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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

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Class Representation

District of Massachusetts Denies Motion to Strike Class Representative

Henderson & Hershenson v. Bank of N.Y. Mellon Nat'l Ass'n, No. 15-10599-PBS (D. Mass. Sept. 25, 2017)
Click here to view the opinion.

Judge Patti B. Saris denied the Bank of New York Mellon's (BNY Mellon) motion to strike putative class representative Ashby Henderson. BNY Mellon claimed that Henderson had inadequate knowledge of the case to serve as class representative, that she ceded control of the case to unfit class counsel and that her interests conflicted with the interests of the class. First, the court held that BNY Mellon should not have filed a motion to strike the class representative but should have opposed class certification because its motion to strike relied on evidence besides the pleadings, and the plaintiffs had already filed a motion for class certification. Instead, the court considered BNY Mellon's arguments as a partial opposition to the motion for class certification on the grounds that Henderson was an inadequate class representative. Although BNY Mellon argued that Henderson lacked sufficient understanding to serve as class representative, the court disagreed and noted that she explained "the essential nature of her claims, at least to the extent that is reasonable to expect from a layperson class representative in a complex financial case." Additionally, BNY Mellon alleged that Henderson ceded control to her attorney and did not represent the interests of the class. Again, the court disagreed. It held that Henderson did not exclusively rely on her counsel, that she understood that she and the other plaintiffs were represented by several attorneys and that she worked cooperatively with them.

Fiduciary Duties

Mergers and Acquisitions

Court of Chancery Applies *Corwin* to Dismiss Post-Closing Fiduciary Duty Claims

Morrison v. Berry, No. 12808-VCG (Del. Ch. Sept. 28, 2017)
Click here to view the opinion.

Vice Chancellor Sam Glasscock III granted a motion to dismiss fiduciary duty claims asserted in connection with the sale of The Fresh Market to Apollo Management, L.P. In his decision, the vice chancellor noted that the case was "exemplary" of the "utility" of the doctrine adopted by the Delaware Supreme Court in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which held that the business judgment rule is the appropriate standard of review for a post-closing damages action when a merger transaction that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the target company's disinterested stockholders.

The plaintiff stockholder alleged that Fresh Market's founder, a director and 10 percent owner, sought out a private equity buyer for Fresh Market without the knowledge of the other eight members of the company's board of directors and reached a preliminary agreement with Apollo to roll over his shares. When Apollo made an unsolicited offer to acquire Fresh Market, the founder recused himself from the process, and the remaining board members formed a three-member special committee, hired a financial advisor and conducted a three-month auction process that included reaching out to 32 potential bidders. The process yielded five indications of interest and "several" offers.

In an attempt to argue that the stockholder vote was not fully informed, the plaintiff asserted several disclosure claims, including that (1) the Schedule 14D-9 failed to disclose that the sensitivities the company's financial advisor ran on management projections "included upside as well as downside sensitivities"; and (2) the Schedule 14D-9 was misleading because it did not fully describe the founder's role in the process and that the process was in fact a "sham." The court rejected both of these arguments, finding, among other things, that the complaint failed to allege that the disclosed projections represented "anything other than [the board's] best estimates," and that the plaintiff's description of the process as a "sham" was "not supported by the record." The court accordingly granted the motion to dismiss.

Court of Chancery Rejects Post-Closing Bad Faith Claims

Kahn v. Stern, No. 12498-VCG (Del. Ch. Aug. 28, 2017)
Click here to view the opinion.

Vice Chancellor Sam Glasscock III granted a motion to dismiss a stockholder plaintiff's post-closing claims that the board of directors of Kreisler Manufacturing Corporation acted in bad faith in approving a sale of the company and certain "side deals" with insider directors, and in issuing disclosures in connection with the merger.

In connection with the transaction, the board formed a special committee consisting of two of the five members of the board, which, with the assistance of a financial advisor and outside legal counsel, conducted a sales process that included reaching out to 55 potential bidders. The process generated seven indications of interest and three offers. According to the plaintiff, two insider directors then negotiated "side deals" for themselves that included future employment with the surviving entity and a rollover of equity. In addition, the plaintiff challenged omissions in the information statement issued in connection with the transaction, including the failure to disclose management's projections used in the financial advisor's analyses. The plaintiff alleged, among other things, that (1) a majority of the board was interested in the transaction, and (2) a majority of the board acted in bad faith in approving the side deals and issuing the challenged disclosures.

