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Class Actions — Class Certification

Southern District of Ohio Grants Institutional Investors' Motion for Class Certification and Appointment as Lead Plaintiffs in Securities Fraud Class Action

Willis v. Big Lots, Inc., No. 12-cv-604 (S.D. Ohio Mar. 17, 2017)
Click here to view the opinion.

Judge Michael H. Watson granted the plaintiffs' motion for class certification and appointed two institutional investors as lead plaintiffs in a securities fraud class action brought against a closeout retailer and its officers under Sections 10(b) and 20(a) of the Securities Exchange Act and Securities and Exchange Commission Rule 10b-5. The plaintiffs alleged that the company provided false and misleading information to investors regarding the retailer's performance and prospects during the class period, which artificially inflated the retailer's stock price. The defendants opposed class certification, arguing that the institutional investors did not have claims typical of all class members, they were not adequate representatives for the class, and individual damages and reliance issues would predominate over classwide issues.

The court rejected the defendants' argument against typicality, reasoning that the plaintiffs' claims — which depended on the fraud-on-the-market reliance theory — were typical of the class, and the institutional investors — who used investment advisers — were not subject to any unique nonreliance defenses because investment advisers still rely on publicly available information, including a stock's market price. Because all class members had an interest in proving the retailer's stock was artificially inflated during the class period regardless of their specific purchase and sale dates, the court rejected the defendants' argument that the institutional investors were inadequate class representatives because they sold their interests prior to the end of the class period. The court swiftly dismissed the defendants' other adequacy arguments, pointing to the institutional investors' active commitment to the case.

Finally, the court concluded that individual inquiries regarding reliance and damages would not predominate. Because the plaintiffs advanced a methodology for calculating damages on a classwide basis that was consistent with their theory of liability, the court found that individual damages issues would not predominate over classwide issues. The court also determined that plaintiffs could invoke the rebuttable presumption of reliance set forth in *Basic v. Levinson*, 485 U.S. 224 (1988). The defendants attempted to rebut this presumption, arguing that the company's stock price was inefficient because it did not increase in a statistically significant manner at the time of the alleged misrepresentations. Citing the U.S. Supreme Court's statement in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), that price impact may be rebutted with "evidence that the misrepresentation (or its correction) did not affect the market price of the defendant's stock," the court adopted the "price maintenance theory," reasoning that a misrepresentation may also have a price impact, by maintaining a stock's artificially inflated price. The court concluded that the defendants failed to rebut the *Basic* presumption because they failed to show that there was no statistically significant price impact following the corrective disclosures. Accordingly, the court certified the class and appointed the institutional investors as class representatives.

ERISA

Sixth Circuit Affirms Dismissal of Plaintiffs' ERISA Claims Against ESOP Fiduciaries

Saumer v. Cliffs Nat. Res. Inc., No. 16-3449 (6th Cir. Apr. 7, 2017)
Click here to view the opinion.

The Sixth Circuit affirmed the district court's dismissal of an Employee Retirement Income Security Act (ERISA) class action brought against the fiduciaries of a mining company's employee stock ownership plan (ESOP). The plaintiffs, participants in the ESOP, alleged that the fiduciaries breached their duty of prudence under ERISA by retaining the company's stock as an investment option because (1) the company's risk profile and business prospects dramatically changed due to the collapse of iron ore and coal prices during the class period, and (2) the defendants possessed inside information, which showed that the company's stock was overvalued. The district court granted the defendants' motion to dismiss.

Relying on the U.S. Supreme Court's opinion in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), the Sixth Circuit affirmed the dismissal. Because "*Dudenhoeffer* plainly holds that a fiduciary may rely on market price as an unbiased assessment of a security's value," the court disposed of the plaintiffs' argument that the company's risk profile would be determinative of the company's stock value. The court rejected the plaintiffs' argument that a "special circumstance" rendered reliance on the market price imprudent in this case because *Dudenhoeffer* also stated that "fiduciaries may prudently 'assume' that stock markets provide the best estimate of a security's value." Finally, the court rejected the plaintiffs' nonpublic information claims, concluding that the plaintiffs failed to allege an alternative action that a prudent fiduciary in the same circumstance "would not have viewed as more likely to harm the fund than to help it." Instead, the alternative actions that were alleged — disclosing the nonpublic information or ceasing investment in the company's stock — could have caused a further collapse in the company's stock price, the court concluded.

SDNY Dismisses ERISA Excessive-Fee Claims With Prejudice

Walker v. Merrill Lynch & Co., Inc., No. 15-cv-1959 (PGG)
(S.D.N.Y. Mar. 31, 2017)
Click here to view the opinion.

