Ninth Circuit Addresses Use of Doctrines of Judicial Notice and Incorporation by Reference at Pleading Stage in Securities Cases

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Introduction

In the Ninth Circuit, defendants typically have two tools available to ask a court to consider in connection with a motion to dismiss information outside the four corners of a complaint. First, a defendant may file a request for judicial notice under Rule 201 of the Federal Rules of Evidence to ask the court to consider material outside of the complaint, so long as the material meets the definition set forth in Federal Rule of Evidence 201 as "not subject to reasonable dispute because it (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." Fed. R. Evid. 201(b). Second, under the incorporation by reference doctrine, a district court may consider documents "whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the [plaintiff's] pleading." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999). This doctrine seeks to prevent plaintiffs from selectively quoting only portions of documents on which their claims are based.

The application of these tools was recently addressed in a published Ninth Circuit opinion, *Khoja v. Orexigen Therapeutics*, Case No. 16-56069 (9th Cir. 2018), in which the panel noted a "concerning pattern in securities cases" in which "overuse" of the doctrines of incorporation by reference and judicial notice has resulted in the dismissal of securities suits at the pleading stage based on materials outside of the complaint. (Order at 15.)

Khoja Opinion

In a decision issued on August 13, 2018, a unanimous three-judge panel affirmed in part and reversed in part the district court's dismissal of a securities fraud action, concluding that "the district court abused its discretion by improperly considering materials outside of the Complaint." (Order at 4.)

The plaintiff brought a putative class action against defendant biotechnology company Orexigen and its officers, alleging that the defendants made material misrepresentations and omissions in violation of the Securities Exchange Act of 1934 based on the company's disclosure of early results from a study of its new drug. The defendants moved to dismiss the complaint and requested judicial notice of 22 documents or, alternatively, that the district court treat those documents as incorporated into the complaint. The district court granted the request with respect to 21 of 22 documents. The court also granted the defendants' motion to dismiss. The plaintiff appealed.

In concluding that the district court abused its discretion by considering some of those documents, the panel noted "a concerning pattern in securities cases like this one: exploiting these procedures improperly to defeat what would otherwise constitute adequately stated claims at the pleading stage." (*Id*. at 15.) The panel stated that this trend of "unscrupulous use of extrinsic documents" at the pleading stage creates a risk "especially significant in SEC fraud matters, where there is already a heightened pleading standard, and the defendants possess materials to which the plaintiffs do not yet have access." (*Id*.) "If 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." (*Id*. at 16.)

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As to the judicially noticed facts, while the district court stated "it would not 'take notice of the truth of the facts cited' within the exhibit" (*Id*. at 17), it took judicial notice of three documents: a transcript of an investors' conference call, a medical report about the drug at issue, and the historical record of the company's patent application for the drug. The panel concluded that certain facts from the medical report and the transcript should not have been judicially noticed because there existed "reasonable dispute" as to what the documents established. (*Id*. at 17-22.) As to the transcript, the panel held that it was "improper to judicially notice a transcript when the substance of the transcript is subject to varying interpretations, and there is a reasonable dispute as to what the transcript establishes." (*Id*. at 19 (quotation omitted).) However, the panel concluded that the date of the conference call could be properly noticed from the transcript. (*Id*. at 18.) The appellate court similarly concluded that the court did not abuse its discretion in taking notice of the patent application, as the court only relied on the application for the date of the application.

The panel also reviewed the documents the district court incorporated by reference, including blog posts and news articles, analyst reports, SEC filings and attachments. In concluding that the district court abused its discretion in incorporating by reference at least seven of these documents, the panel noted that "the doctrine is not a tool for defendants to short-circuit the resolution of a well-pleaded claim" and "what inferences a court may draw from an incorporated documents should also be approached with caution." (*Id*. at 24.) Specifically, the appellate court concluded that the district court abused its discretion because the complaint's reference to the documents were not "sufficiently extensive" or the documents did not "form the basis of any claim in the Complaint." (*Id*. at 26.) Notably, the panel concluded that the trial court appropriately incorporated by reference some of the disputed documents that were mentioned extensively in the complaint.

Conclusion

While the *Khoja* opinion reiterated that when "properly used" the doctrines of judicial notice and incorporation by reference "do have roles to play at the pleading stage," plaintiffs will likely raise this opinion when disputing the use of these doctrines. Parties seeking to judicially notice or incorporate by reference certain facts should be mindful of the panel's cautioning of the "overuse" of these methods and the resulting inefficiency from the court's perspective. In particular, the appellate court noted a specific concern with the abuse of the incorporation by reference doctrine, arising "when parties pile volumes of exhibits to their motion to dismiss," making the briefing "needlessly unwieldy" and demanding the court's "precious time" to review. (*Id*. at 30-31.) Thus, the opinion took issue specifically with the purported overuse of the incorporation by reference doctrine, while reiterating common principles guiding use of judicial notice. Read in context, the opinion underscores the continued use of both doctrines, while warning against their overuse. Even after the *Khoja* opinion, parties may continue to seek to use the doctrines of incorporation by reference and judicial notice, but parties should consider the opinion to avoid overuse.