The parties disputed the independence of only one director, who the plaintiff alleged "had a large, illiquid block of shares, favored a sale of the Company, had aligned himself with [an activist stockholder] who was agitating for a sale, and was excluded from the Special Committee." Rejecting this argument, the court noted that the director had not "received different or unique consideration" and observed that the complaint did not "allege that he faced a liquidity crisis or a particular exigent need that would necessitate a fire sale of his interest." The court also refused to draw an inference about the director's independence from the fact that he was not a member of the special committee.

The court also rejected the plaintiff's bad faith claims, observing that it "is a difficult standard to meet" and explaining that the allegations of the complaint did not support a reasonable inference that a reduction in the merger price allocable to the side deals made board approval inexplicable absent bad faith. Among other things, the court found that with respect to the side deals, "a potential rational business purpose exists: to incentivize proper management of the Company through and after the Merger."

With respect to the disclosure claims, the court observed that in a post-closing damages action with a majority disinterested and independent board, protected by an exculpatory charter provision, the plaintiff bore the burden to plead facts supporting an inference that the board acted in bad faith in issuing a materially deficient disclosure. The court explained that prior to a stockholder vote, "the decision to withhold management projections and other elements leading to the fairness opinion" was likely to "merit injunctive relief," but it ultimately found that, post-close, the complaint failed to allege facts supporting an inference that the board was participating in a "cover-up" or otherwise acted in bad faith in issuing the disclosures.

Derivative Claims

Court of Chancery Dismisses Derivative Claims Involving Alleged Overpayment in Asset Purchase

Chester Cty. Emps'. Ret. Fund v. New Residential Inv. Corp.,
No. 11058-VCMR (Del. Ch. Oct. 6, 2017)
Click here to view the opinion.

Vice Chancellor Tamika Montgomery-Reeves granted a motion to dismiss stockholder derivative claims involving alleged overpayment for assets, finding that the plaintiff failed to demonstrate that demand was futile pursuant to Court of Chancery Rule 23.1.

The plaintiff, a stockholder of New Residential Corp., brought suit challenging a transaction between New Residential and Home Loan Servicing Solutions, Ltd. (HLSS), arguing that the director defendants caused New Residential "to overpay" for assets of HLSS in order to advantage other real estate assets of Fortress, an affiliate of New Residential's manager. The plaintiff alleged that Fortress was New Residential's controlling stockholder and that the transaction was not entirely fair.

The court reiterated the standard for pleading demand futility under *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), pursuant to which demand is futile only if a plaintiff alleges particularized facts to raise a reasonable doubt that either a majority of the directors are disinterested and independent, or the challenged transaction was otherwise the product of a valid exercise of business judgment.

With respect to director independence, the court concluded that the plaintiff failed to raise a reasonable doubt as to the impartiality of a majority of the board. Among other things, the court explained that assertions of "reputational harm," "receipt of indemnification and exculpation rights," "several years of social connections," donations to common charities and stale business dealings were insufficient to impugn the directors' independence or disinterestedness. The court also found that a director whose background of public service suggested he was of "less-than extraordinary means" did not support an allegation that such a director lacked independence or was interested because the board fees were material to him, since such a finding would discourage "regular folks" from board service — a result the court was "especially unwilling to facilitate."

The court also rejected the plaintiff's argument that because a controller was present, invocation of entire fairness "automatically" rendered demand futile. Declining to determine whether Fortress was in fact a controlling stockholder, the court found such an automatic excusal theory was "inconsistent with controlling authority'" in Delaware. Finally, the court concluded that the plaintiff failed to demonstrate that the asset sale between New Residential and HLSS implied a threat of a substantial likelihood of liability because the transaction was not so egregious that board approval amounted to bad faith. The court noted that complaints about the price paid for the assets were "precisely the type of 'Monday morning quarterbacking'" routinely found insufficient to excuse demand.

Insider Trading Claims

Second Circuit Affirms Dismissal of Short-Swing Profit Claims Against Hedge Fund Company

Morrison v. Eminence Partners II, L.P., No. 17-843-cv
(2d Cir. Oct. 19, 2017)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of an investor's claim that a hedge fund company violated Section 16(b) of the Securities Exchange Act by allegedly obtaining "short-swing" profits from the sale of common stock in a national men's clothing company. Before the investor had filed his complaint, the clothing company had completed a corporate reorganization that resulted in shareholders exchanging the company's stock for share in a holding company.

