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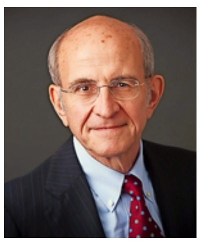
DISCLOSURE

Living With *Leidos*



BY LINDA L. GRIGGS, JOHN J. HUBER, AND CHRISTIAN J. MIXTER

On October 17, 2017, the Supreme Court granted the parties' joint motion to remove the case from the argument calendar and hold in abeyance further proceedings in *Leidos Inc. v. Indiana Public Retirement System, et. al.*, cert. granted, 137 S. Ct. 1395 (March 27, 2017), based upon an apparent settlement of the underlying case. A settlement of the case will make it likely that the litigation and disclosure issues presented by the Second Circuit's decision in *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016) (referred to herein as ''*Leidos*''), will continue until another case presenting the same issue comes before the Supreme Court. In *Leidos*, the Second Circuit relied on its prior ruling in *Stratte McClure v. Morgan Stanley*, 776 F. 3d 94 (2d Cir. 2015) (''*Stratte*''), in deciding that Item 303 of Regulation S-K supplies a duty to disclose for purposes of Section 10(b) under the Securities Exchange Act of 1934, as amended (the ''Exchange Act''), and Rule 10b-5 thereunder. Under *Leidos* and *Stratte*, a company filing a periodic report under the Exchange Act that requires disclosure pursuant to one or more items of Regulation S-K is subject to being sued under Rule 10b-5 for omitting a material fact in the disclosure that was made, regardless of whether that material fact makes any statement in the report misleading. Although the Second Circuit in *Leidos* held that the registrant has to ''actually know'' (*Leidos* at 96) the trend or uncertainty when the periodic report is filed, that holding does not clarify the scope of what a registrant is deemed to know and is limited to Item 303 of Regulation S-K.

Ms. Griggs is a Consultant, and Mr. Mixter is a partner, with Morgan, Lewis & Bockius LLP in Washington, D.C. Mr. Huber is an Affiliate with FTI Consulting in Washington, D.C. The views expressed herein are those of the authors and do not necessarily represent the views of FTI Consulting, Inc., Morgan Lewis or their other professionals.

Leidos and *Stratte* conflict with *Oran v. Stafford*, 226 F. 3d 275 (3d Cir. 2000) (''Oran''), and *NVIDIA Corp. Securities Litigation*, 768 F. 3d 1046 (9th Cir. 2014). The parties' settlement in *Leidos* means that the conflict in the circuits is unresolved. In the Second Circuit, a plaintiff may be able to avoid dismissal of an allegation of a Rule 10b-5 violation for a company's failure to provide disclosure pursuant to an item of Regulation S-K as long as the alleged omission is not '' 'so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of [its] importance.' '' *Leidos* at 96, quoting *ECA, Local 134 IBEW Joint Pension Tr. Of Chi. v. JP Morgan Chase Co.*, 553 F. 3rd 187, 197 (2d Cir. 2000). Plaintiffs may be able to withstand a motion to dismiss even if the item of Regulation S-K provides management with judgment in determining whether to make the disclosure. Since the plaintiff will have the luxury of time and hindsight, the plaintiff will know what transpired after the periodic report was filed in alleging materiality. The CEO/CFO certifications under Sections 906 and 302 of SOX will be argued as demonstrating scienter.

Perhaps even more important, however, is that the Securities and Exchange Commission (''SEC'') agrees with the Second Circuit, not the Third or the Ninth Circuits. As the amicus brief for the Solicitor General and the SEC states on page 8:

> A reasonable investor, reading an MD&A in the applicable legal context, understands it to contain all the information required by Item 303. An MD&A that discloses only some of the information Item 303 requires therefore is misleading.

The Second Circuit described an Item 303 omission as a ''half-truth'' by making the observation that a reasonable investor reading a periodic report would know that Item 303 disclosure in a filing is supposed to contain all of the disclosure required by Item 303. So, if a particular disclosure, such as a known trend or uncertainty, did not appear in the MD&A, the investor could reasonably infer its nonexistence. *Leidos* at 102, citing Donald C. Langevoort and G. Mitu Gulati, The Muddled Duty to Disclose Under Rule 10b-5, 57 VAND. L. REV. 1639, 1680 (2004). The SEC's and the Second Circuit's legerdemain that an omission really constitutes a half-truth to which Rule 10b-5 applies attempts to bridge the gap between these positions and the Supreme Court's statement in *Matrixx Initiatives v. Siracusano*, 563 U.S. 27, 45 (2011), that ''[e]ven with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market.'' The holdings in *Leidos* and *Stratte* and the SEC's position in the United States' *Leidos* amicus brief do not appear to have a stopping point. If an omission of a material fact subjects Item 303 of Regulation S-K to Rule 10b-5, then all of the SEC's disclosure rules are subject to the same potential liability. One can debate what a reasonable investor knows or doesn't know about the scope and nature of the disclosure requirements of the federal securities laws, but, until this issue is finally judicially determined, public companies reporting under the Exchange Act have a new and complex challenge. Potential liability under Rule 10b-5 may not be confined to material misstatements in what actually was disclosed, but also may include omissions of what a plaintiff or the SEC contend should have been disclosed with the benefit of 20-20 hindsight long after the date of filing.

