Legal Backgrounder

Vol. 34 No. 16 October 25, 2019

Washington Legal Foundation
Advocate for Freedom and Justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302 wlf.org

Federal Securities Law Should Supersede Conflicting Procedrual Rules in Securities Class Actions

by Doug Greene, Jessie M. Gabriel, Douglas Shively, and Genevieve York-Erwin

The pleading stage is critically important in securities fraud class actions. A plaintiff's survival of a motion to dismiss opens the door to burdensome discovery at a company's highest levels, and even meritless claims that advance beyond the pleading stage raise the specter of protracted, expensive litigation and the non-zero risk of substantial liability. Not surprisingly, most cases that are not dismissed ultimately settle. While this dynamic is not unique to securities litigation, it is markedly amplified in this context.

Congress enacted the Private Securities Litigation Reform Act of 1995 "[a]s a check against abusive litigation."[1] To prevent meritless securities class actions, the Reform Act, which amends the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act), imposes heightened requirements for pleading that a challenged statement was false or misleading, and that it was made with intent to defraud (scienter). Congress specified that the district court "shall dismiss the complaint" on a motion to dismiss if it does not meet the Reform Act's heightened pleading standard.

Consistent with this intent, two important Supreme Court cases have construed the relevant federal securities statutes as requiring courts to consider the full factual context when evaluating allegations of falsity and scienter. In *Tellabs*, the Court considered what it means for a plaintiff to plead a "strong inference" of scienter, and concluded that "this inquiry is inherently comparative" and requires courts to consider not only the complaint but also documents incorporated by reference and matters of which courts may take judicial notice. A few years later, in *Omnicare Inc.*,[2] the Court reached a similar conclusion with respect to the falsity element, holding that this element also requires courts to consider the full context in which challenged statements were made, including other statements made by the company, industry context, and other publicly available information. Together, these decisions, and the federal securities statutes on which they're based, compel courts to consider the full range of publicly available, judicially noticeable, and incorporated documents and information for context when evaluating the sufficiency of securities claims.

And yet the general rules of procedure and evidence in federal court would seem to limit this mode of evaluation. The federal pleading rules severely restrict the information that courts may consider on motions to dismiss beyond the complaint itself. The federal rules also say that in evaluating a motion to dismiss, courts are to take all factual allegations in the complaint as true and draw all inferences in plaintiffs' favor. In short, the general rules forbid consideration of most outside materials and facts and the weighing of competing inferences, even as the securities statutes require this contextual, comparative analysis.

How then should the federal securities statutes' substantive pleading requirements be harmonized with the federal procedural rules that generally govern courts' consideration of motions to dismiss? Ultimately, the Rules Enabling Act dictates that federal substantive law must control these issues. But this result is rarely (if ever) truly achieved in practice.

---

[1] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (quotation omitted).

[2] *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015).

Doug Greene leads BakerHostetler's firmwide Securities and Governance Litigation Team. **Jessie M. Gabriel** and **Douglas Shively** are Partners, and **Genevieve York-Erwin** is an Associate, with the firm. The authors thank Mr. Greene's former Wilson Sonsini partner **Bruce Vanyo**, now Chair of Katten's Securities Litigation Group, for his helpful feedback on this article. Mr. Vanyo led the Silicon Valley's advocacy for the Private Securities Litigation Reform Act of 1995, and devised legal arguments that shaped key early Reform Act decisions in defendants' favor, including *Silicon Graphics*. The authors hope this Legal Backgrounder yields improvements in the law in the way that those decisions did.

Below we discuss two recent appellate decisions that provide noteworthy examples of courts getting it wrong, confounding the statutory standards by favoring procedural rules over substantive law. These decisions are just the tip of the iceberg: virtually every decision on securities class action motions to dismiss improperly elevates procedure over substance to some degree. This approach is incorrect and risks frustrating Congress' purpose in enacting the Reform Act—screening meritless securities fraud claims at the pleading stage.

In order to effectuate Congressional intent, courts must recognize that the federal securities statutes, including the Reform Act's heightened pleading requirements, trump federal rules of procedure and require courts to consider a fuller range of materials and facts in securities class actions than on a typical motion to dismiss. The defense bar, in turn, can help courts get this right by framing our arguments on this subject in terms of *Omnicare*'s and *Tellabs*'s substantive requirements and animating principles, rather than just the general procedural rules of judicial notice and incorporation by reference.

Recent Decisions Restrict Judicial Notice and Incorporation by Reference

Last year, the Ninth Circuit addressed judicial notice and incorporation by reference in *Khoja v. Orexigen Therapeutics*,[3] a securities class action under the Exchange Act. At its core, the opinion concerned a district court's ability to consider the full array of facts before the court to determine whether a plaintiff properly pleaded all elements of a securities fraud claim.