The district court had previously dismissed the investor's complaint for lack of statutory standing on the grounds that the investor did not hold stock in the issuer to which the short-swing trades pertained at the time he filed his complaint because he now owned stock of the parent holding company. The Second Circuit affirmed, determining that an investor must hold the security in the "issuer" to whom the short-swing profits would accrue at the time a complaint is filed. The court found that several exceptions to the general standing rule under Section 16(b) were inapplicable. The successor-issuer exception did not apply because the reorganized clothing company was not "merged out of existence" and remained a viable entity that itself had standing to bring a Section 16(b) claim for short-swing profits earned from purchases and sales of the company's securities. The fraud exception to standing also did not apply. The investor failed to allege plausible facts that the reorganization was a fraudulent effort to deprive him of statutory standing. The court determined that such an allegation was implausible because the company had completed the reorganization before the investor filed his Section 16(b) claim and it had announced the reorganization in a public filing well before the investor filed a Section 16(b) demand on the company.

Misrepresentations

SDNY Holds That Company's Conduct That Formed Basis of FCPA Violations Led to Material Misstatements and Omissions

In re VEON Ltd. Sec. Litig., No. 15-cv-08672 (ALC)
(S.D.N.Y. Sept. 19, 2017)
Click here to view the opinion.

Judge Andrew L. Carter Jr. granted in part and denied in part a motion to dismiss claims that VEON Ltd., an international telecommunications company, violated Sections 10(b) and 20(a) of the Securities Exchange Act.

The complaint was based substantially on statements included in a deferred prosecution agreement after VEON admitted violating the Foreign Corrupt Practices Act by paying bribes to gain market access in Uzbekistan. The court granted the motion to the extent that the complaint alleged that VEON's accurate financial reports and statements about sales and subscriber numbers were misleading. The court agreed with other courts that have held that "accurately reported income derived from illegal sources is non-actionable despite a failure to disclose the illegality."

In denying the motion in part, the court concluded that certain of VEON's statements were potentially misleading because it had put at issue "the topic of the cause" of its financial success. For example, VEON attributed its increase in mobile subscribers and revenues in Uzbekistan to its "sales and marketing efforts." The court concluded that because VEON had purported to identify a cause of its financial success, its failure to disclose that the illegal conduct had contributed to its success was actionable. The court also concluded that the plaintiffs adequately alleged scienter and loss causation.

Mortgage-Backed Securities

BNY Mellon Awarded Partial Summary Judgment on Claims Concerning 20 Residential Mortgage-Backed Securities Trusts

Phx. Light SF Ltd. v. Bank of N.Y. Mellon,
No. 14-CV-10104 (VEC) (S.D.N.Y. Sept. 7, 2017)
Click here to view the opinion.

In a case brought by investors in mortgage-backed securities, Judge Valerie E. Caproni of the U.S. District Court for the Southern District of New York granted partial summary judgment to the defendant BNY Mellon, the trustee of 27 securitization trusts. The plaintiffs alleged that BNY Mellon breached various contractual duties arising both before and after an "event of default" — including the duty of prudence that arose upon an event of default — in addition to violating the Trust Indenture Act (TIA) and negligently performing its contractual duties.

The court rejected the plaintiffs' argument that BNY Mellon breached its pre-event of default duty to investigate and provide notice of breaches of representations and warranties, and to enforce servicer Countrywide's repurchase obligations in connection with 16 trusts. Although the plaintiffs cited evidence that BNY Mellon knew of "systemic fraud" at Countrywide, that was insufficient to establish that BNY Mellon had "knowledge of any specific breach of any representation or warranty relative to any particular loan" in the Countrywide trusts. The court thus granted BNY Mellon summary judgment with respect to the pre-event of default breach of contract claims in connection with 16 trusts. For the other four trusts, in connection with which BNY Mellon received letters from certificateholders concerning material breaches of representations or warranties in specific loans, the court denied BNY Mellon's motion for summary judgment, finding material facts in dispute.

