BakerHostetler

Winning Motions to Dismiss in Securities Class Actions

By Doug Greene

Securities class actions allege that executives made false statements to increase their company's stock price. Our lead argument is nearly always that our clients did not make a false statement. The law governing securities claims gives courts wide latitude to dismiss litigation, or not. If the judge is persuaded that the defendants tried to tell the truth, he or she will usually find a way to dismiss the litigation. Building on the argument against falsity, we then work on various other arguments in favor of dismissal.

A. The Importance of Defending the Truth of What the Defendants Said

In defending a securities class action, a motion to dismiss is almost automatic and, in virtually all cases, it makes good strategic sense. In most instances, there are only four main arguments in favor of the motion:

1. The complaint hasn't pleaded a false or misleading statement.
2. The challenged statements are protected by the safe harbor for forward-looking statements.
3. The challenged statements weren't made with scienter, even if the complaint has adequately pleaded their falsity.
4. The complaint hasn't adequately pleaded loss causation.

The core argument of virtually every brief is falsity: Standing up for a client's statements provides the foundation for all the other arguments. For most clients, it is important to stand up and say, "I didn't lie." And an emphasis on challenging the falsity allegations encompasses clients' most fundamental responses to the lawsuit, i.e., they reported accurate facts, made forecasts that reflected their best judgment at the time, gave opinions about their business that they genuinely believed, issued financial statements that were the result of a robust financial reporting process, etc.

The Reform Act and the cases that have interpreted it provide securities defense lawyers with broad latitude to attack falsity. A proper falsity analysis always starts by examining each challenged statement individually, and matching it up with the facts that the plaintiffs allege illustrate its falsity. Then, defense counsel can usually support the truth of what the clients said in numerous ways that are still within the proper scope of the motion-to-dismiss standard:

- Showing that the facts alleged do not actually undermine the challenged statements because of mismatch of timing or substance.
- Pointing out gaps, inconsistencies and contradictions in the plaintiffs' allegations.
- Showing that the facts the plaintiffs assert are insufficiently detailed under the Reform Act.
- Attacking allegations that the plaintiffs claim to be facts, but that are really opinions, speculation and unsupported conclusions.
- Putting the defendants' allegedly false or misleading statements in their full context to show that they were not misleading.
- Pointing to judicially noticeable facts that contradict the plaintiffs' theory.

These arguments must be supplemented by a robust understanding of the relevant factual background, which defines and frames the direction of any argument we ultimately make based on the complaint and judicially noticeable facts. Such an analysis is not simply allowed, but is required by the Supreme Court's decision in *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*, 135 S. Ct. 1318 (2015), which makes clear that a court must consider the full context of a statement in determining whether it is "misleading." We helped shape the Court's decision through an amicus brief we wrote on behalf of Washington Legal Foundation.

Yet many motions to dismiss do not make a forceful argument against falsity supported with a specific challenge to the facts alleged by the plaintiffs. Some motions superficially assert that the allegations are too vague to satisfy the pleading standard and do not engage in a detailed defense of the statements with the available facts. Others simply attack the credibility of the "confidential witnesses" without addressing in sufficient detail the content of the information the complaint attributes to them. Still others fall back on the doctrine of "puffery," which posits that even if false, the challenged statements were immaterial.

By focusing on these and similar approaches, a brief may leave the judge with the impression that defendants concede falsity, and that the real defense is that the false statements were not made with scienter.

That's risky for several reasons. First, detailed, substantive arguments against falsity are some of the strongest arguments that defendants can make. Second, they provide the foundation for the rest of the motion. Omitting a strong falsity argument weakens the argument against scienter and fails to paint the best possible no-fraud picture for the judge – which is ultimately what helps a judge to be comfortable in granting a motion to dismiss.

1. Emphasizing the Truth of What the Defendants Said Strengthens the Scienter Argument

The element of scienter requires a plaintiff to demonstrate that the defendant said something knowingly or recklessly false. In order to do this, plaintiffs must tie their scienter allegations to each particular challenged statement. It is not enough to generally allege, as plaintiffs often do, that defendants had a general "motive to lie."

When I analyze scienter allegations, I ask myself, "Scienter as to what?" Asking this question often unlocks strong arguments against scienter, because complaints often make scienter allegations that are largely detached from their allegations of falsity.

Often this is the case because the falsity allegations are insufficient to begin with. But many motions to dismiss are unable to point out this lack of connection, because they don't focus on falsity in a rigorous and thorough way.

Focusing on falsity is also necessary because of how courts analyze falsity and scienter. Although they are separate elements that should be analyzed separately, courts often analyze them together. Arguing a lack of falsity thus provides essential ingredients for this combined analysis.

