ALERT MEMORANDUM

Ninth Circuit Addresses When Courts May Consider Materials Outside the Complaint in Motions to Dismiss Securities Claims

August 28, 2018

On August 13, 2018, the Ninth Circuit issued *Khoja v. Orexigen Therapeutics, Inc.*,[1] an important decision regarding the manner in which courts may—and may not—consider documents outside the four corners of a complaint when deciding a motion to dismiss in a securities case, either through incorporation by reference or judicial notice. The decision describes the circumstances in which defendants can rely on documents that are not attached to the complaint as exhibits in a motion to dismiss in the Ninth Circuit—historically one of the most significant jurisdictions for federal securities filings.[2]

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:

NEW YORK

Meredith Kotler
+1 212 225 2130
mkotler@cgsh.com

Roger A. Cooper
+1 212 225 2283
racooper@cgsh.com

Jared Gerber
+1 212 225 2507
jgerber@cgsh.com

Matthew M. Karlan
+1 212 225 2845
mkarlan@cgsh.com

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

[1] No. 16-56069, __ F.3d __, 2018 WL 3826298 (9th Cir. Aug. 13, 2018).
[2] *See* NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2017 Full-Year Review* 13 (January 29, 2018) (Second Circuit and Ninth Circuit continue to experience the most filings, with 97 and 89 new cases filed in each respective circuit in 2017).

© Cleary Gottlieb Steen & Hamilton LLP, 2018. All rights reserved.
This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Background

The Supreme Court has made clear that while "a Rule 12(b)(6) motion to dismiss a § 10(b) action" requires that the court "accept all factual allegations in the complaint as true," courts also "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."[3]

These two procedures—judicial notice and incorporation by reference—are similar in some respects. Both allow the court to look beyond the four corners of the complaint without converting the motion to dismiss into one for summary judgment.[4] The two procedures differ in other respects, however. Judicial notice is expressly permitted by Federal Rule of Evidence 201 and provides that the court may, on its own or at the request of a party and at any stage of the proceeding, consider "a fact that is not subject to reasonable dispute because" it either (1) is "generally known within the trial court's territorial jurisdiction," or (2) "can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned."[5] In contrast, incorporation by reference is a judicially created doctrine that allows the court to treat certain documents as though they are part of the complaint itself if the complaint refers extensively to the document or the document forms the basis of the plaintiff's claim.[6] As explained by the courts, the doctrine prevents a plaintiff from gaining an unfair advantage through misrepresenting or selectively quoting such documents in its pleading.[7]

Relying on judicial notice and incorporation by reference, defendants in securities cases have long been permitted to submit documents outside the pleadings in support of motions to dismiss. For example, defendants have relied upon such materials in presenting arguments concerning whether statements were false or misleading in the context in which they appeared, such as a prospectus[8]; the failure to plead loss causation, including by reference to publicly available stock price information on the dates of alleged corrective disclosures[9]; and the applicable statute of limitations, which may be triggered by notice of "storm warnings" evidenced in contemporaneous public documents such as news reports.[10]

As discussed below, the Ninth Circuit's recent decision addresses the circumstances where it is appropriate to rely on judicial notice and incorporation by reference at the motion to dismiss stage. Properly read, however, it should not foreclose defendants from presenting meritorious defenses through a motion to dismiss where the meaning or import of the documents relied upon is unambiguous.

[3] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007).

[4] 5B Wright & Miller, Fed. Prac. & Proc. Civ. § 1357 (3d ed.); *cf.* Fed. R. Civ. P. 12(d) (generally requiring conversion of motion to dismiss to motion for summary judgment where "matters outside the pleadings are presented to and not excluded by the court").

[5] Fed. R. Evid. 201(b).

[6] *See United States v. Ritchie*, 342 F.3d 903, 908 (9th Cir. 2003).

[7] *See, e.g.*, *Swartz v. KPMG LLP*, 476 F.3d 756, 763 (9th Cir. 2007).

[8] *See, e.g.*, *Kramer v. Time Warner Inc.*, 937 F.2d 767, 769-70 (2d Cir. 1991).

[9] *See, e.g.*, *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1064 n.7 (9th Cir. 2008).

[10] *See, e.g.*, *Staehr v. Hartford Fin. Servs. Grp., Inc.*, 547 F.3d 406, 425 (2d Cir. 2008).

The District Court's Decision

Khoja was an appeal from the dismissal of a putative class action alleging claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934[11] and SEC Rule 10b-5[12] related to the development by defendant Orexigen Therapeutics, Inc ("Orexigen") of Contrave, a drug intended to treat obesity. The claims arose from Orexigen's alleged premature "leaking" of the preliminary—and highly positive—results of an initial drug trial before it was completed.