With regard to the plaintiffs' post-event of default claims concerning five trusts in which an event of default was conceded, the court denied BNY Mellon's motion for summary judgment. The court held that whether BNY Mellon's issuance of a notice of an event of default, without further action, was sufficient to discharge its duty of prudence was a question of fact that could not be resolved on summary judgment. With regard to the remaining trusts, for which an event of default was not conceded, the court held that knowledge of an event of default — which triggered the duty of prudence — arose only upon written notice. Thus, BNY Mellon was entitled to summary judgment where there was no evidence that it had received written notice of an event of default, even if it had actual knowledge of that event. The plaintiffs' claims under the TIA, which relied on similar evidence, were also dismissed with respect to these trusts. The court denied the plaintiffs' cross motion for summary judgment on the claims concerning the duty of prudence, which required resolution of disputed issues of material fact.

The court also denied the plaintiffs' negligence claims, reasoning that they were barred by the economic loss doctrine and duplicative of the contract claims.

PSLRA – Pleading Standards

Third Circuit Holds Defendant Had No Duty to Disclose Loss of Distributor

Williams v. Globus Med., Inc., No. 16-3607 (3d Cir. Aug. 23, 2017)
Click here to view the opinion.

The Third Circuit affirmed the dismissal of a putative securities fraud class action, holding that the plaintiffs failed to sufficiently allege that the challenged statements and omissions were false or misleading.

The defendant, a medical device company, uses independent distributors to sell its products. The defendant allowed its contract with one of its distributors to expire. The plaintiffs brought suit, alleging that the defendant omitted that it had lost a distributor in its historical statements and that the defendant made misleading forward-looking statements by issuing revenue projections that failed to account for the lost distributor.

The district court dismissed the plaintiffs' claims, and the Third Circuit affirmed. With regard to failing to disclose the expired contract in its historical statements, the court explained that corporations do not have an affirmative duty to disclose all information under the federal securities laws. So long as the omitted information was not necessary to prevent a defendant's statements from being misleading, the defendant was not liable for its failure to disclose information about the distributor. Here, while the defendants warned that the loss of an independent distributor could negatively impact its sales, the plaintiffs did not plead that the defendant's sales were adversely affected by the loss of the distributor or that a drop in sales was inevitable. Therefore, under the plaintiffs' own allegations, the defendant had no duty to disclose the loss of the distributor.

The court also dismissed the plaintiffs' claims based on the defendant's forward-looking revenue projections because those allegations hinged on the conclusory assertion that the projections incorporated sales figures from the lost distributor. However, because the plaintiffs did not cite contemporaneous sources to show that the defendant in fact incorporated sales figures from the distributor into its projections, the allegations failed to satisfy the specificity requirement of the Private Securities Litigation Reform Act pleading standard.

Eastern District of Michigan Dismisses Securities Fraud Claims Alleging Capital Expenditure and Customer Relationship Misstatements

USM Holdings, Inc. v. Simon, No. 15-14251
(E.D. Mich. Sept. 12, 2017)
Click here to view the opinion.

The Eastern District of Michigan dismissed with prejudice securities fraud claims against the former officers of a target company arising from alleged misstatements in the diligence process and in the resulting merger agreement. The buyer brought suit against, among other defendants, the former CEO and chief financial officer of the target company, an automotive manufacturer. The buyer alleged that these defendants made misstatements regarding the state of the target's capital expenditures and the target's relationships with its two largest customers, in violation of Section

10(b) of the Securities Exchange Act and Rule 10b-5. The court dismissed these claims with prejudice, emphasizing the high bar of pleading fraud under the Private Securities Litigation Reform Act (PSLRA).

The buyer alleged that the target made material misstatements and omissions regarding the state of the target's capital expenditures on manufacturing machinery. The buyer set out three theories for these alleged misstatements: upkeep (alleging that the target had failed to maintain and repair its machinery as it represented during the course of diligence); forecast (alleging that a draft capital expenditure budget involved misleading figures); and failure to spend (alleging that the target failed to make certain capital expenditures prior to closing). The court rejected all three theories, each time noting the particularity in pleading required by the PSLRA. The court found that the buyer failed to plead facts regarding, for example, the officers' specific knowledge that certain machinery was in disrepair.