We continue to believe, as stated in our recent articles (''When Rules Collide – *Leidos*, the Supreme Court, and the Risk to MD&A,'' 49 SRLR 1511 and 1554), that *Leidos* and *Stratte* were wrongly decided. We understand, however, that it is difficult for counsel and their clients to ignore one, much less two Second Circuit decisions. Therefore, this article suggests ways in which public companies and their advisors may want to address the disclosure challenges presented by the ongoing conflict in the circuits.

In light of this known litigation uncertainty, management and counsel should consider discussing the issues presented by *Leidos* with the company's board of directors in a privileged meeting. This discussion could consider whether the time, effort and expense of evaluating the need to amend the company's disclosure controls and procedures (''DC&Ps'') in light of *Leidos* are necessary given that, even prior to *Stratte* and *Leidos*, a creative private plaintiff could find some disclosure, among the voluminous and complex required disclosures, that was rendered misleading by the omitted information. See Grundfest, Joseph, ''Ask Me No Questions and I will Tell You No Lies: The Insignficance of *Leidos* before the United States Supreme Court'' (September 26, 2017) https://ssrn.com/abstract=3043990. Put simply, is *Leidos* a distinction without a difference from a litigation standpoint as Professor Grundfest has argued or does it signify a sea change in Rule 10b-5 litigation? This discussion with the board may be followed by discussions with the audit committee as case law developments occur in the future.

If the board decides to address *Leidos*, management and its advisors may wish to consider one or more of the following:

- Review and possibly enhance DC&Ps (how information is recorded, processed, summarized and reported in a timely fashion under Rules 13a-14(c) and 15d-14(c)) to facilitate earlier identification of issues that may become material in the future, so that such issues percolate up to senior management earlier than current policies and procedures provide.
- Even if a company decides not to amend its DC&Ps, it may want to consider reviewing the disclosure committee charter to consider the need to specify consideration of the SEC's Two-Step Test under Item 303(a)(3)(ii) to buttress a later argument in litigation based on now Justice, then Judge Alito's observation in *Oran* that the Two-Step Test imposes a different test of materiality than that set out by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). The Two-Step Test requires disclosure unless management determines that the trend or uncertainty is immaterial or remote.
- Include more people, particularly lawyers, in the drafting process at earlier stages, which may lengthen the time for preparation of a periodic report. Since companies need to consider Rule 10b-5 litigation risk, litigation counsel may be involved in DC&Ps as well as disclosure committee discussions and analyst calls. Senior management may need to be involved at an earlier stage to make judgments about potential disclosure issues.
- Revise the presentation in periodic reports to take full advantage of *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, __ U.S. __, 135 S. Ct. 1318 (2015) and the safe harbors for forward-looking statements and to address the SEC's amicus brief at page 18 relating to the inaccuracy of the certifications of the CEO and CFO under Section 302 and 906 of Sarbanes-Oxley. To obtain protection for opinions as to the completeness of a report, including with respect to trends and uncertainties, companies may want to consider disclosing that the decisions as to what to disclose in the report, including with respect to the outcome of both trends and uncertainties that are disclosed and those that are not disclosed, are opinions. Management should have a reasonable basis for these decisions, including its decisions to disclose the outcomes of trends and uncertainties as well as its decisions not to disclose such outcomes. Disclosure such as the following could be considered:

> Management's decisions to provide the disclosures included in this report, including its decisions about the outcome of the trends and uncertainties discussed in this report as well as [its/any] decisions to omit disclosure about

certain trends and uncertainties, are management's opinions based upon its analysis of required disclosures, including the materiality of omitted disclosures as well as the outcome of trends and uncertainties and the reasonably likely impact of such trends and uncertainties on the company's results, financial condition and cash flow.

■ Anticipate and prepare draft responses to more questions from analysts on conference calls if more disclosure about trends and uncertainties is included in periodic reports.

■ Analyze the potential liability resulting from *Leidos* under Section 11 and Section 12(a)(2) under the Securities Act of 1933, as amended (the "Securities Act"), for periodic reports that are incorporated by reference into registration statements, particularly shelf registration statements.

■ While these steps may appear at first blush to be overly defensive and unnecessary, only time will tell whether a private plaintiff (or the SEC) alleges an omission under Rule 10b-5 based on *Leidos* when a public company has not taken these or other steps to respond to *Leidos*.

The SEC's recent proposals, Release No. 33-10425, "FAST Act Modernization and Simplification of Regulation S-K," do not address this issue and, arguably exacerbate registrants' challenges if the SEC adopts the proposal to permit registrants to omit the MD&A disclosure for prior years when it is not material. We believe that the SEC should (a) change the position in its amicus brief; and (b) conduct further rulemaking to provide more assurance to companies that they will not be caught in a disclosure trap by *Leidos/Stratte*. The amicus brief's position runs counter to the implications of Chairman Clayton's speech pointing out the trend of fewer and fewer companies reporting to the SEC under the Exchange Act. Given the potential for increased liability and compliance costs, the response by public companies to *Leidos* may be to consider going private. In addition, fewer IPOs may occur when companies can raise capital and stay private in light of the increased number of record holders under Section 12(g) of the Exchange Act and Rule 144A as well as the changes to Regulation D under the Securities Act.