Even when courts analyze falsity and scienter separately, a proper scienter analysis requires a foundational falsity analysis because, as noted above, scienter analysis asks whether the defendant knew that a particular statement was false. Without an understanding of exactly why that challenged statement was false and what facts allegedly demonstrate that falsity, the scienter analysis meanders, devolving into an analysis of knowledge of facts that may or may not be probative of the speaker's state of mind related to that statement.

The tendency to lump scienter and falsity together is exemplified by the scienter doctrines that we call "scienter shortcuts": (1) the corporate scienter doctrine and (2) the core operations inference of scienter. Under these doctrines, courts draw inferences about what the defendants knew based upon the prominence of the falsity allegations. The more blatant the falsity, the more likely courts are to infer scienter. A superficial falsity argument weakens defendants' ability to attack these scienter shortcuts, which plaintiffs are asserting more and more routinely.

2. Emphasizing the Truth of What the Defendants Said Makes the Judge Feel Better About Dismissing the Litigation

It is a good strategy for a defendant to thoroughly argue lack of falsity even if (1) there are better alternative grounds for dismissal, and (2) the challenge to falsity is unlikely to be successful as an independent ground for dismissal. This is for the simple reason that judges are humans – they will feel better about dismissing a case based on other grounds if you can make them feel comfortable that there was not a false statement to begin with.

For example, courts are often reluctant to dismiss a complaint solely on safe harbor grounds because it is seen as a "license to lie," so it is strategically wise also to argue that forward-looking statements were not false in the first place. Similarly, even if lack of scienter is the best basis for dismissal, it is a good strategy to defend on the basis that no one said anything wrong, rather than appearing to concede falsity and being left to contend "but they didn't mean to."

In most cases, judges have enough latitude under the pleading standards to dismiss or not. The pivotal "fact" is whether the judge feels the case is really a fraud case.

A motion to dismiss that vigorously defends the truth of what the defendants said is more likely to make the judge feel that there really is no fraud there.

Conversely, if the defendants make an argument that essentially concedes falsity and relies solely on the argument that the falsity was immaterial, wasn't intentional or is not subject to challenge under the safe harbor, a judge may stretch to find a way to allow the case to continue.

Put simply, a judge is more likely to dismiss a case in which a defendant says "I didn't lie" than to dismiss a case in which defendants argue "I may have lied, but I didn't mean to," "I may have lied, but it doesn't matter" or "I may have lied, but the law protects me anyway." Even when a complaint might ultimately be dismissed on other grounds, a strong challenge to falsity is essential to help the judge feel that he or she has reached a just result.

3. The Supreme Court's Decision in Omnicare Defines Falsity Analysis for Statements of Opinion and Fact

Omnicare held that a statement of opinion is only false under the federal securities laws if the speaker does not genuinely believe it, and is misleading only if it omits information that, in context, would cause the statement to mislead a reasonable investor.

The Court's ruling in *Omnicare* was a significant victory for the defense bar for two primary reasons:

1. The Court made clear that an opinion is false only if it was not sincerely believed by the speaker at the time it was expressed, a concept sometimes referred to as "subjective falsity." The Court thus explicitly rejected the possibility that a statement of opinion could be false because "external facts show the opinion to be incorrect," a company failed to "disclose some fact cutting the other way," or the company didn't disclose that others disagreed with its opinion. This ruling resolved two decades of confusing and conflicting case law regarding what makes a statement of opinion false, which had often permitted meritless securities cases to survive dismissal motions.
2. *Omnicare* declared that whether a statement of opinion (and by clear implication, a statement of fact) was misleading "always depends on context." The Court emphasized that showing a statement to be misleading is "no small task" for plaintiffs, and that the Court must consider not only the full statement being challenged and the context in which it was made, but also other statements made by the company and other publicly available information, including the customs and practices of the relevant industry.

Evaluating challenged statements in their broader context almost always benefits defendants, because it helps the court better understand the challenged statements and makes them seem fairer than they might in isolation. *Omnicare* now explicitly requires courts to evaluate challenged statements within their broader contexts.

Although *Omnicare* arose from a claim under Section 11 of the Securities Act, all of its core concepts are equally applicable to Section 10(b) and other securities claims with similar falsity elements. Due to the importance of its holdings and the detailed way in which it explains them, *Omnicare* is the most significant post-Reform Act Supreme Court case to analyze the falsity element of a securities class action claim. It lays out the core principles of falsity in the same way that the Court did for scienter in its 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308 (2007).

If used correctly, *Omnicare* thus has the potential to be the most helpful securities case for defendants since *Tellabs,* providing attorneys with a blueprint for how to structure their falsity arguments in order to defeat more complaints on motions to dismiss.