The buyer also alleged that the target made material misstatements and omissions regarding its relationship with its two largest customers because the target did not disclose ongoing contract disputes with these customers. The court again found that the buyer's pleadings failed to satisfy the PSLRA standard, emphasizing the need to allege detailed facts and figures regarding the disputes and even the method by which a party arrived at those facts and figures.

Scienter

Securities Fraud Class Action Based on Product Recall Allowed to Proceed

Godinez v. Alere Inc., No. 16-10766-PBS
(D. Mass. Aug. 23, 2017)
Click here to view the opinion.

Judge Patti B. Saris of the U.S. District Court for the District of Massachusetts denied a motion to dismiss a putative Section 10(b) securities fraud class action against medical device manufacturer Alere Inc., with respect to allegations that it failed to disclose the need to recall its INRatio blood-clotting measurement tool. Although Alere issued a recall of INRatio in July 2016, the plaintiffs alleged that Alere was on notice of problems with the product as early as 2014 and that a recall was sufficiently probable prior to July 2016 so as to require accrual or disclosure of an associated loss contingency under generally accepted accounting principles. For example, Alere's 2014 Form 10-K disclosed a partial recall of INRatio test strips, but, as the court found, did "not make the market fully aware of the failure rate associated with INRatio product malfunctions, necessitating the FDA's suggestion of a full recall." The court found that a number of alleged facts gave rise to a strong inference of scienter, including "the 2014 partial recall and correction, the high volume of consumer complaints, consumer injuries, and increased quality assurance staffing, the FDA's advice to prepare for a voluntary recall, and the timing of potentially lucrative merger discussions ... (which could have been scuttled by disclosure of a likely recall), after which [the CEO and CFO] stood to receive a combined $29 million in change-in-control payments." The court accordingly allowed claims based on the recall to proceed to discovery.

The court dismissed all other allegations of fraud, including allegations that Alere failed to disclose weaknesses in internal controls related to revenue recognition. Although Alere was aware of internal control issues related to corporate taxation, the court found that "[p]laintiffs do not convincingly argue that an internal control problem in one accounting area puts a company or its senior management on notice of internal control problems in all other aspects of the company's accounting procedures." The court further rejected allegations that Alere failed to disclose certain billing improprieties in divisions subject to regulatory investigation, holding that "[t]he mere existence of an investigative subpoena ... has limited probative value where there are no allegations that the issues being investigated were previously disclosed to senior management."

Securities Exchange Act

DC Circuit Affirms SEC Finding That Investment Banker Who Passed Along Statements From His Boss Was Liable for Securities Fraud

Lorenzo v. SEC, No. 15-1202 (D.C. Cir. Sept. 29, 2017)
Click here to view the opinion.

On September 29, 2017, a two-judge majority of the D.C. Circuit upheld the Securities and Exchange Commission's (SEC) determination that investment banker Francis Lorenzo violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rules 10b-5(a) and (c) by passing along to investors statements made by Lorenzo's boss, holding that Lorenzo knew the statements were false and misleading when he sent them.

On October 14, 2009, Lorenzo, director of investment banking for a registered brokerage firm, emailed two potential investors several "key" points about Waste2Energy Holdings, Inc.'s (W2E) pending debenture offering. W2E had recently lost almost all of its value and was offering up to $15 million in convertible debentures. In his emails, Lorenzo forwarded information provided to him by his boss touting the highly attractive nature of the offering but omitted any mention of the devaluation of W2E's intangible assets. One of the emails noted it was being sent at the request of Lorenzo's boss, the owner of the brokerage firm, and the other email said it was being sent at the request of the owner and another broker. In both emails, Lorenzo signed his name and title at the bottom and urged the investors to call him with any questions.

On February 15, 2013, the SEC filed an action alleging Lorenzo violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rules 10b-5(a)-(c). An administrative law judge found the statements in the emails were false and that Lorenzo acted recklessly in passing them along to investors. The judge ordered Lorenzo to cease and desist from violating the various provisions, permanently barred him from participating in the securities industry and ordered him to pay a civil monetary penalty of $15,000.

Following an unsuccessful petition for review, Lorenzo appealed to the D.C. Circuit and argued that the statements were not false or misleading, he did not act with the requisite intent in forwarding them and he did not "make" the statements within the meaning of Rule 10b-5(b).

