is indeed an omission that can

serve as the basis for a Section 10(b) securities fraud claim" if it "satisfies the materiality requirements outlined in *Basic Inc.* v. *Levinson*, 485 U.S. 224 . . . and if all of the other requirements to sustain an action under Section 10(b) are fulfilled." *Stratte-McClure* v. *Morgan Stanley*, 776 F.3d 94, 100 (2d Cir. 2015). The Second Circuit reasoned that "[d]ue to the obligatory nature of these regulations, a reasonable investor would interpret the absence of an Item 303 disclosure to imply the nonexistence of 'known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations.'" *Id.* at 102 (quoting Item 303).

The Second Circuit applied its *Stratte-McClure* holding in *Indiana Public Retirement System* v. *SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016), and held that a registrant's failure to disclose under Item 303 its exposure for overbilling on government contract work could give rise to a Section 10(b) securities fraud claim. The Second Circuit held that, to have liability, the registrant must have "actual knowledge of the relevant trend or uncertainty" "when it files the relevant report with the SEC" and that "[i]t is not enough that it should have known of the existing trend, event, or uncertainty." *Id.* at 95.

Citing the split between the Second, Third and Ninth Circuits, the *SAIC* defendants petitioned for *certiorari*. Notably, as the *SAIC* defendants pointed out in their petition, the Second and Ninth Circuits see the most securities class action filings in the country. Their petition was granted earlier today.

IMPLICATIONS

The U.S. Supreme Court's decision, which likely will not be issued until the first half of 2018, at the earliest, may resolve the different approaches of the federal appeals courts regarding whether an alleged omission of "known trends or uncertainties" under Item 303 of Regulation S-K can be the predicate of a Section 10(b) securities fraud action.

The appellants in the U.S. Supreme Court may argue that expanding Section 10(b) liability to Item 303 disclosures may incentivize registrants to provide lengthier and more detailed disclosures and cautionary statements under Item 303. As the U.S. Supreme Court has previously recognized, "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decisionmaking." *TSC Indus., Inc*. v. *Northway, Inc.*, 426 U.S. 438, 448-449 (1976). More recently, the past Chair of the SEC questioned "whether information overload is occurring as rules proliferate and as we contemplate what should and should not be required to be disclosed going forward." Chair Mary Jo White, *The Path Forward on Disclosure*, Speech to the Nat'l Assoc. of Corporate Dirs. (Oct. 15, 2013) (available at www.sec.gov). This is a particular concern with Item 303 disclosures because, as academic commentators have observed, such disclosures may concern "soft information" that is not subject to objective verification. *See* Denise Voight Crawford & Dean Galaro, *A Rule 10b–5 Private Right of Action for MD&A Violations?*, 43 No. 3 Sec. Reg. L.J. Art. 1 (2015).

Irrespective of how the U.S. Supreme Court may rule, registrants will need to continue to comply with Item 303 disclosure requirements, which remain subject to the SEC's review and comment process. Further, the disclosures will remain subject to a registrant's required disclosure controls and procedures.

Accordingly, although this U.S. Supreme Court appeal will not affect the need for registrants to comply with their disclosure obligations under Item 303, it may affect the scope of their potential exposure to liability under Section 10(b).

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