Judge Paul G. Gardephe dismissed breach of fiduciary claims under Section 404 of ERISA against Merrill Lynch for the second time, this time with prejudice. The plaintiff was a participant in Clifford Chance LLP's 401(k) plan (the Plan) and alleged that Merrill Lynch, a service provider to the Plan, breached its fiduciary duties in structuring the Plan to offer predominantly high-fee, actively managed mutual fund investment options and collecting excessive service fees from the mutual funds, some of which were managed by Merrill. The court held that the complaint did not adequately allege that Merrill was an ERISA fiduciary with respect to the plan because there was no allegation that Merrill had discretionary authority over the Plan's assets. While Merrill had in the past acted as the Plan's investment adviser, Merrill had ceased serving in that role before the class period began. Merrill's current role was limited to providing individualized investment advice to participants rather than selecting funds for the Plan. Thus, it was the Plan trustees, not Merrill, that had fiduciary authority over the challenged decision to include allegedly high-cost, actively managed funds in the Plan. Further, Merrill's agreement with the Plan expressly provided that it was not the fiduciary responsible for the selection of the investment options available under the Plan. The court further rejected the argument that Merrill was a fiduciary because it had the power to set its own compensation, reasoning that it did not control the Plan's negotiation and approval of those terms — the Plan sponsor was free to take or leave Merrill's services.

Fiduciary Duties — Mergers and Acquisitions

Delaware Court of Chancery Dismisses Stockholders' Challenge in Transaction With Gold and Silver Producer

In re Paramount Gold and Silver Corp. Stockholders Litig.,
No. 10499-CB (Del. Ch. Apr. 13, 2017)
Click here to view the opinion.

Former stockholders of Paramount Gold and Silver Corporation sued members of its board of directors, challenging a transaction that Paramount entered into with Coeur Mining. Paramount, which owned two mining projects, spun one off into a separate entity and distributed approximately 95 percent of the new entity's shares to Paramount's stockholders. Paramount also agreed to a merger that would then hold a second mining project. In connection with that merger agreement, Paramount entered into a royalty agreement that gave Coeur a 0.7 percent royalty interest in the second mining project in exchange for $5.25 million.

The plaintiffs' primary argument was that *Unocal* enhanced scrutiny should apply to the transactions because the royalty agreement, when combined with the termination fee provision in the merger agreement, constituted an unreasonable deal protection device. In granting the defendants' motion to dismiss, the court disagreed, finding that (1) the terms of the royalty agreement did not prevent any interested party from making a competing bid for Paramount; and (2) the termination fee in the merger agreement (3.42 percent of the estimated merger value) was itself concededly reasonable. The court also concluded that because the stockholder vote approving the transaction was fully informed, under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), the business judgment rule protected the Paramount board's decision to approve the merger agreement. The court further held that even if *Corwin* did not apply, the plaintiffs failed to state a nonexculpated claim for breach of fiduciary duty against the defendants.

Delaware Court of Chancery Holds That Plaintiff Adequately Pleaded Bad Faith, Breach of Duty of Loyalty in Merger Challenge Involving Large Cash Payments for Directors

In re Saba Software, Inc. Stockholder Litig., C.A. No. 10697-VCS
(Del. Ch. Apr. 11, 2017)
Click here to view the opinion.

In a challenge of the merger of Saba Software with Vector Capital Management, after the SEC alleged that former Saba executives had engaged in a fraudulent scheme to inflate Saba's earnings, Saba agreed to restate its financials but announced it would not complete the restatement before the SEC's deadline. The board subsequently pursued a sale process and approved Vector's offer. The SEC then issued an order to deregister Saba's stock, and by the time the stockholders voted to approve the merger, Saba's shares had been deregistered. When the board approved the merger, the directors granted themselves equity awards that would be cashed out upon consummation of the merger in the place of prior awards that had been canceled due to the deregistration.

The court denied the directors' motion to dismiss. First, the court rejected the defendants' argument that *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) applied because the complaint adequately pleaded that the stockholder vote approving the merger was coerced and not fully informed. The court found that Saba's proxy disclosures contained two

material omissions and that the vote was coerced because the stockholders faced the "Hobson's choice" of "keeping their recently-deregistered, illiquid stock or accepting the Merger price" and thus had "no practical alternative but to vote in favor of the Merger." Because *Corwin* was inapplicable, the court determined that *Revlon* enhanced scrutiny would apply. This case appears to be the first in which the Court of Chancery refused to apply *Corwin* to dismiss at the pleading stage a post-merger deal case for money damages that would otherwise invoke *Revlon*. Having found that *Revlon* applied, the court held that the plaintiff adequately pleaded bad faith and a breach of the duty of loyalty by alleging that the directors rushed the sale process and stockholder vote and awarded themselves large cash payments.

Initial Public Offerings

EDNY Dismisses Claims That Online Retail Company Violated Securities Laws in Connection With IPO

Saleh Altayyar, et al. v. Etsy Inc., et al., No. 15-cv-2785-AMD (E.D.N.Y. Mar. 16, 2017)
Click here to view the opinion.