Judge Sri Srinivasan, writing for the majority, held that the statements were false and misleading and that Lorenzo acted extremely recklessly in sending them because, at the time he sent the emails, Lorenzo knew W2E did not have sufficient assets, was headed for financial ruin and his brokerage firm had not agreed to raise the additional monies needed to repay the debenture holders.

The court rejected the argument that merely sending the statements at the request of his boss was insufficient to establish liability. The court held that although Lorenzo's boss supplied the content of the statements, Lorenzo effectively vouched for them by passing them along in his role as director of investment banking and by inviting the investors to call him with any questions. The court, however, agreed with Lorenzo that he was not liable under Rule 10b-5(b), holding that Lorenzo did not make the challenged statements because his boss, not Lorenzo, retained ultimate authority over the statements.

In so holding, the court considered the U.S. Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011). In *Janus*, the Supreme Court held that an investment adviser who assisted in preparing a mutual fund's prospectuses did not "make" the statements in the prospectuses as required under Rule 10b-5(b) because the adviser did not have "ultimate control" over the statements' content and dissemination. Like the adviser in *Janus*, the court held that Lorenzo did not have "ultimate control" over the statements in the emails because Lorenzo's boss: (1) asked him to send the emails; (2) supplied the content; and (3) approved the emails for distribution.

Relying on *Janus*, Lorenzo argued that because he did not "make" the statements at issue, he should not be liable under the other securities fraud provisions. The court held that the conduct at issue in *Janus* materially differed from Lorenzo's conduct. In *Janus*, the adviser drafted false statements that an independent entity chose to disseminate in its own name, and the adviser's role in drafting the statements was unknown to the investors who received the statements. The court held that, unlike in *Janus*, the investors were aware of Lorenzo's role in the matter because he sent the emails from his account and under his name, in his capacity as director of investment banking.

Eastern District of Virginia Holds That Liability Under Section 14(a) Securities Exchange Act Requires Only Proof of Negligence, Not Fraud or Reckless Disregard

Knurr v. Orbital ATK Inc., No. 1:16-cv-1031 (E.D. Va. Sept. 26, 2017)
Click here to view the opinion.

On September 26, 2017, the U.S. District Court for the Eastern District of Virginia denied the defendants' motion to dismiss claims under Section 14(a) of the Securities Exchange Act, holding that the plaintiffs sufficiently alleged the defendants acted negligently in issuing a misleading proxy statement.

In 2015, defendant Orbital ATK, an aerospace and defense company, acquired another aerospace and defense company. Before the merger, the target entered into a multiyear contract with the U.S. Army. A year after the transaction closed, Orbital restated its financial statements to correct information concerning the target's contract with the Army and to clarify that the costs associated with the contract would exceed Orbital's revenues over the life of the contract. The plaintiffs sued, alleging the defendants violated Section 14(a) of the Securities Exchange Act and Rule 14a-9.

A central issue in dispute was the state of mind required to establish liability under Section 14(a). The defendants argued that the plaintiffs must plead and prove that the defendants acted with fraudulent intent or reckless disregard for the truth. The plaintiffs argued that they need only plead and prove the defendants acted negligently.

The court agreed with the plaintiffs. It noted that the U.S. Supreme Court and the Fourth Circuit have expressly declined to rule on the state of mind required to establish liability under Section 14(a). Looking first to the plain text of the statute, the court observed that neither Section 14(a) nor Rule 14a-9 refers to a state of mind. The court then looked to the statutory context and noted that where Congress intended to impose an intentionality requirement, it used terms like "manipulative," "deceptive," "device" or "contrivance" to describe the requisite state of mind.

The court also considered Supreme Court case law noting that terms like "device," "scheme" and "artifice" connote knowing and intentional practices. The court held that because Section 14(a) does not use such terms, the drafters of the statute must have intended the standard to be negligence. The court also remarked that a majority of the circuits to address the issue have held that Section 14(a) requires only a showing of negligence, not intentionality.

The defendants argued that even if negligence is the standard, the PSLRA requires the plaintiffs to plead facts giving rise to a "strong inference" of negligence in order to state a claim. The court declined to address the issue, concluding that even if the PSLRA applies to Section 14(a) claims, the plaintiffs' complaint alleged sufficient facts to support a strong inference that the defendants were negligent in issuing the challenged statements because the plaintiffs alleged ample facts suggesting the defendants could have discovered the massive losses associated with the contract if they had conducted proper due diligence.