Nevertheless, some commentators and members of the defense bar have raised alarm about *Omnicare,* asserting the decision was a win for plaintiffs because it created a new area of potential liability for statements of opinion that were honestly held, but nonetheless misleading. The view that *Omnicare* was a plaintiff-friendly result seems to be based on two misconceptions. The first is a misunderstanding of the law as it existed before *Omnicare*, and the second is a misunderstanding of the ruling itself.

Because of the importance of *Omnicare* to so many securities class actions, it's useful both to review the history of the law governing the truth of opinions and to explain how and why *Omnicare* is helpful to defendants.

a. Pre-Omnicare Law Governing Statements of Opinion Was Hopelessly Muddled

Some commentators have argued that the law before *Omnicare* established a clear standard that favored defendants, namely that statements of opinion were actionable only if they misstated the speakers' true opinion.

But this is a misunderstanding of the law governing statements of opinion before *Omnicare* – law that was anything but clear, despite the fact that the Supreme Court had previously addressed the issue in 1991 in *Virginia Bankshares v. Sandberg,* 501 U.S. 1083 (1991).

Virginia Bankshares established the so-called “subjective falsity” standard, holding that a statement of opinion may be actionable as a false statement of “fact” only to the extent to which it is a “misstatement of the psychological fact of the speaker’s belief in what he says.”

Yet the *Virginia Bankshares* decision was itself hardly a paragon of clarity, and its holding took nearly 20 years to catch on. In the meantime, the most influential standard on statements of opinion continued to be the plaintiff-friendly one articulated in 1989 by the Ninth Circuit in *In re Apple Computer Securities Litigation,* which held that opinions are actionable if (1) they are not genuinely believed, (2) there is no reasonable basis for the belief, or (3) the speaker knows undisclosed facts that tend to seriously undermine the opinion. *See, e.g., In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).

The tide began to turn in 2009, when the Ninth Circuit applied *Virginia Bankshares* in *Rubke v. Capitol Bancorp Ltd.,* 551 F.3d 1156 (9th Cir. 2009), and held that plaintiffs bringing cases under Section 11 must plead that statements of opinion were subjectively false. The Second Circuit followed in the footsteps of *Rubke* in 2011, applying the *Virginia Bankshares* standard of subjective falsity in *Fait v. Regions Financial Corp.,* 655 F.3d 105 (2d Cir. 2011).

However, the *Rubke* court did not expressly consider or overrule the plaintiff-friendly *Apple* standard, which courts around the country continued to widely apply. Meanwhile, many other courts continued to ignore both *Apple* and *Virginia Bankshares,* and instead engaged in the amorphous discussion of whether statements of opinion were “soft” information or “puffery” that could not form the basis for any securities liability.

Adding to this confusion was the fact that neither *Rubke* nor *Fait* had attempted to address what made a statement of opinion “misleading,” the second half of the falsity standard articulated throughout the securities laws (including in Section 10(b) and Section 11).

For example, Rule 10b-5 provides for liability if companies “make any untrue statement of a material fact” or “omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” 15 U.S.C. § 78j; see also 15 U.S.C. § 77k(a) (Section 11 provides that there is liability for registration statements connected with public offerings if they “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”).

On the one hand, the fact that the circuit courts had declined to reach the question of what could make a statement of opinion “misleading” left district courts to struggle with it on their own, with results that were sometimes disastrous from a defense point of view. On the other hand, this oversight led some defense attorneys to incorrectly believe that the Second Circuit and Ninth Circuit had simply eliminated the “misleading” half of the “false or misleading statement” element of the securities laws when it came to statements of opinion – and thus to argue that plaintiffs could not allege that a statement of opinion was misleading.

This hodgepodge of conflicting precedent culminated in the confused Sixth Circuit opinion that the Court reviewed in *Omnicare.* The Sixth Circuit jumbled concepts of falsity, materiality and scienter to arrive at the conclusion that under Section 11, a statement of opinion can be “false” if it is later determined that the opinion was incorrect – even if it was genuinely believed by the speaker at the time.

b. Omnicare Will Help Defendants Win More Cases

The Supreme Court decision in *Omnicare* did not give a clear win to either the *Omnicare* plaintiffs or the defendants because the justices found the positions the parties advanced to be untenable. The Court overruled the Sixth Circuit’s holding by recognizing that a statement of opinion is only “false” if it was not genuinely believed. At the same time, the Court also rejected *Omnicare’s* position that a statement of opinion could never be misleading, holding that – like any other statement – a statement of opinion may indeed be misleading.

The *Omnicare* ruling sidestepped many potential landmines in articulating how a statement of opinion could be misleading, and instead established a clear test that was consistent with existing law. It emphasized that an opinion is not misleading just because “external facts show the opinion to be incorrect,” if a company fails to disclose “some fact cutting the other way,” or if the company does not disclose that some disagree with its opinion.