Judge Ann M. Donnelly dismissed with prejudice claims that an online peer-to-peer commerce company violated Section 10(b) of the Securities Exchange Act by making material misstatements and omissions in connection with the company's April 16, 2015, initial public offering (IPO). The company's share price allegedly dropped after the company's quarterly earnings disclosures and an analyst report suggesting that the company's growth was harmed by counterfeit goods being sold through the company's online platform as well as by increased competition. The plaintiffs alleged that, although the company's registration statement and previous periodic filings emphasized the company's commitment to providing a platform for artisans and small-batch manufacturers and preventing counterfeit manufacturers, certain confidential witnesses purportedly stated that the company failed to implement adequate controls for preventing mass-produced and counterfeit goods.

The defendants argued that the plaintiffs had failed to sufficiently plead fraud and scienter under the applicable heightened standards. The court agreed, finding that although the "allegations might show that [the company's] compliance practices were imperfect ... and that its managers knew of ongoing infringement problems," the plaintiffs failed to "establish that the challenged values statements were objectively false or disbelieved when [the company] made them." Further, the court found that the company's statements about its values and counter-infringement policies were aspirational and accompanied by sufficient cautionary language about the limits of preventing infiltration by purveyors of counterfeit goods.

Misrepresentations

Ninth Circuit Holds That CEO's Conduct in Violation of Corporate Code of Ethics Is Not Actionable Securities Fraud

Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard Co., No. 14-16433 (9th Cir. Jan. 19, 2017)
Click here to view the opinion.

In an issue of first impression, the Ninth Circuit held that a CEO's violation of the corporate code of ethics he publicly touted did not give rise to an actionable claim for securities fraud.

After 2006, the CEO of Hewlett-Packard (HP) spearheaded a revision of HP's ethical standards. According to the complaint, "HP reinforced the importance of its corporate code of ethics, the Standards of Business Conduct ("SBC")," and the CEO "took many opportunities to proclaim HP's integrity and its intention to enforce violations of the SBC." Notwithstanding these reinforcements and proclamations, the CEO allegedly was forced to resign in 2010 after an investigation revealed that he had covered up a "very close personal relationship" with an adult film actress, including doctoring expense reports to hide their relationship. The actress allegedly also claimed that the CEO had disclosed confidential information to her about an impending merger. Following the CEO's resignation, HP's stock price dropped, resulting in an alleged loss of $10 billion to shareholders.

The putative class action raised two theories: (1) the defendants' public statements about business ethics and the SBC were material misrepresentations, given the CEO's conduct, and (2) the defendants' failures to disclose the CEO's conduct constituted a material omission.

In affirming the dismissal of the action, the panel first determined that the defendants' affirmative statements during the class period were not false or misleading because they were not "objectively verifiable statements." Rather, the statements were "inherently aspirational." The court reasoned that a "contrary interpretation ... is simply untenable, as it could turn all corporate wrongdoing into securities fraud." Second, the court concluded that, even if the statements were misleading, they were not material because "[i]t simply cannot be that a reasonable investor's decision would conceivably have been affected by HP's compliance with SEC regulations requiring publication of ethics standards."

Finally, with regard to the plaintiffs' omission theory, the court held that there could not have been a material omission because there was no duty to disclose the CEO's conduct. As the panel explained, the "promotion of ethical conduct at HP did not reasonably suggest that there would be no violations of the SBC by the CEO or anyone else." Absent an impression that everyone

at HP was in full compliance with the ethical standards, the defendants were under no duty to disclose the CEO's conduct, even if it violated HP's ethical code.

District of Colorado Grants Dismissal of Claims Against Food Distributor

Okla. Police Pension & Ret. Sys. v. Boulder Brands Inc., No. 15-cv-00679-MSK-KMT (D. Colo. Mar. 28, 2017)
Click here to view the opinion.

Judge Marcia S. Krieger dismissed claims that a food manufacturer and distributor violated Section 10(b) of the Securities Exchange Act by allegedly making false and misleading statements regarding the company's promotional efforts to increase sales of its high-margin products, such as margarines, oils and spreads, as opposed to its low-margin products, such as gluten-free and other "natural" products. The plaintiffs also alleged that the company failed to disclose various operational difficulties it was experiencing in fulfilling orders and meeting customer demands. The company allegedly led investors to believe that it was committed to maintaining strong profits from its high-margin product business when it was actually decreasing promotional spending on that product line.

The court found that these allegations did not demonstrate a misrepresentation because the company had previously told investors that it was decreasing promotional spending on those products. Further, the company's statement that it was decreasing support was indefinite as to the extent and timing of the change and did not demonstrate an actual change had taken place at the time the statement was made. The court also found that that the plaintiffs failed to adequately plead that the company had misled investors about its operational abilities. The court reasoned that the complaint did not show that the company's statements about improving its margin were rendered misleading by failing to disclose warehouse problems because the company could have conceivably improved margins even without fixing the warehouse problems. The company's statements about its improved customer service capabilities also were not inconsistent with its operational difficulties and were in any event an "accurate reporting of historical successes." Lastly, the company's statements regarding its profit projections were not actionable because the plaintiffs failed to allege that those projections were false at the time they were made or that the company's expectations were unrealistic.

