

Securities Regulation Daily Wrap Up, TOP STORY—9th Cir.: Broad scienter allegations, even considered holistically, must fail, (Oct. 2, 2014)

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By Amy Leisinger, J.D.

A Ninth Circuit panel affirmed a district court's dismissal of a securities fraud action against NVIDIA Corporation and other defendants under Exchange Act Sections 10(b) and 20(a) and Rule 10b-5. According to the panel, the plaintiffs failed adequately to allege facts giving rise to a strong inference of scienter or showing that the defendants intentionally misled investors or were at least reckless. In addition, the panel stated, neither the corporate scienter doctrine nor the core operations doctrine could support a strong inference of scienter (*In re NVIDIA Corporation Securities Litigation*, October 2, 2014, O'Connell, B.).

Background. In 2008, NVIDIA, a publicly traded semiconductor company, disclosed information to investors about defects in two of its products and later stated that it would take a \$150-\$200 million charge to cover costs. NVIDIA's share price thereafter dropped 31 percent.

Between November 2007 and May 2008, NVIDIA filed several forms with the SEC routinely including a statement explaining that "[its] products may contain defects or flaws," and warning investors that "[it] may be required to reimburse customers for costs to repair or replace the affected products." To cover costs relating to inevitable defects, NVIDIA automatically records a reduction to revenue as a cash reserve. As product return and replacement costs accrue, NVIDIA withdraws cash from that reserve. Given the highly complex nature of NVIDIA's products, there is an inherent risk that some will fail.

In their complaint, the plaintiffs alleged that NVIDIA knew of and should have informed investors of product defects earlier and that, absent such a disclosure, the company's intervening statements were misleading to investors. The district court dismissed the complaint, specifically holding that the plaintiffs failed to sufficiently plead scienter.

Scienter. Reviewing the dismissal *de novo*, the panel considered the plaintiffs' argument that the district court erred by failing to consider their allegations of scienter in the context of Item 303 of Regulation S-K, which requires certain disclosures. According to the plaintiffs, if the information is material, failure to disclose it constitutes a material omission for purposes of the antifraud provisions of the Exchange Act. Citing the position of the Third Circuit, the panel determined that Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5. "Because the materiality standards for Rule 10b-5 and [Item 303] differ significantly, the 'demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5,'" the court explained.

The court also found that the district did not err in failing to consider the plaintiffs' allegations of scienter holistically. The most compelling inference is that NVIDIA was investigating the cause and the scope of the defects and, when it finally determined that its liability would exceed its reserves, it disclosed the problems. "Any inference of scienter requires more than this," the panel stated. The plaintiffs have not sufficiently alleged that the defendants intentionally misled investors, or acted with deliberate recklessness, by not disclosing the problems earlier than they did. Even if the issues were easily identifiable at an earlier time, it "does not necessarily follow that NVIDIA would be responsible for those failures or should have known that it would be responsible," the panel concluded.

The panel also rejected the plaintiffs' contentions that their allegations give rise to an inference of scienter under the corporate scienter doctrine or the core operations doctrine. The defendants statements were not "so

dramatically false” or so “critical to a business’s ‘core operations’” so as to create an inference that key corporate officials knew of falsity, the panel stated.

The case is No. 11-17708.

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Companies: New Jersey Carpenters Pension and Annuity Funds; NVIDIA Corp.

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