The plaintiffs alleged that Orexigen's concealment of material facts and misstatements on the benefits of its drugs artificially inflated its stock's value. Once the truth was revealed, according to plaintiffs, Orexigen's common stock price plunged 25 percent in three days. In their motion to dismiss, the defendants requested that the district court consider various documents referenced in the complaint and other documents subject to judicial notice, and the court did.

The Ninth Circuit found that the district court abused its discretion by considering the documents, citing the general rule that "a court may take judicial notice of matters of public record without converting the motion to dismiss into a summary judgment motion, but a court *cannot* take judicial notice of disputed facts contained in such public records."[4] The panel found, for example, the district court erred when it failed to specify which facts it judicially noticed from a transcript, but merely indicated that it would not "take notice of the truth of the facts cited within the exhibit."[5] Regarding incorporation by reference, the panel held "it is improper to assume the truth of an incorporated document if such assumptions only serve to dispute facts stated in a well-pleaded complaint," and "if a document merely creates a defense to the well-pled allegations in the complaint, then that document did not necessarily form the basis of the complaint"[6]

The panel's holdings reflect its concern that if defendants can "present their own version of the facts at the pleading stage—and district courts accept those facts as uncontroverted and true—it becomes near impossible for even the most aggrieved plaintiff to demonstrate a sufficiently 'plausible' claim for relief."[7] In this regard, the panel noted that it perceived a "concerning pattern in securities cases … exploiting these procedures [*i.e.*, judicial noticing and incorporation by reference] improperly to defeat what would otherwise constitute adequately stated claims at the pleading stage."[8]

The Ninth Circuit is not alone in struggling with this issue. The Fourth Circuit issued a similar opinion in *Zak v. Chelsea Therapeutics International Ltd*.[9] There, the plaintiffs also alleged that the defendants made material misstatements and omissions about the company's new drug, and the district court granted the defendants' motion to dismiss.

---

[3] 899 F.3d 988 (9th Cir. 2018).
[4] *Id.* at 999 (emphasis added).
[5] *Id.* (internal quotations omitted).
[6] *Id.* at 1000.
[7] *Id.* at 999 (citing *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)).
[8] *Id.* at 998.
[9] 780 F.3d 597 (4th Cir. 2015).

The appellants argued that the district court erred in taking judicial notice of certain documents filed with the U.S. Securities and Exchange Commission, principally Form 4s concerning the defendants' individual transactions in the company's stock. The appellants contended the documents were not integral to the complaint because the appellants did not rely on the defendants' stock transactions to plead scienter. The appellees argued that courts regularly review SEC filings at the pleading stage and that these filings were important in order to properly weigh the competing inferences regarding scienter.

The Fourth Circuit held that a court may look to outside evidence, such as the Form 4s, only when it is "integral to and explicitly relied on in the complaint and when the plaintiffs do not challenge the document's authenticity."[10] Moreover, even when looking to outside documents is proper, courts must still construe them in the light most favorable to plaintiffs.[11] Because the complaint did not rely on the Form 4s, the panel held those filings were not integral to the complaint and that the district court improperly considered them.[12] The court also held that the district court improperly construed the documents against the plaintiffs: While the court used them to make findings of fact, the documents themselves failed to establish such facts. The panel found this to be reversible error.

Supreme Court's Construction of Reform Act Requires Courts to Consider Full Context

The Supreme Court's decisions in *Omnicare* and *Tellabs* call into question decisions like *Orexigen* and *Chelsea Therapeutics*. While these circuit court decisions restrict the record a court may consider at the pleading stage, the Supreme Court's decisions require courts to consider the full context properly before the court in evaluating allegations of falsity and scienter.

In *Omnicare*, the Supreme Court emphasized that showing a statement to be misleading is "no small task" for plaintiffs. [13] In determining whether plaintiffs meet this burden, courts 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.

Omnicare followed *Tellabs*, the Supreme Court's seminal scienter decision. In *Tellabs*, the Court construed the Reform Act's requirement that plaintiffs must plead a "strong inference" of scienter. The *Tellabs* Court rejected the Seventh Circuit's holding that a plaintiff need only allege '"facts from which … a reasonable person could infer that the defendant acted with the required intent.'"[14] While that standard comports generally with federal pleading rules, *Tellabs* held that it falls short of the Reform Act's requirements: "Congress did not merely require plaintiffs to 'provide a factual basis for [their] scienter allegations' …. Instead, Congress required plaintiffs to plead with particularity facts that give rise to a 'strong'—*i.e.*, a powerful or cogent—inference."[15]

From these principles, the *Tellabs* Court concluded:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite "strong inference" of scienter, a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff.[16]

In conducting this comparative inquiry, "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."[17]

---

[10] *Id.* at 606-07 (internal quotations and citations omitted).
[11] *Id.* at 607.
[12] *Id.*
[13] *Omnicare* arose in the context of a Securities Act claim, but lower courts have applied *Omnicare* to Exchange Act claims as well, since the element of falsity is common to both the Securities Act and Exchange Act. *See, e.g., City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology Inc.*, 856 F.3d 605 (9th Cir. 2017); *Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016).
[14] *Tellabs*, 551 U.S. at 323 (internal citations omitted).
[15] *Id.*
[16] *Id.*
[17] *Id.* at 322.