SDNY Upholds Some Securities Fraud Claims Arising From Alleged Bribery Abroad

In re Eletrobras Sec. Litig., No. 15-cv-5754 (S.D.N.Y. Mar. 25, 2017)
Click here to view the opinion.

Judge John G. Koeltl upheld some securities fraud claims brought by purchasers of U.S. exchange-traded securities of Centrais Eletricas Brasileiras S.A. arising from the company's alleged involvement in bribery and other corruption, but dismissed others against an individual defendant. As an initial matter, the court held that the class could include both holders of American depositary shares (ADS) and bonds because "[w]hile the accompanying levels of risk between ADSs and bonds do differ," the difference was not sufficient to defeat certification. As to claims under Section 10 of the Securities Exchange Act, the court held that the plaintiffs had adequately alleged that the company had made misstatements about its code of ethics. The company allegedly cited its code of ethics to demonstrate "the strength of its internal controls and its commitment to transparency and ethical conduct," but the court found those statements to be misleading because the comments stood in "stark contrast" to explanatory notes in subsequent annual reports, which purportedly demonstrated "bribery and bid-rigging" and "a lack of effective internal controls over its corruption prevention program."

The court also held that the plaintiffs had plausibly alleged that the company's annual reports contained misstatements regarding the company's financial condition. Although these misstatements may have been small numerically and immaterial by quantitative standards, the court held that they were qualitatively material because some of the company's officers had suffered criminal consequences in connection with the allegedly illegal activity, the company overhauled its governance system thereafter — entirely replacing its board of directors and management — and management attempted to downplay the purported misconduct in the wake of media reports regarding the illegal activity.

However, the court granted one individual defendant's motion to dismiss because the plaintiffs had not adequately pleaded scienter. This officer had publicly stated that he signed the code of ethics and was involved only with one of the company's smaller subsidiaries, in contrast to other defendants who signed the company's annual reports, were aware of the internal audit purportedly revealing significant lack of controls within the company and held positions more proximate to the alleged corruption. The court also dismissed claims based on scheme liability against three of the officers but maintained the claim against the company. Scheme liability requires that a defendant

commit a deceptive act in furtherance of an "alleged scheme to defraud" that is distinct from any alleged misstatements. The court dismissed this claim against three of the officers because the plaintiffs had not pleaded that they participated in an "inherently deceptive" act separate to the misrepresentations at issue. However, the court held that the plaintiffs had adequately pleaded that a fourth officer had participated in bribery, and the court also imputed this action to the company. Although the company argued that it had not benefited from the actions of the officer — and thus intent should not be imputed pursuant to the "adverse interest exception" — the court found that the company had "likely benefitted at least in part from the alleged deceptive scheme by receiving political advantages derived from such illicit payments."

Relatedly, in another recent case involving bribery allegations, *In re Braskem S.A. Securities Litigation*, No. 15-cv-05132 (S.D.N.Y. Mar. 30, 2017), the court granted a motion to dismiss, in part, finding that alleged misstatements regarding the company's culture and ethics were not actionable because the statements were made in routine filings and not to "fend off inquiries about wrongdoing." However, the court denied the motion to dismiss with respect to representations regarding the pricing of certain petroleum products in light of an alleged bribery scheme permitting the company to obtain the products at below-market prices.

PSLRA

First Circuit Affirms Dismissal of Putative Securities Class Action Against Biogen Inc.

In re Biogen Inc. Sec. Litig., No. 16-1976 (1st Cir. May 12, 2017)
Click here to view the opinion.

The First Circuit affirmed the dismissal of claims under Section 10(b) of the Securities Exchange Act alleging, according to confidential witnesses, that Biogen and certain of its current and former officers intentionally misled the public regarding the impact on drug sales resulting from the company's earlier announcement that a patient treated with the drug had died from complications associated with the rare neurological disease progressive multifocal leukoencephalopathy (PML). The First Circuit held that the complaint failed to meet the rigorous pleading standards for allegations of scienter under the Private Securities Litigation Reform Act. The court observed that the statements attributed to confidential witnesses "are so lacking in connecting detail that they cannot give rise to a strong inference of scienter" and that "[t]he statements do not even begin to quantify the magnitude of the sales decline at the company level," nor do they "explain with any precision whether the sales decline resulted from higher discontinuations, fewer new starts, changes in the market, or some combination of these factors." The First Circuit concluded that "the confidential witness statements are consistent with the defendants' public disclosures," which "repeatedly returned to the PML incident as one factor impacting [the drug's] performance."

For more detail regarding this case, see our May 15, 2017, client alert "First Circuit Affirms Dismissal of Securities Class Action Against Biogen Inc."