The Court also rejected the Solicitor General’s plaintiff-friendly approach, which would have required that every opinion have a “reasonable basis.” Rather, the Court seized upon the approach that we had urged in our amicus brief, finding that, as with a statement of fact, an opinion is misleading if it omits information that is necessary to avoid giving a reasonable investor a false impression of the “real facts,” when the statement is taken as a whole and considered in its full context.

The Court then explained in detail, using hypothetical examples, how this standard applies to statements of opinion. It emphasized that whether a statement is misleading "always depends on context," because a statement must be understood in its "broader frame," including "in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information," as well as the "customs and practices of the relevant industry."

Emphasizing that pleading the existence of a misleading opinion is "no small task" for plaintiffs, the Court described the variety of contextual weapons that defense attorneys can use to fight against allegations that a statement of opinion – or any kind of statement – was misleading due to omission.

This is perhaps the most significant portion of the ruling from the defense perspective. Good defense lawyers already took advantage of existing law, such as *Tellabs,* to supply courts with a wide variety of contextual information, including the text surrounding challenged statements, other statements filed with the SEC, and further information that was available to the market and subject to judicial notice. *Tellabs,* 551 U.S. at 322 ("courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice"). But now the Supreme Court has further mandated that such a contextual analysis is necessary, not only to determine the existence of scienter, but also to judge whether a statement can be viewed as misleading.

Defense counsel and other commentators who have opined that *Omnicare* was a plaintiff-friendly holding fundamentally misunderstand several aspects of the ruling.

First, some have wrongly asserted that the Court expanded defendants' liability risk because opinions can be actionable. Statements of opinion have never enjoyed anything approaching complete immunity under the securities laws. The second element of the "false or misleading" standard had to apply to opinion statements in some way – in *Omnicare*, the Court merely clarified and specified how. The Court's holding fits statements of opinion into the existing legal frameworks used by many circuits, including the Second Circuit and the Ninth Circuit, to analyze whether any statement is misleading due to an omission under the plain language of Section 11 and Rule 10b-5.

Second, the Court did not, contrary to some assessments of *Omnicare,* implement a "reasonable basis" test for opinions similar to the test the Solicitor General advocated. The Solicitor General's test would have implemented a standard close to the plaintiff-friendly *Apple* test to evaluate the "reasonableness" of the opinion itself, such that a genuinely held statement of opinion could nevertheless be false if a court later determined that the speaker did not have a "reasonable basis" to hold that opinion.

This test is deeply flawed because such a "reasonableness" inquiry is, in and of itself, entirely subjective, meaning that whether an opinion was true or false would hinge on someone else's later opinion as to its "reasonableness."

Although the *Omnicare* Court does use the word "reasonable," it does so only to state (consistent with pre-existing law) that whether an opinion statement is "misleading" due to an omission is dependent upon what the statement in its full context would convey to a reasonable investor. Because registration statements are "formal documents, filed with the Securities and Exchange Commission as a legal prerequisite for selling securities to the public," the Court found that investors would reasonably assume that statements made in this context rested on a "meaningful inquiry," and did not "reflect baseless, off-the-cuff judgments." As the Court emphasized, this test is objective, far different from the subjective "reasonable basis" approach advocated by the Solicitor General.

B. Forward-Looking Statements and the Reform Act's Safe Harbor

Public companies around the country labor under a misunderstanding: that the Private Securities Litigation Reform Act's safe harbor protects them from liability for their guidance and projections if they simply follow the statute's requirements. But the safe harbor is not so safe – because they think it goes too far, many judges go to great lengths to avoid the statute's plain language. Companies and their securities litigation defense counsel can usually work around this judicial attitude and take advantage of the statute's protections, however, with the right approach to preparing and defending the company's disclosures.

The safe harbor was a key component of the 1995 reforms of securities class action litigation. Congress sought "to encourage issuers to disseminate relevant information to the market without fear of open-ended liability." H. R. Rep. No. 104-369, at 32 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 731. The safe harbor straightforwardly says that a material forward-looking statement is not actionable if it either (1) is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," or (2) is made without actual knowledge of its falsity. 15 U.S.C. § 77z-2(c)(1); 15 U.S.C. § 78u-5(c)(1).

Yet courts' application of the safe harbor has been anything but straightforward. Indeed, courts have committed some basic legal errors in their attempts to nullify it. Foremost among these is the tendency to collapse the two prongs – thus essentially reading "or" to mean "and" – to hold that actual knowledge that the forward-looking statement is false means that the cautionary language can't be meaningful. Courts also engage in other types of legal gymnastics to take the statements out of the safe harbor, such as straining to convert forward-looking statements into present-tense declarations.