ISBN 1056 3059

Tellabs's holding that the Reform Act requires courts to weigh "plausible nonculpable explanations … as well as inferences favoring the plaintiff" at the pleading stage marks a significant departure from general motion-to-dismiss procedures, where all reasonable inferences must be drawn in the plaintiff's favor. The significance of this innovation is diminished, however, to the extent courts are precluded from considering facts properly before them through judicial notice or incorporation by reference, or construing them solely in plaintiffs' favor under 12(b)(6) standards. Indeed, even the rarely-challenged general rule that courts may not consider judicially noticed facts as true conflicts with the substantive securities laws to the extent that it prevents courts from considering facts that are necessary to a full contextual analysis and proper weighing of competing inferences.

In deciding *Tellabs*, the Supreme Court signaled that the Reform Act's pleading requirements contemplate a judicial "gatekeeping" function that goes beyond the scope of normal motion-to-dismiss procedures. In an illuminating footnote, the Court observed that "in numerous contexts, gatekeeping judicial determinations prevent submission of claims to a jury's judgment without violating the Seventh Amendment," citing as examples "judgment as a matter of law," "summary judgment," and that "expert testimony can be excluded based on judicial determination of reliability."[18] On this point, *Tellabs* also referenced a 1902 Supreme Court decision upholding a procedure requiring defendants to submit affidavits supporting their defenses in certain contract actions, and authorizing courts to enter judgment for plaintiffs when it found an affidavit to be unsatisfactory. The *Tellabs* Court noted that "[j]ust as the purpose of § 21D(b) [*i.e.*, the Reform Act's heightened scienter requirement] is to screen out frivolous complaints, the purpose of the prescription at issue in *Fidelity & Deposit Co.* was to 'preserve the court from frivolous defenses.'"[19] The Court thus strongly suggested a far more significant departure from normal procedures than *Orexigen* and *Chelsea Therapeutics* reflect. Indeed, the procedural limitations imposed by these appellate decisions would seem to undermine the intended substantive effects of the Reform Act.

The Conflict Must Be Resolved in Favor of Federal Statutes

This conflict between decisions like *Orexigen* and *Chelsea Therapeutics* and the contextual, comparative analysis of falsity and scienter required by the Supreme Court's construction of federal securities law must be resolved in favor of the federal statutes. Courts generally recognize that the Reform Act and other substantive federal statutes supersede procedural rules to the extent they conflict. The Sixth Circuit, for example, has held that "[i]n light of [the Reform Act's heightened pleading] requirements, we think it is correct to interpret [the Reform Act] as … limiting the scope of Rule 15(a)," otherwise "the purpose of [the Reform Act] would be frustrated."[20] While other federal circuit courts have disagreed that Rule 15 conflicts with the Reform Act, they have not disputed the premise that the Reform Act would prevail in a conflict.[21]

Moreover, the Rules Enabling Act provides that procedural rules may not abridge a party's substantive rights.[22] The Supreme Court has explained that a procedural rule infringes substantive rights "if it alters the rules of decision by which the court will adjudicate those rights," as opposed to "governing only the manner and the means by which the litigants' rights are enforced."[23] For this reason too, procedural rules that conflict with the federal securities statutes' substantive requirements must give way.

Conclusion

Decisions like *Orexigen* and *Chelsea Therapeutics* conflict with the Supreme Court's direction to courts to consider all relevant facts—whether or not specifically pled—to gain a more complete picture at the motion-to-dismiss stage, and to prevent plaintiffs from cherry-picking allegations to survive a motion to dismiss. But defense counsel can help combat this doctrinal confusion through better briefing. When seeking consideration of materials or facts outside the complaint at the pleading stage, the defense bar should ground its arguments in the substantive requirements of the '33 Act, '34 Act, and Reform Act, as construed by *Omnicare* and *Tellabs*, not just the procedural rules of judicial notice and incorporation by reference.

---

[18] *Id.* at 327 n.8 (citations omitted).
[19] *Id.* at 327–28.
[20] *Miller v. Champion Enterprises Inc.*, 346 F.3d 660, 692 (6th Cir. 2003).
[21] *See, e.g., ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 56 (1st Cir. 2008); *Belizan v. Hershon*, 434 F.3d 579, 584 (D.C. Cir. 2006).
[22] 28 U.S.C. § 2072(b).
[23] *Shady Grove Orthopedic Associates PA v. Allstate Insurance Co.,* 559 U.S. 393 (2010).

  ISBN 1056 3059