Registration Statement Liability

Safe Harbor Provision of Regulation D's Rule 508(a) Available to Defendant in SEC Enforcement Action

SEC v. Levin, No. 15-14375 (11th Cir. Feb. 23, 2017)
Click here to view the opinion.

The Eleventh Circuit reversed in part the district court's grant of summary judgment to the SEC, holding that the safe harbor provision of Regulation D's Rule 508 is available to defendants in SEC enforcement actions. The defendant allegedly became involved in a Ponzi scheme, wherein investors were solicited to purchase fake settlement agreements supposedly reached in sexual harassment and whistleblower suits. The defendant allegedly issued promissory notes stemming from this Ponzi scheme to 90 investors. The promissory notes were not registered with the SEC.

The SEC brought an enforcement action, alleging, among other things, that the defendant sold unregistered securities in violation of Sections 5(a) and (c) of the Securities Act. The defendant argued that the promissory notes were exempt from registration because they were protected by the safe harbor provision of Rule 508(a) of Regulation D. The SEC countered that the provision was available only in private actions.

The district court granted summary judgment for the SEC, and the Eleventh Circuit reversed. Relying on "the plain language of the regulation and regulatory history," and employing various canons of statutory construction, the court held that Rule 508(a) "preserves the safe harbor in SEC enforcement actions." Moreover, because there were disputes of fact as to whether the defendant was entitled to the protections of the safe harbor provision under the circumstances, the court remanded the case for further proceedings.

SDNY Dismisses Claims Against Chinese-Based Steel Processing Company

Pehlivanian, et al., v. China Gerui Advanced Materials Grp., et al., No. 14 Civ. 9443 (S.D.N.Y. Mar. 29, 2017)
Click here to view the opinion.

Judge Edgardo Ramos dismissed claims that a Chinese-based steel company violated Section 10(b) of the Securities Exchange Act and Sections 11 and 12 of the Securities Act by allegedly misrepresenting the terms of a land acquisition transaction and the acquisition of a collection of antique porcelain. The plaintiff alleged that statements regarding the company's land acquisition were "a complete fraud" because the land use rights were never transferred to the company; that the statements regarding the porcelain transaction contained material omissions, such as the provenance of the collection and what steps were being taken to liquidate it; and that the company had failed to file financial statements with the SEC since January 2015, even though the company had made filings with a Chinese regulator, purportedly demonstrating that the company had prioritized its requirements under Chinese law over U.S. requirements. In turn, the defendants argued that the complaint was merely an attempt "to improperly disguise corporate mismanagement allegations as securities fraud allegations."

The district court ruled that the complaint failed to "identify specifically which of Defendants' statements are false or misleading" because the company's annual reports made clear that the transaction was still in progress. Regarding the porcelain transaction, the court determined that the defendants had no duty to disclose the allegedly omitted details. Finally, regarding the claim that the company's Securities and Exchange Commission (SEC) filings were false and misleading, the court found that even if the company did prioritize its regulatory filings in China after January 2015, the company's statements in previous SEC filings could not be false or misleading based solely on that fact because "[t]he truth of a statement made in the registration statement is adjudged by the facts as they existed when the registration statement became effective." The court dismissed the Securities Exchange Act claims because there were no adequately pleaded materially false or misleading statements, and it dismissed the Securities Act claims because the plaintiff failed to adequately plead that the registration statements at issue (from 2009 through 2013) were false and misleading.

Reliance

EDNY Dismisses Claim Against Attorney in Connection With Allegedly Misleading Opinion Letters

Orlan et al. v. Spongetech Delivery Sys., Inc., et al., No. 10-CV-4093 (E.D.N.Y. Mar. 24, 2017)
Click here to view the opinion.

Judge Dora L. Irizarry dismissed claims by investors of a sponge company alleging that an attorney violated Section 10(b) of the Securities Exchange Act by writing more than 90 opinion letters containing materially false and misleading statements and omissions regarding the removal of restrictive legends from shares of the company. The plaintiffs alleged that once the restrictive legends were removed, the shares flooded the market, diluting the value of their share prices. The plaintiffs further alleged that the attorney misleadingly advised the stock transfer agent that the restrictive legends could be removed by either improperly representing (1) that certain entities affiliated with the company had held the securities for six months or longer when they had not, or (2) that certain affiliated entities were actually nonaffiliated entities. The district court dismissed the claims because the plaintiffs did not sufficiently allege that they considered or relied on his opinion letters when deciding whether to invest in the company (or were even aware of the opinion letters at the time of purchase). Although the defendant had allegedly admitted some of the alleged conduct before the SEC, the court found that "the admissions were not pled with particularity as Plaintiffs failed to attach the actual SEC record of testimony or specific citations thereto." Because the plaintiffs had failed to plead reliance, the court determined that the plaintiffs had failed to plead materiality and loss causation.