The most notorious erroneous safe harbor decision was written by one of the country's most renowned judges, Judge Frank Easterbrook. In *Asher v. Baxter,* 377 F.3d 727 (7th Cir. 2004), Judge Easterbrook read into the safe harbor the word "the" before "important" in the phrase "identifying important factors," to then hold that discovery was required to determine whether the company's cautionary language contained "the (or any of the) 'important sources of variance'" between the forecast and the actual results. *Id.* at 734. The statute only requires a company to identify "important factors," not *the* important factors.

Judge Easterbrook's misreading of the statute injected a subjective component into an objective inquiry; it purported to require courts to evaluate the company's disclosure decisions, i.e., what the company thought were "the" important factors. This error led the court to permit discovery on what the company thought was "important" – a procedure directly contrary to Congress's clear intent that courts apply the safe harbor on a motion to dismiss and "not provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made." H.R. Rep. No. 104-369, at 44 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 743.

Frequently, courts simply avoid defendants' safe harbor arguments, choosing either to treat the safe harbor as a secondary issue or to avoid dealing with it at all. The safe harbor was meant to create a clear disclosure system: If companies have meaningful risk disclosures, they can make projections without fear of liability. When judges avoid the safe harbor, companies' projections are judged by legal rules and pleading requirements that result in less-certain and less-protective outcomes, even if judges get to the right result on other grounds. And if companies come to realize that they do not have the clear safe harbor protection Congress meant to provide, they will make fewer and/or less meaningful forward-looking statements.

The root of these problems is that many judges don't like the idea that the safe harbor allows companies to escape liability for knowingly false forward-looking statements. Some courts have explicitly questioned the safe harbor's effect. For example, in *In re Stone & Webster, Inc. Securities Litigation,* the First Circuit called the safe harbor a "curious statute, which grants (within limits) a license to defraud." 414 F.3d 187, 212 (1st Cir. 2005).

And the Second Circuit, in its first decision analyzing the safe harbor – 15 years after the Reform Act was enacted, illustrating the degree of judicial avoidance – correctly interpreted "or" to mean "or," but stated that "Congress may wish to give further direction on …. the reference point by which we should judge whether an issuer has identified the factors that realistically could cause results to differ from projections. May an issuer be protected by the meaningful cautionary language prong of the safe harbor even where his cautionary statement omitted a major risk that he knew about at the time he made the statement?" *Slayton v. American Express Co.,* 604 F.3d 758, 772 (2d Cir. 2010). (Soon after the Second Circuit decided *American Express*, the Ninth Circuit also interpreted "or" to mean "or." *In re Cutera, Inc. Sec. Litig.,* 610 F.3d 1103, 1112-13 (9th Cir. 2010).)

This judicial antipathy for the safe harbor won't change. So it is up to companies to draft cautionary statements that will be effective in the face of this skepticism, and for securities defense counsel to make safe harbor arguments that resonate with dubious judges.

For these reasons, we take a dual approach to defending forward-looking statements:

1. We defend the honesty of the challenged forward-looking statements. For example, the complaint, along with incorporated and judicially noticeable facts, often allows defense counsel to support the reasonableness of challenged earnings guidance.

Some defense lawyers avoid this approach because it is fact-intensive, which they worry may cause judges to believe that dismissal isn't appropriate. We have found, however, that judges who believe that the forward-looking statements have a reasonable basis (and are thus assured that they were not knowingly dishonest) are more comfortable applying the safe harbor, or granting the motion on another basis such as lack of falsity.

2. We then use the safe harbor to demonstrate that the company's safe harbor cautionary statements show that it really did its best to warn of the risks it faced. Judges can tell if a company's risk factors aren't thoughtful and customized. Too often, the risk factors become part of the SEC-filing boilerplate, and don't receive careful thought with each new disclosure. But risk factors that don't change from period to period, especially when it's apparent that the risks *have* changed, are less likely to be found meaningful. And even though many risks don't fundamentally change every quarter, facets of those risks often do, or there might be another, more specific risk that could be added.

On the other hand, the least effective arguments are those that rest on the literal terms of the safe harbor, which create the impression that defendants are trying to skate on a technicality. It is these types of arguments – lacking in a sophisticated supporting analysis of the context of the challenged forward-looking statements and of the thoughtfulness of the cautionary language – that cause the courts to try to evade what they see as the unjust application of the safe harbor. Defense counsel should appreciate that safe harbor "law" includes not only the statute and decisions interpreting it, but also the skepticism with which many judges evaluate safe harbor arguments.