As part of the regulatory approval process, the Food and Drug Administration ("FDA") required that Orexigen conduct a study (the "Light Study") to assess whether Contrave increased the risk of major adverse cardiovascular events. The FDA required that the trial results remain confidential, so Orexigen entered into a data access plan with the two bodies overseeing the study—an independent Executive Steering Committee ("ESC") and a Data Monitoring Committee ("DMC")—under which it agreed that access would be limited to certain individuals involved in the approval process.

In July 2014, the company submitted a patent application for Contrave to the United States Patent and Trademark Office ("USPTO"), in which it included the interim results. Although Orexigen initially requested that the results be kept confidential, in December 2014, it requested that the USPTO publish the patent application with the results. The USPTO did so in March 2015 and Orexigen then filed a Form 8-K with the Securities and Exchange Commission ("SEC"), describing the interim results, following which Orexigen's stock price increased. Weeks later, on March 26, 2015, the ESC informed Orexigen of further updated interim results, which no longer indicated a heart benefit, and the ESC therefore voted to halt the Light Study. Although Orexigen discussed the Light Study in SEC filings and an investor call in May 2018, it did not disclose this new information. On May 12, 2015, the ESC itself disclosed to the market the updated results and its vote to end the study, following which the price of Orexigen's stock declined.

Plaintiffs filed putative class action complaints against Orexigen and certain of its executives, alleging securities claims related to the company's statements concerning Contrave. Among other things, plaintiffs alleged that Orexigen failed to disclose the unreliability of the initial interim results and later failed to disclose the updated interim results (which no longer showed a heart benefit associated with the drug) and that the ESC had voted to terminate the study.

Defendants' motion to dismiss requested that the district court take judicial notice of, or incorporate by reference, twenty-two documents, including certain USPTO files, SEC filings, news articles, analyst reports, and press releases. The court largely granted the request, concluding that all but one of the documents was either "explicitly referenced and relied on" in the complaint, such that they were incorporated by reference and considered part of the pleading, or else were documents subject to judicial notice, though not for "the truth of the facts cited" therein.[13] Relying on several of these documents, the district court concluded that none of the alleged misstatements or omissions was actionable.[14]

[11] 15 U.S.C. §§ 78j(b), 78t.
[12] 17 C.F.R. § 240.10b-5.
[13] *Khoja v. Orexigen Therapeutics, Inc.*, 189 F. Supp. 3d 998, 1009-12 (S.D. Cal. 2016) (internal quotation marks omitted), *aff'd in part, rev'd in part and remanded*, No. 16-56069, 2018 WL 3826298 (9th Cir. Aug. 13, 2018).
[14] *Id.* at 1014-20.

The Ninth Circuit's Decision

The Ninth Circuit began its discussion by noting what it described as "a concerning pattern in securities cases" regarding the use of judicial notice and incorporation by reference.[15] While acknowledging that the Supreme Court had authorized consideration of matters outside the pleadings on a motion to dismiss, the Ninth Circuit stated that "the unscrupulous use of extrinsic documents to resolve competing theories against the complaint risks premature dismissals of plausible claims that may turn out to be valid after discovery," adding that "[i]f defendants are permitted to 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."[16]

The court then addressed the propriety of the district court's rulings with respect to judicial notice and incorporation by reference.

Judicial Notice

The court first addressed three documents that the district court had concluded were subject to judicial notice. In doing so, the court emphasized that while Federal Rule of Evidence 201 allows a court to notice a fact "not subject to reasonable dispute," "accuracy is only part of the inquiry under Rule 201(b). A court must also consider—and identify—which fact or facts it is noticing from such a transcript. Just because the document itself is susceptible to judicial notice does not mean that every assertion of fact within that document is judicially noticeable for its truth."[17]

Thus, with respect to one of the three documents, Orexigen's international patent application, the Ninth Circuit concluded that the district court's limited use of the document to establish the date of the application was proper because the document was published by a foreign government agency and its authenticity was not subject to dispute.[18] However, with respect to the other two documents—a September 11, 2014 investor call transcript and a December 18, 2014 EMA report—the Ninth Circuit concluded that judicial notice was not appropriate, even though the documents' authenticity and accuracy were not in doubt, because in both cases "there [was] a reasonable dispute as to what the [document] establishes."[19] While judicial notice of each document itself was appropriate, it was not proper to take judicial notice of the contents of each document for the purpose for which it was offered.