Sanctions

SDNY Denies Motion for Sanctions in 'Abusive Litigation' Case

Zagami v. Cellceutix Corp., No. 15 Civ. 7194 (S.D.N.Y. Mar. 29, 2017)
Click here to view the opinion.

Judge Katherine Polk Failla denied a motion pursuant to Fed. R. Civ. P. 11 for sanctions against the plaintiff in a lawsuit that defendants argued amounted to "abusive litigation." The court had previously dismissed the plaintiff's case in its entirety. Pursuant to the Private Securities Litigation Reform Act, sanctions are mandatory if Rule 11 is violated and a violation occurs whenever the nonfrivolous claims that are joined with frivolous ones are insufficiently meritorious to save the complaint as a whole from being abusive. In this case, the court found that the "[p]laintiff

raised several claims with legitimate, if ultimately unavailing, legal arguments." The court credited certain allegations regarding the misrepresentation of a key individual's educational background and certain public statements made by that person. The court also credited allegations that the defendant had misstated the effectiveness of one of its drugs, and it stated that the claim had "failed largely for pleading insufficiencies." Further, the court found that the plaintiff's claims regarding certain scientific terminology "were permissible attempts to seek clarity in the law" and stated that the plaintiff's argument regarding the need for additional disclosures was not "objectively unreasonable." Likewise, the court held that it was not unreasonable for the plaintiff to rely, in part, on a lengthy and detailed internet post, even though the source was anonymous. In addition, the court noted that consideration of the iterations of the three complaints filed in the action demonstrated that the plaintiffs had attempted to plead a cognizable claim.

SEC Enforcement Actions

'Relief Defendants' May Not Defeat Jurisdiction by Merely Asserting a Claim of Entitlement to the Disputed Funds

SEC v. Messina, No. 15-55325 (9th Cir. Mar. 21, 2017)
Click here to view the opinion.

In an issue of first impression, the Ninth Circuit held that "relief defendants" cannot defeat jurisdiction in federal court simply by asserting an ownership interest in disputed money.

The SEC is authorized to bring civil enforcement actions seeking equitable relief against those violating the Securities Exchange Act. In these actions, federal courts may order disgorgement from nonviolating third parties who have received proceeds of others' violations to which the third parties have no legitimate claim. These nonviolating third parties are "relief defendants." For a court to exercise jurisdiction over relief defendants (and ultimately obtain disgorgement), the SEC must show that the relief defendants (1) received ill-gotten funds and (2) do not have a legitimate claim to those funds.

Vincent J. Messina, a lawyer, had a client who was allegedly engaged in a worldwide pyramid scheme that defrauded investors out of $57 million through unregistered securities offerings. The SEC claimed that Messina received $5 million from his client's unlawfully obtained funds and sought to disgorge that money from him. Messina maintained that the $5 million was merely a loan from his client, not the proceeds of illegal activity. Messina argued that the district court did not have jurisdiction over him to order disgorgement because he asserted a "facially colorable" claim to the disputed funds as a loan.

After a two-day evidentiary hearing, the district court granted the SEC's motion for disgorgement, holding that it had jurisdiction over Messina because Messina did not have a legitimate claim to those funds. The Ninth Circuit affirmed, holding that relief defendants may not divest a district court of jurisdiction to proceed against them simply by asserting a "facially colorable" claim of entitlement to the disputed funds. Rather, the relief defendant must demonstrate "an interest both 'recognized in law' and 'valid in fact.'" Here, Messina failed to make that showing, given the district court's factually supported finding that the $5 million "loan" was a sham.

Securities Fraud Pleading Standards

SDNY Dismisses Putative Class Claims Against Fast-Food Retailer

Ong v. Chipotle Mexican Grill, Inc., No. 16 Civ. 141 (KPF) (S.D.N.Y. Mar. 8, 2017)
Click here to view the opinion.

Judge Katherine Polk Failla dismissed claims that a fast-food retailer specializing in Mexican food violated Section 10(b) of the Securities Exchange Act by allegedly failing to disclose certain conduct related to the company's food handling processes that led to several E. coli outbreaks at restaurants across the United States and a related investigation by the Centers for Disease Control and Prevention (CDC). The plaintiffs specifically alleged that the company failed to disclose (1) its transition from using central commissary kitchens to prepare and process food to in-store processing and the increased risk of food-borne illness outbreaks resulting from that change; (2) the existence (and extent of) certain E. coli outbreaks that occurred at the company's restaurants and the status of the CDC's subsequent investigations into the outbreaks; and (3) the associated changes in the company's risk factors and the impact of the outbreaks on the company's financial performance and future.

Judge Failla concluded that the plaintiffs did not adequately plead that the company failed to disclose a heightened risk from the company's transition to in-store preparation because the company had transitioned to in-store production well before the first E. coli outbreak, suggesting that the transition did not actually heighten the company's risk. The court also reasoned that the company's generalized statement regarding its food-safety programs were inactionable puffery.