Securities Fraud Pleading Standards

Ninth Circuit Reverses Dismissal of Securities Fraud Action, Holds Statements Regarding FDA Warning Letter Were Materially Misleading

In re Atossa Genetics Inc. Sec. Litig., No. 14-35933
(9th Cir. Aug. 18, 2017)
Click here to view the opinion.

The Ninth Circuit reversed in part the dismissal of a putative securities fraud class action, holding that certain statements regarding a Food and Drug Administration (FDA) warning letter and FDA clearance of a medical device were materially false or misleading.

The defendant developed and marketed products used to detect precancerous conditions. The FDA sent a warning letter to the defendant, stating that one of its devices — the MASCT system — was not being used for the purpose for which it was cleared, and that another one of its tools — the ForeCYTE Test — required independent clearance. Several months later, the FDA ordered the defendant to recall both the MASCT system and ForeCYTE Test. After the defendant disclosed the recall order to investors, its share price dropped over 46 percent.

The district court dismissed the plaintiffs' claims, concluding that all of the challenged statements were either not false or immaterial. The Ninth Circuit reversed in part.

First, the court held that the plaintiffs sufficiently pleaded that the defendant's statements describing the ForeCYTE Test as FDA-cleared were materially false. Citing an analyst report giving the defendant a "BUY" rating based in part on the defendant's "approved" products, the court concluded that the approval status of the ForeCYTE Test significantly altered the total mix of information that investors would consider.

Second, the court held that the defendant's Form 8-K filing giving notice of the FDA's warning letter was materially misleading because it reflected only a subset of the FDA's concerns and omitted the rest, leading to the reasonable inference that the FDA raised no concerns other than those disclosed.

Finally, the court held that opinion statements made by the defendant's CEO were misleading. Applying *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*, 856 F.3d 605 (9th Cir. 2017), the court concluded that the CEO omitted facts concerning his knowledge of the FDA's letter that would conflict with what a reasonable investor would take away from his challenged statement.

Central District of California Holds That Anonymous Blog Post Based on Publicly Available Information Can Be Material and Constitute a Corrective Disclosure

In re Banc of Cal. Sec. Litig., no: SACV 17-00118 AG (DFM)
(C.D. Cal. Sept. 6, 2017)
Click here to view the opinion.

Judge Andrew J. Guilford denied the defendant's motion to dismiss a putative securities fraud class action, finding that the plaintiffs sufficiently alleged that the anonymous short-seller blog post that caused the company's stock to drop 29 percent was both material and a corrective disclosure.

The plaintiffs' allegations were based largely on a blog post claiming that an individual who was convicted of securities fraud had connections to the defendant company's CEO and that the company failed to disclose those connections in certain public statements. The blogger later revealed the sources of his post — sources that were publicly available.

The court rejected the defendant's argument that the information contained within the blog post was immaterial as a matter of law because it was based on publically available sources. The court agreed with the plaintiffs' distinction "between situations where information is readily and easily available to investors, and situations where the information is only discoverable by combing through and analyzing hundreds of legal and agency documents." The court rejected the defendant's loss causation arguments on the same grounds, finding that the blog post could have revealed the truth behind the defendant's omissions, even though it was based on publicly available information. The court cited the sharp stock drop as evidence that the market had not previously known about the alleged connections between the man convicted of securities fraud and the defendant company's CEO.

Inside the Courts
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SLUSA Pre-Emption

Ninth Circuit Holds Dismissals Pursuant to SLUSA Are Jurisdictional and Therefore Must Be Without Prejudice

Hampton v. Pac. Inv. Mgmt. Co., No. 15-56841
(9th Cir. Aug. 24, 2017)
Click here to view the opinion.

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action but joined the Third Circuit in holding that dismissals pursuant to the Securities Litigation Uniform Standards Act (SLUSA) are based on lack of subject matter jurisdiction, not a decision on the merits, and therefore must be without prejudice.

The plaintiff brought claims for breach of contract and breach of fiduciary duty under Massachusetts law. The district court dismissed the claims with prejudice, holding that the claims were barred under SLUSA because SLUSA does not permit a plaintiff to file a putative class action in federal court based on state law, where the plaintiff alleges a material falsehood or omission connected to the purchase or sale of federally regulated securities.