C. Plaintiffs Are Increasingly Relying on Item 303 of Regulation S-K – But to What Effect?

SEC forms, under both the Securities Act and the Exchange Act, require the disclosure of various items described in SEC Regulation S-K. Some of the most important disclosures are found in S-K Item 303(a), which includes "management's discussion and analysis" (MD&A) of the company's "financial condition, changes in financial condition and results of operations." And Item 303(a)(3)(ii) indicates that the MD&A must include a description of "any known trends or uncertainties that have had or that the [company] reasonably expects will have a material … unfavorable impact on net sales or revenues or income from continuing operations."

This is a high hurdle for a plaintiff to clear: A company must actually know (1) the facts underlying the trend or uncertainty, (2) that those known facts yield a trend or uncertainty and (3) that the trend or uncertainty will have a negative and material impact.

The key liability provisions of the federal securities laws, Section 10(b) of the Exchange Act and Section 11 of the Securities Act, prohibit a false statement or omission of a fact that causes a statement to be misleading. In addition, the text of Section 11 allows a claim to be based on the issuer's failure to disclose "a material fact required to be stated" in a registration statement. 15 U.S.C. § 77k(a). One such requirement is Item 303. *Panther Partners Inc. v. Ikanos Communications, Inc.*, 681 F.3d 114, 120 (2nd Cir. 2012). Based on this statutory language – which is unique to Section 11 – Section 11 claims appropriately can include claims based on Item 303.

Panther Partners is the decision that has fueled Item 303's use by plaintiffs' counsel. In *Panther Partners*, the Second Circuit held that Item 303 required the issuer, Ikanos Communications, to disclose information about a high product defect rate, and that the omission of this information from a registration statement gave rise to a cause of action under Section 11.

There are two important facets of the decision that have largely been overlooked. First, the court emphasized Section 11's requirement, which isn't present in the statute or decisions under Section 10(b), that an issuer must disclose "a material fact required to be stated" in a registration statement. Second, the court was troubled by the fact that the company's risk factor statement about product defects suggested there were no defects when, in fact, there were:

> *In light of these allegations, the Registration Statement's generic cautionary language that "[h]ighly complex products such as those that [Ikanos] offer[s] frequently contain defects and bugs" was incomplete and, consequently, did not fulfill Ikanos's duty to inform the investing public of the particular, factually based uncertainties of which it was aware in the weeks leading up to the Secondary Offering. Id. at 122.*

We could make a strong argument that the driver of the court's decision was a false or misleading risk factor, and Item 303 was just the way the court articulated its

conclusion. As we noted in the previous section, courts are often troubled by boilerplate risk factors, especially those that describe in hypothetical terms risks that have actually materialized.

In the wake of *Panther Partners*, plaintiffs' lawyers began to use Item 303 with increasing frequency, including in Section 10(b) cases. With the increase in the volume of Item 303 claims came a circuit split: The Ninth Circuit has held that Item 303 does not establish an independent duty of disclosure for the purposes of Section 10(b), and the Second Circuit has held that it does – although with the qualification that an Item 303 omission can only support a Section 10(b) claim if all the independent requirements of such a claim are met. *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015).

In March 2017, the Supreme Court granted certiorari in *Leidos, Inc. v. Indiana Public Retirement System*, a Second Circuit case that would allow the Court to address the circuit split. Although the parties settled in October 2017, mooting the Supreme Court's review, we never believed that the attention paid to Item 303 by litigants and courts made much sense. In a Working Paper entitled "Ask Me No Questions and I Will Tell You No Lies: The Insignificance of *Leidos* Before the United States Supreme Court," Stanford Law School Professor and former SEC Commissioner Joseph Grundfest agreed. In that article, Professor Grundfest predicted the Supreme Court would conclude the issue would be a "nothing burger." Rock Center for Corporate Governance Working Paper Series No. 229 (Sept. 27, 2017).

We first reached this same conclusion in a roundabout way in a case we defended shortly after the Second Circuit's *Panther Partners* decision. There were two offerings at issue in that case, and because of *Panther Partners*, plaintiffs' counsel featured the Item 303 allegations. We drafted a detailed motion-to-dismiss section on the Item 303 issue. But as we evaluated our arguments in light of the page limit, we kept shortening the Item 303 argument.

In the end, we decided that the Item 303 claim was redundant: The court wasn't going to deny the motion to dismiss under Item 303 without also finding that the plaintiffs had sufficiently pleaded a false statement and scienter, because the plaintiffs challenged many statements and pleaded scienter using the same allegations that formed the basis of the Item 303 claim. So in the filed version of the motion, the argument became a fraction of the size of the original one. And in the reply brief, the Item 303 argument was reduced to a short footnote.

