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Justices should recognize that silence is golden

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Leidos v. Indiana Public Retirement System
Oral argument: Nov. 6

For decades, practitioners have understood that companies can minimize exposure for private claims of securities fraud by remaining silent.

As children, many of us are taught that if you have nothing good to say, then you should not say anything at all. This is a good rule in life, and it is an even better rule in private Section 10(b) cases. So why is the Supreme Court considering otherwise?

Under Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5, it is unlawful to make a statement that is either materially false or affirmatively misleading because the statement omits material information. There are no "pure omissions" cases under Section 10(b) or Rule 10b-5, as neither provision requires a company to say anything. Indeed, 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). "[C] ompanies can control what they have to disclose under these provisions by controlling what they say to the market." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 45 (2011). A recent circuit split, however, has cast doubt on the application of this rule.

The *Leidos* Case

In *Leidos*, the company defendant, Leidos, Inc. (previously known as SAIC), allegedly failed to disclose in its 2010 10-K information related to a contract between the company and the city of New York. When the 10-K was filed, SAIC was under investigation for an alleged kickback scheme involving former company managers. The 10-K made no mention of the contract or the government's investigation. In their lawsuit, the plaintiffs alleged that SAIC's 2010 10-K omitted information required to be disclosed under Item 303 of Regulation S-K. Among other things, Item 303 requires companies to disclose "any 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." Plaintiffs alleged that SAIC was liable for securities fraud because it did not disclose the government's investigation and the company's potential exposure to civil and criminal liability. *See Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85, 94-97 (2d Cir. 2016).

2nd vs. 9th and 3rd Circuits

In contrast to other circuits, the 2nd U.S. Circuit Court of Appeals (reversing the district court's dismissal) held that Item 303 establishes an affirmative duty to disclose under Section 10(b) and Rule 10b-5. Applying its earlier decision in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015), the court stated: "Item 303 imposes an affirmative duty to disclose that can serve as the basis for a securities fraud claim under Section 10(b)." The court explained that "failure to comply with Item 303 ... *can* give rise to liability under Rule 10b-5 so long as the omission is *material* ... and the other elements of Rule 10b-5 have been established."

The 2nd Circuit reasoned that Item 303 creates an affirmative duty to disclose because a Section 10(b) duty "can derive from statutes or regulations that obligate a party to speak." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 102 (2d Cir. 2015). Therefore, "omitting an item required to be disclosed [in] a[n] [SEC filing] can render that ... statement misleading." This conclusion, however, contradicts rulings on the same issue from the 9th and 3rd U.S. Circuit Courts of Appeals.

In *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014), the 9th Circuit, relying on the 3rd Circuit's decision in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), came to the opposite conclusion, holding: "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." The 9th Circuit reasoned that disclosure under Section 10(b) is required only "when necessary to make statements made, in light of the circumstances under which they are made, not misleading," repeating that "[s]ilence, absent a duty to disclose is not misleading under Rule 10b-5."

The court also highlighted the difference between the materiality standards for Section 10(b) under *Basic v. Levinson* and Item 303. Whereas Section 10(b) materiality is determined by applying a probability/magnitude test, Item 303 materiality is determined by asking whether a known trend or uncertainty is reasonably likely to occur; if management cannot make that determination, then disclosure is required unless management determines that the known trend or uncertainty is not reasonably likely to have a material effect on the company's financial condition or results of operations. The court found that, since these materiality standards "differ significantly," demonstrating a violation of Item 303 "does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty must be separately shown."

Which circuit is correct? Does Item 303 create an affirmative duty to disclose under Section 10(b) and Rule 10b-5? And what are the implications of the Supreme Court's ruling?

Silence Is Not Securities Fraud

Consistent with long-standing Section 10(b) jurisprudence, the Supreme Court should reverse the 2nd Circuit for several reasons.

First, for decades, practitioners have understood that companies can minimize exposure for pri-

vate claims of securities fraud by remaining silent. This bedrock principle has allowed defendants to avoid private Section 10(b) claims in the first instance or to achieve early dismissals, both of which may become less likely if the Supreme Court finds an affirmative duty to disclose under Section 10(b).

Second, Item 303 in particular contains "squishy" elements prone to second guessing. When does something become a "trend"? When is it "reasonable" to expect that an "uncertainty" will have a material effect? In most situations, a plaintiff could point to something that, in hindsight, looks like a "trend" or "uncertainty" and argue that it should have been disclosed. Some courts may find that these issues cannot be resolved on the pleadings.

Third, private liability for failing to disclose under Item 303 may increase the number of individual defendants, as well as their exposure. The typical Section 10(b) case cites alleged misstatements in SEC filings, but often focuses on statements made by CEOs and CFOs in press releases and conference calls. Item 303, however, applies to 10-Ks and 10-Qs. A company's 10-K is signed by all of its board members. It is not much of a stretch to imagine that plaintiffs will accuse the entire board of violating Section 10(b) by failing to comply with Item 303 in a 10-K.

Fourth, a ruling finding an affirmative duty to disclose may create issues far beyond Item 303. Many other SEC rules, as well as other federal and state statutes and regulations, require companies to disclose information. Why stop at Item 303? Violation of any of these rules could wind up serving as the basis for a private Section 10(b) claim.

Finally, the ruling in *Leidos* may signal the direction of the Gorsuch Supreme Court. For more than two decades, the Supreme Court has been emphasizing that the implied private right of action under Section 10(b) should be interpreted narrowly. After all, Congress could legislate an affirmative duty to disclose under Section 10(b), just as it did under Section 11. In *Leidos*, the Supreme Court has an opportunity to demonstrate the consistency of its rulings or to reverse course.

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