The Ninth Circuit affirmed the district court's dismissal of the plaintiff's claims but vacated the portion of the district court's order that dismissed the claims with prejudice. Circuit courts are split on whether motions to dismiss based on SLUSA pre-emption should be brought under Federal Rule of Civil Procedure 12(b)(1), for lack of subject matter jurisdiction, or 12(b)(6), for failure to state a claim. Dismissals under Rule 12(b)(1) must be without prejudice because a court without subject matter jurisdiction cannot decide the merits of a case. Dismissals under Rule 12(b)(6), on the other hand, are judgments on the merits of a case and thus may be with prejudice.

The court held that dismissals under SLUSA are jurisdictional and that motions to dismiss based on SLUSA pre-emption must be brought under Rule 12(b)(1). While the panel acknowledged that the Ninth Circuit has previously affirmed district court decisions dismissing cases based on SLUSA pre-emption under Rule 12(b)(6), it determined that these decisions carried no precedential weight because jurisdiction in those cases was assumed by the courts and the parties.

Statute of Limitations

SDNY Dismisses Putative Class Claims Brought by Investors in a Multinational Power Management Company

In re Eaton Corp. Sec. Litig., No. 16-cv-5894 (JGK)
(S.D.N.Y. Sep. 20, 2017)
Click here to view the opinion.

Judge John G. Koeltl dismissed putative class claims against a multinational power management company and two senior executives brought under Section 20(a) and Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. In a consolidated class action complaint, the putative class plaintiffs alleged that, in a series of conference calls and meetings, SEC filings and press statements in connection with a merger, the defendants materially misled and thereby harmed investors about whether the company could spin off or divest its vehicle business, and if so, what the tax consequences would be. The plaintiffs alleged that the first of these misstatements occurred on May 21, 2012, and that the last occurred on November 13, 2013.

The plaintiffs claimed that the defendants misled investors by claiming that there was nothing in the deal from a tax perspective that would prevent the company from divesting its vehicle business. The plaintiffs claimed that the truth was revealed during a July 29, 2014, call, when the company admitted that it was not possible to do any tax-free spin-off for five years. The plaintiffs filed an initial complaint on July 22, 2016, alleging a class period from November 13, 2013 (the date of the last purportedly misleading statement), through July 29, 2014. They filed a consolidated class action complaint on January 13, 2017, alleging an expanded class period from May 21, 2012 (the date of the first purportedly misleading statement), through July 29, 2014. The plaintiffs claimed that the executives intentionally misled investors, as evidenced by the tens of millions of dollars in company stock they sold during the class period.

The defendants argued that the claims of the extended class members were time-barred by the two-year statute of limitations for securities fraud claims and that the statements were not materially misleading because the company did not spin off its vehicle business and did not intend to. Regarding the statute of limitations, the plaintiffs contended that the claims of the extended class members were not time-barred because they related back to the date of the initial filing on July 22, 2016. The court, following the "persuasive" reasoning of *Wilder v. News*

Corp., No. 11 Civ. 4947 (PGG), 2015 WL 5853763 (S.D.N.Y. Oct. 7, 2015), sided with the defendants, finding that the new class members' claims did not relate back to the filing of the original complaint because the consolidated class action complaint did not satisfy Federal Rule of Civil Procedure 15(c)(1)(C). Under that rule, an amended pleading with new parties may relate back to the original complaint if the omission of the new parties in the original complaint was a mistake about the identity of the omitted parties. The court noted that "the plaintiff does not attempt to argue that the failure to include the purported class members who purchased Eaton securities prior to November 13, 2013 ... was the result of a mistake in identity" and found the claims of the new class members were time-barred.

Similarly, regarding materiality, the court sided with the defendants, finding that their omission of the tax consequences was not materially misleading because they "were under no duty to disclose the hypothetical tax consequences of a potential spin-off" that the defendants said the company had no interest in pursuing. The court noted that the "defendants ... made clear from the day the merger was announced that there were no plans to spin off [the company's] automotive business." The court therefore concluded that "the theoretical tax consequences of a hypothetical transaction that was never planned and never occurred is not material, and the defendants were under no duty to disclose them." Finally, regarding scienter, the court found that, although the defendants sold a lot of stock during the class period, their stock transactions were consistent with those in the periods immediately before and immediately after the class period.

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