Companies affirmatively say many things on the subject matter of an omission sufficient to yield an Item 303 claim. Indeed, it's hard to imagine a case in which an issue is so major as to require Item 303 disclosure but isn't something about which the company has spoken. And given that this is the case, and Item 303's disclosure requirements are infused with knowledge requirements, it also would be an anomalous case in which there is an Item 303 violation but not scienter.

For example, if a company violates Item 303 by not disclosing that its biggest customer is switching suppliers next quarter, and proceeds to say things about its business and financial outlook as if nothing had happened, it has made misleading statements with intent to defraud. The Item 303 claim adds nothing.

Why, then, have plaintiffs' counsel pushed Item 303 claims so hard? It's mostly to combat the cardinal rule that silence, absent a duty to disclose, is not misleading. Companies omit thousands of facts every time they speak, and it's relatively easy for a plaintiff to identify omitted facts. But it's analytically difficult work – and often unsuccessful – to challenge affirmative statements.

Another important reason is defendants' attack on the fraud-on-the-market presumption of reliance over the past several years – first on the legitimacy of *Basic v. Levinson*, which gave rise to securities class actions, and now on its viability in specific cases under the price-impact rule of *Halliburton II*. Claims of pure omission under Item 303 arguably would fall under an alternative basis for reliance under *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), rather than under *Basic*, which would make class certification easier and more certain.

But we believe Item 303 will remain a "nothing burger," to borrow Professor Grundfest's term. The Supreme Court will not hear *Leidos*, and it's hard to imagine the Court taking up the issue again anytime soon. More fundamentally, we continue to believe Item 303 does no separate work, as discussed above. Indeed, despite the popularity of Item 303 with plaintiffs' lawyers, *Panther Partners* and *Stratte-McClure* have not produced an explosion of successful claims in the Second Circuit. We also think plaintiffs may curtail their assertion of 303 claims because of their lack of success on the merits, and also because defendants infrequently challenge class certification under *Halliburton II*, making it unnecessary for plaintiffs to resort to a pure omissions theory for demonstrating reliance.

D. The Importance of Focusing the Scienter Analysis on Knowledge of Falsity

Scienter allegations are of two types, with the second far more prevalent:

1. Allegations pleading facts about what the defendant knew, to attempt to plead that he or she knew the challenged statements were false.
2. Allegations that the defendant "must have" meant to lie, based on circumstantial considerations such as a defendant's stock sales, corporate transactions, the temporal proximity of the challenged statement to the disclosure of the "truth," and the relationship of the subject of the challenged statements to the company's "core operations."

As with falsity, the primary flaw in most defense arguments against scienter is their failure to engage in a fact-specific analysis of the complaint's allegations about what the defendants knew in regard to each specific challenged statement. All too often, defendants allow themselves to be drawn to the plaintiffs' preferred ground of battle, focusing on arguing about the sufficiency of the circumstantial evidence that plaintiffs use to create the impression that the defendants must have done something wrong.

Circumstantial scienter allegations are only ways to try to make an educated guess about what the speaker knew or intended. But the Reform Act's scienter standard requires particularized pleading yielding a "strong inference" that the defendant lied on purpose – a very high standard. So it makes no sense for defense counsel not to approach the issue directly, by making it clear that the speaker did not lie, and holding plaintiffs to the strict standard of showing specific scienter as to each challenged statement.

For this reason, all effective motions to dismiss start by testing the complaint's allegations that the defendants actually knew, or were intentionally reckless about not knowing, the facts establishing falsity. This means that for each statement and each defendant, the motion to dismiss must isolate the statement and the reasons that the complaint alleges it was false, and analyze what the complaint alleges each defendant knew about those facts at the time he or she made each challenged statement.

Without this focus on each specific challenged statement, the scienter inquiry is vague, and becomes more about whether the defendant seems bad, or had generally bad motives, than about whether he or she lied on purpose. A good motion to dismiss does not let plaintiffs get away with these kinds of generalized allegations.

The problem becomes worse if defense counsel approaches falsity categorically, without careful scrutiny of why the complaint alleges the challenged statements were false. Without this focus, defense counsel can't meaningfully answer the central question in the Reform Act analysis – "scienter as to what?" – because there isn't a sufficient nexus between the challenged statements and contemporaneous facts that made the statements false. The scienter inquiry thus becomes unmoored from knowledge that specific statements were false.

The result is a lower burden for plaintiffs: If they are able to plead falsity and the defendants seemed to know something about the general subject matter, scienter is almost a foregone conclusion.

This problem is even worse under the "core operations" inference of scienter and the "corporate scienter" doctrine. Each of these theories allows a plaintiff to avoid pleading specific facts establishing the speaker's scienter. For example, the core operations inference posits that scienter can be inferred where it would be "absurd to suggest" that a senior executive doesn't know facts about the company's "core operations." Many motions to dismiss set up some formulation of this statement as a legal rule and make a simplistic syllogistic argument from it. Such arguments devolve into "did not, did so" debates, and thus play into plaintiffs' hands because they are detached from knowledge of falsity.