As to the company's statements that health officials had concluded that there was "no ongoing risk" related to the E. coli outbreak, the court concluded that the statements may have been "half-truths" at the time they were made in light of the ongoing

CDC investigation. Likewise, the court found that the company's representation that there had been no material changes in its risk factors also may have been misleading in light of four E. coli outbreaks identified at the time. The court also determined that the company had not disclosed the potential impact on financial performance as a result of the outbreaks. However, the court expressed skepticism that any of the statements above were materials and would have "altered the total mix of information available" to investors in light of the highly publicized nature of the outbreaks. Further, the court held that the plaintiffs had failed to adequately plead a strong inference of scienter. The court noted that stock sales by the company's executives did not indicate motive because the transactions were several months before the outbreaks occurred, and the more compelling explanation was that the executives sold their stock because they were receiving decreased salaries from the company. Further, the company's statement that there was "no ongoing risk" related to the E. coli was forward-looking and not inconsistent with the CDC's backward-looking statement that it was still investigating the causes of the outbreak and the infected persons. In addition, the court determined that the company did not need to make specific disclosures regarding the impact of the outbreaks on future financial performance in light of its other disclosures regarding the outbreaks.

Scienter

Sixth Circuit Affirms Dismissal of Securities Fraud Class Action Brought Against Officers, Directors, and Principal Shareholders of Kitchenware Company and Its Underwriters

IBEW Local No. 58 Annuity Fund v. EveryWare Global, Inc., No. 16-3445 (6th Cir. Feb. 21, 2017)
Click here to view the opinion.

The Sixth Circuit affirmed the dismissal of claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act, SEC Rule 10b-5, and Sections 11, 12(a)(2) and 15 of the Securities Act against officers, directors and principal shareholders of a now-bankrupt kitchenware company and its underwriters. The plaintiffs claimed that the defendants made material misrepresentations and omissions in the company's 2013 earnings projections, investor presentations, registration statement and prospectus as a part of a so-called "pump and dump" scheme.

The Sixth Circuit affirmed the dismissal, concluding that the plaintiffs' Securities Exchange Act claims failed to meet the heightened pleading standard for scienter and that their Securities Act claims failed to plausibly allege any material misrepresentations by the defendants. The Sixth Circuit adopted the district court's reasoning that the plaintiffs failed to plead particularized facts giving rise to a strong inference of scienter because they failed to plead that (1) the CEO had actual knowledge that the 2013 earnings projections were false or misleading, or (2) the defendants acted with "a mental state embracing intent to deceive, manipulate, or defraud." The Sixth Circuit also adopted the district court's reasoning that the plaintiffs failed to plausibly plead facts showing that the company's registration statement and prospectus contained material misrepresentations.

Northern District of Illinois Denies Motion to Dismiss Misrepresentation Claims Against Biopharmaceutical Company and CEO

Rubinstein v. Gonzalez, No. 14-cv-9465 (N.D. Ill. Mar. 10, 2017)
Click here to view the opinion.

Judge Robert M. Dow, Jr. denied a motion to dismiss a class action brought against a biopharmaceutical company and its CEO for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act and SEC Rule 10b-5. The class action plaintiffs alleged that the defendants acted at least recklessly in misrepresenting that the primary rationale for a failed merger involving a corporate tax inversion was strategic, rather than to obtain favorable tax treatment. The plaintiffs identified three statements as misleading or containing omissions of material fact: (1) comments by the CEO on an investor call that tax benefits were not the primary rationale for the transaction; (2) statements in an SEC filing that listed tax benefits as one of 10 strategic benefits of the merger; and (3) statements by the CEO in a letter to employees of the target company, after U.S. tax authorities had taken actions to prevent corporate inversions, that the biopharmaceutical company planned to pursue the merger. Because the merger was abandoned after U.S. tax authorities acted to limit inversions, the plaintiffs alleged that these statements understated the importance of the merger's tax benefits.

The district court determined that the plaintiffs failed to plead that the comments on the investor call and statements in the SEC filing were misrepresentations because the tax benefits did not have to be the primary rationale for the transaction for the company to terminate the transaction after those benefits were eliminated. The district court also reaffirmed its prior ruling that the plaintiffs adequately pleaded that the letter to the target employees was a misrepresentation. The district court next concluded that the plaintiffs adequately pleaded that the defendants acted with scienter based on allegations the defendants acted recklessly in issuing the letter before performing a detailed consideration of the change in U.S. tax rules and its effect on the transaction. In support of this conclusion, the court cited a later statement from a board member that the letter was issued to calm employee unrest at the target.

Whistleblower Protections

Ninth Circuit Joins Second Circuit in Expanding Dodd-Frank Whistleblower Protections

Somers v. Dig. Realty Trust Inc., No. 15-17352
(9th Cir. Mar. 8, 2017)
Click here to view the opinion.