Incorporation by Reference

The court then addressed the fifteen documents that Khoja argued had been improperly incorporated. While many of the court's rulings turn on the specific allegations at issue and the extent to which the complaint relied upon the disputed materials,[20] the Ninth Circuit's analysis cautions against fact-finding at the pleading stage. The court stressed that while it is appropriate to consider a document as incorporated where the plaintiff refers extensively to the document or the document forms the basis of the plaintiff's claim,

---

[15] *Khoja*, 2018 WL 3826298, at *6.
[16] *Id.*
[17] *Id.* at *7.
[18] *Id.* at *9.
[19] *Id.* at *8.
[20] The Ninth Circuit noted the difficulty in determining precisely how much of a reference is required for the doctrine to apply. While the "mere mention of the existence of a document is insufficient," incorporation by reference applies "if the plaintiff refers extensively to the document" or if "the document forms the basis of the plaintiff's claim"—even if the complaint does not explicitly reference the document. *Id.* at *9 (citations and quotation marks omitted).

it may be improper to consider a document that merely forms the basis of a *defense* to those claims.[21]

Relatedly, the court stated that "what inferences a court may draw from an incorporated document should also be approached with caution"—while a court may generally assume an incorporated document's contents are true for purposes of a motion to dismiss, "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."[22]

Applying these principles, the Ninth Circuit held that the district court had made a number of errors. For example, in an effort to counter the complaint's allegations that certain Orexigen executives had a financial incentive under their equity incentive plan to inflate the company's stock price, Orexigen sought to introduce three SEC filings showing that such awards were "routinely" granted on an annual basis. The Ninth Circuit concluded that the complaint's passing references to these documents were insufficient, and that plaintiff's "claims did not arise from these proxy statements and incentive plans."[23] Beyond this, however, the court held that "[a]sking the district court to conclude that the alleged financial incentives were routine went beyond testing the sufficiency of the claims and into the realm of factual disputes."[24] Similarly, the Ninth Circuit held that the district court erred in incorporating the drug's entire patent history.[25] While acknowledging that the complaint alleged that the defendants engaged in a scheme improperly to publish the Light Study results through a patent application, and that "the USPTO file history is certainly relevant because it sets forth the timeline" of that process, the Ninth Circuit concluded that "the sufficiency of the alleged scheme itself does not depend on what the entire USPTO file history says," and thus "[w]hether Orexigen has other reasons or explanations for publishing the patent goes beyond the sufficiency of the alleged scheme at the pleading stage."[26]

Takeaways

The Ninth Circuit's decision in *Khoja v. Orexigen Therapeutics, Inc.* serves as an important reminder to defendants seeking dismissal of federal securities claims of the circumstances in which they can rely on documents outside the complaint at the pleading stage. It offers at least three key takeaways.

First, while plaintiffs may cite the hesitations expressed by the Ninth Circuit, the case did not abolish the well-settled law permitting reliance on documents outside the complaint in appropriate circumstances. Indeed, while it chastised what it viewed as abusive practices, the Ninth Circuit affirmed the district court's rulings with respect to nine of the eighteen documents challenged on appeal. In particular, the Ninth Circuit did not hesitate to affirm incorporation by reference of documents—including government reports, blog posts, market reports, and SEC filings—that were either referenced at length in the complaint or which formed the basis for plaintiff's claims, including documents cited by plaintiffs in an effort to plead the existence of false or misleading statements, the market's reliance on those statements, and the corrective disclosure of such statements.

[21] *Id.* at *10.
[22] *Id.* at *10.
[23] *Id.* at *13.
[24] *Id.* at *13.
[25] *Id.* at *14.
[26] *Id.* at *14.

Second, while judicial notice and incorporation by reference at the motion to dismiss stage may be approached with caution where they require the district court to resolve disputed factual issues or address a fact-based defense, the propriety of these procedures is not all-or-nothing; much depends on the specific materials within a document that are being relied upon, and for what purpose. Thus, defendants should take care to specify the aspects of the documents they are asking the court to consider, and why.

Finally, as a practical matter, defendants should be judicious in their reliance on extrinsic documents in support of a motion to dismiss in the Ninth Circuit. A good part of the Ninth Circuit's apparent frustration appears to have stemmed from the perceived blunderbuss approach employed in cases where defendants have "pile[d] on" documents indiscriminately.[27] Indeed, while the district court granted Orexigen's motion with respect to twenty-one documents, it only appears to have relied on a relative handful of those documents in deciding the motion to dismiss. Defendants may therefore attempt to focus on only those documents most centrally important to their motion, saving a more fulsome documentary record for a later stage, if necessary.

…

CLEARY GOTTLIEB

[27] *See id.* at *12 ("When parties pile on volumes of exhibits to their motion to dismiss, hoping to squeeze some into the complaint, their submissions can become needlessly unwieldy.").