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Antifraud

Omission Based Securities Fraud Claims: Determining a Duty to Disclose Before Reaching the Question of Materiality

BY MEG KEELEY

Plaintiffs in securities cases commonly allege not only affirmative misrepresentations, but also omissions. Such omission-based claims can be particularly troublesome because of how easy it is for a plaintiff to take the stand and testify that he would have liked to have known some particular piece of information and that, had he known it, it would have influenced his decision regarding a security. Litigants frequently focus on the element of materiality in defending against such claims.

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But another critical limitation on omission-based liability is that there must have been a duty to speak in the first instance. Too often this requirement that there be a duty to speak is given little consideration by the courts—allowing claims to go to the jury based upon a theory of what the investor would have liked to have known. This is not the standard, and litigants need to be vigilant in challenging omission-based claims that fall outside the actionable parameters.

The Duty to Speak Rule 10b-5 of the Securities and Exchange Commission's Rules and Regulations provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to 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, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[1]

This standard does not require one to disclose every material fact. No one is ''required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities law only when the corporation is subject to a duty to disclose the omitted facts.''[2] As the court articulated it in *Glazer v. Formica Corp.*:

> the concepts of materiality and duty to disclose are different. ''The materiality of the information claimed not to have been disclosed . . . is not enough to make out a sustainable claim of securities fraud. Even if information is material, there is no liability under Rule 10b-5 unless there is a duty to disclose it.''[3]

Non-Insider Trading Claims Outside the insider trading context, discussed below, the duty to speak can arise from two sources. *First*, explicit in the text of subsection (b) is the right to bring a claim based upon the so-called ''half-truth''—that is when a material statement is made, but at the same time a material fact is omitted which alters the meaning of that statement.[4] *Second*, the securities statutes and regulations themselves proscribe that certain, specified information must be disclosed in public filings.[5]

One need go no further than what is required by these two sources, however. As the Second Circuit recently explained in the analogous context of a mutual fund's offering documents, there are three potential bases for liability based on filings with the SEC:

> (1) A misrepresentation; (2) an omission in contravention of an affirmative legal disclosure obligation; and (3) an omission of information that is necessary to prevent existing disclosures from being misleading.[6]

The requirement of an affirmative legal obligation makes sense in light of the SEC's detailed and extensive regulations governing disclosures. As a district court explained it in the context of an alleged omission in an Annual Report:

> The SEC . . . was given complete discretion to require in corporate reports only such information as it deems necessary or appropriate in the public interest or to protect investors. A general admonition to include ''all material information'' in annual reports preempts the promulgated regulations' instructions on what information to include and, because of the threat of civil liability, it would result in all sorts of information appearing in the reports that the SEC may prefer be left out. If the SEC wanted all possibly material information to be in the annual reports, we suspect that the regulations would have been amended to require it. The utility of such a regulation would be doubtful.[7]

Although the requirement of a duty to speak is not focused on nearly as much as it should be, a number of courts have dismissed securities claims based on the lack of a duty to speak. In *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.*,[8] for example, the plaintiffs accused Philip Morris of securities fraud for failing to disclose a new marketing plan it was testing which would have served as a ''sharp break'' from the company's historic practices. The Second Circuit explicitly found that the ''information was such that a reasonable investor probably would want to know about it,''[9] but nonetheless held that there was no duty to disclose the possibility of implementing the new plan because that possibility did not render any other statement by the company materially misleading.[10]

Litigants thus need to ensure that they do not leap immediately to the question of materiality. Many omission-based claims should be dismissed because there is no duty to disclose the information in the first instance.[11]

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[1] 17 C.F.R. § 240.10b-5 (2010).

[2] *ZVI Trading Corp. Employee's Money Purchase Plan & Trust v. Ross* (*In re Time Warner Sec. Litig.*), 9 F.3d 259, 267 (2d Cir. 1993); *cf. In re Morgan Stanley Tech. Fund Sec. Litig.*, 592 F.3d 347 (2d Cir. 2010).

[3] 964 F.2d 149, 156 (2d Cir. 1992) (quoting *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990) (en banc)).

[4] *See, e.g.*, *McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992, 998 (10th Cir. 2002).

[5] *See, e.g.*, Regulation S-X, 17 C.F.R. Part 210 (setting forth the requirements for financial statements).