A divided Ninth Circuit panel joined the Second Circuit in expanding Dodd-Frank whistleblower protections to apply not only to those who disclose potential violations to the SEC but also to employees who report internally. The Ninth Circuit's decision deepens a circuit split, after the Fifth Circuit in 2013 held that the Dodd-Frank anti-retaliation provisions protect only whistleblowers who report to the SEC.

The plaintiff allegedly made several complaints to senior management at his employer, the defendant, regarding possible securities law violations. The plaintiff did not report any of his concerns to the SEC. He was subsequently fired.

The plaintiff brought suit against his former employer, alleging violation of Section 21F of the Exchange Act, the anti-retaliation provision of the Dodd-Frank Act. The defendant moved to dismiss on the grounds that, under Dodd-Frank, a "whistleblower" is defined only as someone who reports to the SEC. The district court denied the defendant's motion to dismiss, and the Ninth Circuit affirmed.

The court reasoned that the definition of "whistleblower" found in Dodd-Frank — which includes only those employees who report potential wrongdoing "to the Commission" — is not dispositive. Rather, as the U.S. Supreme Court stated in *King v. Burwell*, 135 S. Ct. 2480 (2015), "[t]he use of a term in one part of a statute 'may mean a different thing' in a different part, depending on context." That is so even where the statute contains a "definitional provision" specifically defining the term. On this point, the court also relied on a 2011 regulation issued by the SEC interpreting Section 21F, which defines the term "whistleblower" to include those who report potential wrongdoing internally. That regulation and interpretation, the court stated, was "entitled to deference."

Finally, the court explained that provisions of "Sarbanes-Oxley and the Exchange Act mandate internal reporting before external reporting," and "[l]eaving employees without protection for that required preliminary step would result in early retaliation before information could reach the regulators." Such a result would cut against legislative intent to safeguard investors in public companies and the whistleblowers themselves.

The defendant has filed a *writ of certiorari* with the Supreme Court.

Inside the Courts
An Update From Skadden Securities Litigators

Contacts

New York
Four Times Square
New York, NY 10036
212.735.3000

John K. Carroll
212.735.2280
john.carroll@skadden.com

Jonathan Frank
212.735.3386
jonathan.frank@skadden.com

William P. Frank
212.735.2400
william.frank@skadden.com

Robert A. Fumerton
212.735.3902
robert.fumerton@skadden.com

Jay B. Kasner
212.735.2628
jay.kasner@skadden.com

Jonathan J. Lerner
212.735.2550
jonathan.lerner@skadden.com

Scott D. Musoff
212.735.7852
scott.musoff@skadden.com

Joseph N. Sacca
212.735.2358
joseph.sacca@skadden.com

Susan L. Saltzstein
212.735.4132
susan.saltzstein@skadden.com

Seth M. Schwartz
212.735.2710
seth.schwartz@skadden.com

Robert E. Zimet
212.735.2520
robert.zimet@skadden.com

George A. Zimmerman
212.735.2047
george.zimmerman@skadden.com

Boston
500 Boylston St.
Boston, MA 02116
617.573.4800

James R. Carroll
617.573.4801
james.carroll@skadden.com

Thomas J. Dougherty
617.573.4820
dougherty@skadden.com

Peter Simshauser*
617.573.4880
peter.simshauser@skadden.com

Chicago
155 N. Wacker Drive
Chicago, IL 60606
312.407.0700

Matthew R. Kipp
312.407.0728
matthew.kipp@skadden.com

Michael Y. Scudder
312.407.0877
michael.scudder@skadden.com

Charles F. Smith*
312.407.0516
charles.smith@skadden.com

Houston
1000 Louisiana St., Suite 6800
Houston, TX 77002
713.655.5100

Noelle M. Reed
713.655.5122
noelle.reed@skadden.com

Los Angeles
300 S. Grand Ave., Suite 3400
Los Angeles, CA 90071
213.687.5000

Peter B. Morrison*
213.687.5304
peter.morrison@skadden.com

Palo Alto
525 University Ave.
Palo Alto, CA 94301
650.470.4500

Jack P. DiCanio
650.470.4660
jack.dicanio@skadden.com

Amy S. Park*
650.470.4511
amy.park@skadden.com

Washington, D.C.
1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

Jennifer L. Spaziano
202.371.7872
jen.spaziano@skadden.com

Charles F. Walker
202.371.7862
charles.walker@skadden.com

Wilmington
One Rodney Square
920 N. King St.
Wilmington, DE 19801
302.651.3000

Paul J. Lockwood
302.651.3210
paul.lockwood@skadden.com

Edward B. Micheletti*
302.651.3220
edward.micheletti@skadden.com

Robert S. Saunders
302.651.3170
rob.saunders@skadden.com

Jennifer C. Voss
302.651.3230
jennifer.voss@skadden.com

Edward P. Welch
302.651.3060
edward.welch@skadden.com

*Editors

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