Instead, the right approach to the core operations inference is to understand that it requires a falsity so blatant that we can strongly infer that the executive had knowledge of the exact facts that made the statement false – not just the subject matter of the facts. The most effective defense against the core operations inference thus focuses on falsity first, to show that even if a statement is false, it is at least a close call, which makes it hard for plaintiffs to contend that defendants must have known of this falsity.

This can't be done effectively if the argument against falsity is categorical (i.e., it embraces arguments such as "puffery" rather than discussing the specific statements), or otherwise fails to address the falsity allegations in detail. Of course, it is impossible to make this argument effectively if the scienter section of the brief precedes the falsity section.

Conclusion

Securities class actions can be defeated at the motion to dismiss stage with the right approach. We do not rely on technicalities or gotchas. They send the wrong signal to the judge, and do not work in most cases. Instead, we emphasize that our clients told the truth. With that argument as our foundation, we then present the full set of available arguments so that the judge has a menu of options for dismissing the litigation.

Securities and Governance Litigation Team

Our nationwide team of more than 50 attorneys comprises full-time securities litigators, former Securities and Exchange Commission (SEC) and Department of Justice (DOJ) enforcement trial lawyers, and prominent commercial litigators. Our turnkey team features the full skill set our clients need to win at each stage of the litigation.

We are devoted to winning every case at the earliest possible time. We have an excellent track record of obtaining dismissals prior to any discovery. But if the case survives a motion to dismiss, we don't just throw in the towel: we stand ready to defeat or limit class certification, prevail on summary judgment, and take the case to trial. We are committed to putting "litigation" back in securities and governance litigation.

Of course, we are always attuned to the right time to engage in mediation. Litigating to win – up to and including trial if necessary – best positions our clients to achieve settlements that protect their reputations and resources. Through decades of experience, we have gained the respect of key mediators, plaintiffs' counsel, and D&O insurers and brokers. These relationships are critical to effective mediation of securities and governance cases.

We are also sensitive to the economics of each case. Increasingly, plaintiffs' lawyers are pursuing securities and governance cases against both small and large public companies. We have the ability to scale our team and approach to defend every case both efficiently and effectively. We also are highly experienced in the use of document-processing technology to handle discovery documents and help marshal key facts – which leads to significant efficiencies.

All of this is about protecting people. At the core of every securities or governance case are people accused of doing something wrong – not just directors and officers but also hardworking company employees who find themselves at the center of a securities suit. We focus our defense of each case on these people. From designing legal arguments that defend their honesty, to client-focused economics that maximize their insurance protection, to sensitivity to the stress the litigation may cause them, we work hard to protect people and keep them as comfortable as possible. Protecting people is our top priority in every case.

About the Author

[Doug Greene](#) leads BakerHostetler's firmwide Securities and Governance Litigation Team.

Doug is one of the most experienced and successful securities and governance litigators in the United States. He defends and counsels clients in securities class actions, shareholder derivative actions, shareholder challenges to mergers and acquisitions, SEC investigations, and internal investigations.

Doug has focused his practice exclusively on such cases since 1997 and is one of only a handful of full-time practitioners nationwide. He has handled more than 100 securities and corporate governance litigation matters, defending companies of every size and industry — from aerospace giant Boeing, to beverage manufacturer Jones Soda.

Securities and governance litigation can be frustrating — it accuses good people of doing bad things. Doug is devoted to helping clients through it as quickly and comfortably as possible. His defense emphasizes his clients' honesty and good faith, defending the truth of what they said and their intent to do and say the right thing. He doesn't rely on technicalities or gotchas.

Doug also works hard to shape securities law, so that executives can speak publicly and make business decisions without fear of unfair liability. He founded and wrote a pioneering securities and governance litigation blog. He has published dozens of articles. He is a sought-after speaker. He authored U.S. Supreme Court amicus briefs in the Omnicare, Cyan and Quality Systems securities class actions. In Omnicare, Doug contributed to the groundbreaking Supreme Court decision that executives cannot be liable for voicing their honestly held opinions — a position he had long championed.

Clients refer to Doug as an "expert securities litigator." One client said, "Doug Greene came to the [counsel selection] meeting with an in-depth understanding of the specific details of the case and proposed a strategy on how to move forward with a realistic timeline." Another client said, "Doug makes himself available seven days per week, and the first thing he provides is his cell phone number along with a promise to be available at any time, even if it's just to alleviate my worries … I would use [him] again in a heartbeat."

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