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Supreme Court to Examine Key Question of Securities Fraud Liability Based Solely on Omissions

On March 27, 2017, the Supreme Court granted certiorari in a potentially significant securities case addressing the scope of claims under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, based solely on alleged omissions of material information. *Leidos, Inc. v. Indiana Public Retirement System*, Supreme Court No. 16-581. The Supreme Court will resolve a split between the Second and Ninth circuits caused by the Second Circuit's holding that issuers may be liable for federal securities fraud by omitting information required to be disclosed by SEC regulations, even if those omissions do not render affirmative disclosures misleading.

Traditionally, to prevail under Section 10(b) and Rule 10b-5(b), a plaintiff must prove either a false statement or an omission of facts that renders a company's affirmative statements misleading. The Second Circuit in *Leidos* held that a case can also be predicated on an alleged failure to disclose information required to be disclosed under Item 303 of Securities and Exchange Commission Regulation S-K ("Item 303"), such as "known trends or uncertainties . . . that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."

In recent years, various plaintiffs have attempted to use Item 303 as a hook to support litigation when an adverse event (such as negative financial reports) occurs as a result of market developments, even where there has been no prior disclosure on the subject, thereby deviating from traditional Section 10(b) case law. The Second Circuit's standard increases the likelihood that plaintiffs will use negative market developments to support a claim that management knew or was reckless in not anticipating those developments.

The petition for certiorari argues that the Second Circuit's decision departs from the intent and purpose of Item 303 and Section 10(b) and is inconsistent with Supreme Court precedent that a fraud claim predicated on an omission can only be brought when that omission renders a prior affirmative statement misleading. Petitioners and amici assert that because Item 303 requires disclosure of subjective views about what is reasonably likely to happen, claims arising out of a failure to disclose pursuant to Item 303 are particularly susceptible to "fraud by hindsight."

The petition for certiorari highlights a circuit split between the Ninth Circuit and the Second Circuit on this issue, and notes that since the circuit split developed, plaintiffs asserting Item 303-based claims have largely abandoned the Ninth Circuit in favor of the Second Circuit. Petitioners also argue that the Second

Circuit rule is inconsistent with the Supreme Court's decision in *Matrixx Initiatives, Inc. v. Siracusano*, which held that "[Section] 10(b) and Rule 10b-5 do not create an affirmative duty to disclose any and all material information," 563 U.S. 27, 44 (2011), and stands for the proposition that an issuer may protect itself from Section 10(b) liability by controlling what it says to the market. Respondents argue that because a Section 10(b) claim also requires proof of (1) scienter, (2) reliance, and (3) damages, concerns of excessive litigation or forum shopping are unfounded.

A broad reversal of the Second Circuit not only would extinguish claims based on Item 303, but also may call into question the viability of claims predicated on other SEC rules. Argument is expected to be scheduled in the fall and the decision will likely be released sometime during the 2017–2018 term.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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