[6] *In re Morgan Stanley Tech. Fund Sec. Litig.*, 592 F.3d 347, 360 (2d Cir. 2010).

[7] *New Jersey v. Sprint Corp.*, 314 F. Supp. 2d 1119, 1129 (D. Kan. 2004) (alteration, quotations and citations omitted) (finding no general duty to disclose the impending departure of the top two executives, regardless of whether that departure was tentative or inevitable).

[8] 75 F.3d 801, 809–11 (2d Cir. 1996).

[9] *Id.* at 809.

[10] *Id.* at 810. *See also*, *Levit v. Lyondell Petrochemical Co.* (*In re Lyondell Petrochemical Co. Sec. Litig.*), 984 F.2d 1050, 1052 (9th Cir. 1993) (''This court recognizes that the . . . SEC does not require a company to disclose financial projections.'' (internal quotation omitted)); *Fecht v. N. Telecom Ltd.* (*In re N. Telecom Ltd. Sec. Litig.*), 116 F. Supp. 2d 446, 459 (S.D.N.Y. 2000) (''Plaintiffs cite no case in which a company has been held to be generally obligated to disclose internal problems merely because those problems were potentially significant. Indeed courts generally do not impose a duty to disclose in such circumstances.'' (citing cases)); *New Jersey v. Sprint Corp.*, 314 F. Supp. 2d at 1128–29.

[11] Similarly, jurors should not be allowed to hear testimony regarding what an investor would have liked to have known

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Insider Trading Claims A different regulatory standard applies in the context of insider trading. Under the ''classical theory'' of insider trading, there is no duty to speak unless there is a fiduciary or confidential relationship between the parties.[12] Once that duty is established, however, *all* material information becomes subject to disclosure prior to trading. ''[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' ''[13] The Court explained in *Chiarella* that a duty to disclose exists between a corporate insider in possession of material non-public information and a shareholder with whom he transacts because of the ''relationship of trust and confidence'' that exists between them that prevents ''a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.''[14] Thus it has been said that a corporate insider has a duty to ''disclose'' or to ''abstain'' from trading.

While this standard serves typically to broaden an insider's disclosure obligations—requiring disclosure of any material fact—it should be noted that once one steps away from the context of a publicly traded corporation, a fiduciary duty may not be so easy to establish. For example, at least one court has held that a hedge fund manager owes his duty to the fund, not the individual investors.[15] Similarly, bondholders—who are in a contractual relationship with a corporation—are not owed a fiduciary duty.[16] With respect to claims against these entities, plaintiffs should not be allowed to sustain an omission-based claim absent either a statutory duty of disclosure, or a half-truth.

Conclusion Materiality is a critical element in securities fraud cases, and much effort is focused on proving immateriality in defending against such claims. But in the rush to prove alleged omissions are immaterial, do not forget to ask the equally critical question of whether there was a duty to speak in the first instance.

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unless the plaintiff first establishes that the defendant had a duty to disclose the information at issue.

[12] The other theory of insider trading liability is known as the ''misappropriation theory,'' and it holds that a person violates § 10b of the 1934 Securities Exchange Act and Rule 10b-5 ''when he misappropriates confidential information for securities trading purposes, in a breach of a duty owed to the source of the information.'' *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). Thus ''the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.'' *Id.* at 652–53.

[13] *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (second alteration in original) (quoting Restatement (Second) of Torts § 551(2)(a) (1977)).

[14] *Id.* at 228–29 (first and second alterations in original) (internal quotations omitted).

[15] *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006).

[16] *See, e.g.*, *Alexandra Global Master Fund Ltd. v. Ikon Office Solutions, Inc.*, No. 06 Civ. 5383, 2007 U.S. Dist. LEXIS 52546, at *14 (S.D.N.Y. July 19, 2007) (rejecting 10b-5 claim against corporation for trading on inside information at the expense of bondholders and stating that ''[i]t is well established that corporations do not have a fiduciary relationship with their unsecured creditors, including debt security holders. The relationship is contractual rather than fiduciary.'' (citing cases)); *Salovaara v. Jackson Nat'l Life Ins. Co.*, 66 F. Supp. 2d 593 (D.N.J. 1999), *aff'd per curiam*, 246 F.3d 289 (3d Cir. 2001).