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Collateral Estoppel

D. Mass. Grants Summary Judgment in Civil Case Against Investment Adviser Who Pleaded Guilty to Similar Criminal Convictions

SEC v. Cody, No. 16-cv-12510 (D. Mass. Dec. 5, 2019)
Click here to view the opinion.

Judge F. Dennis Saylor IV granted summary judgment on claims of violations of Section 206 of the Investment Advisers Act and Section 10(b) of the Securities Exchange Act brought by the Securities and Exchange Commission against an investment adviser who was also a broker representative. The government alleged that the investment adviser hid significant account losses from clients by lying and creating false documents concerning their accounts. The government also alleged that the investment adviser failed to disclose to his clients that he had been suspended from associating with any FINRA member firm. The investment adviser was later charged in a criminal case for committing fraud under the Investment Advisers Act. The investment adviser pleaded guilty to those criminal charges, and the SEC moved for summary judgment, arguing that the investment adviser was collaterally estopped from contesting the SEC charges because he pleaded and was found guilty to similar criminal convictions.

The court determined that what the investment adviser pleaded guilty to — a willful violation of Section 206(2) — has "nearly identical" "necessary elements for civil liability under § 206(2)." The court noted that the *mens rea* requirements for criminal liability and civil liability were not the same but reasoned that "acting with scienter or a willful state of mind satisfie[d] the lesser requirement of a negligent state of mind." The court also found that the investment adviser's guilty plea "preclude[d] him from contesting the SEC's claim under § 10(b) and Rule 10b-5(c) of the Exchange Act." In addition, the undisputed evidence showed that the investment adviser bought and sold securities in the accounts of certain victims, and his "fraudulent acts were employed in connection with the purchase or sale of a security" and therefore that element was met.

D. Mass. Grants Summary Judgment Against CEO and Finds Two Companies Liable for the CEO's Conduct

SEC v. Muraca, No. 17-cv-11400 (D. Mass. Dec. 5, 2019)
Click here to view the opinion.

Judge F. Dennis Saylor IV granted summary judgment on claims of violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act brought by the Securities and Exchange Commission against a CEO and the two biotechnology companies he founded. The SEC alleged that the CEO "raised investor funds and then diverted a substantial portion for his personal use." The CEO was previously indicted for federal wire fraud and making a false statement to the FBI. The SEC moved for summary judgment, arguing issue preclusion, and one of the companies cross-moved for summary judgment, arguing that it should not be held liable for the CEO's actions.

The court granted the SEC's motion and denied the company's motion, holding that the CEO was precluded from contesting the SEC's claims against him because he had already been convicted of similar criminal claims. The court reasoned that the CEO's wire-fraud conviction "required the jury to find all of the elements that are necessary to support civil liability under § 17(a), § 10(b) and Rule 10b-5; that he made a material misrepresentation, with scienter, in connection with the purchase or sale of securities." The court noted that the "factual allegations underlying [the CEO's] criminal conviction are nearly identical to those underlying the civil allegations," and therefore found him precluded from contesting the SEC's claims. The court determined that the SEC was not judicially estopped from arguing issue preclusion concerning the CEO's criminal conviction, rejecting the company's argument that because the government (*i.e.*, the Department of Justice) in the criminal conviction portrayed the company as a victim of the CEO's crimes, the government (*i.e.*, the SEC) could not now argue the opposite. The court found that because the DOJ and the SEC are separate parties their positions were not contrary.

The court also determined that the CEO's conduct was imputable to the companies, rejecting the argument that the CEO was not acting within the scope of his employment or on behalf of the company when he diverted funds for his own use. The court

reasoned, for example, that when the CEO raised more than $1 million of investor funds (which he subsequently used for his personal benefit) he was acting on behalf of the company as he told investors their funds were for the companies.

Fiduciary Duties

Annual Meetings and Corporate Elections

Delaware Supreme Court Reverses Court of Chancery, Enforcing 'Clear and Unambiguous' Language in Advance-Notice Bylaws

BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd., No. 297, 2019 (Del. Jan. 13, 2020)
Click here to view the opinion.

The Delaware Supreme Court reversed the Court of Chancery's issuance of a mandatory injunction prohibiting two trusts from deeming a stockholder's nominations to the board ineligible because the stockholder failed to respond to the trusts' request for additional information within the five-business-day time period expressly stated in the trusts' bylaws.[1]

Saba Capital Master Fund, Ltd., a stockholder of two Black-Rock-affiliated trusts, delivered a timely "nomination notice" to each of the two trusts to nominate four individuals to their respective boards. The bylaws of each trust provided that a stockholder giving notice of a nomination "shall further update and supplement such notice, if necessary, so that: ... any subsequent information reasonably requested by the Board of Directors [of the trust] to determine that the Proposed Nominee has met the director qualifications as set out in Section 1 of Article II is provided, and such update and supplement shall be delivered to or be mailed and received by the Secretary at the principal executive offices of the Fund no later than five (5) business days after the request by the Board of Directors for subsequent information regarding director qualifications has been delivered to or mailed and received by such shareholder of record."

The trusts' counsel emailed Saba a request for additional information, attaching a questionnaire. When Saba did not respond within five business days, the trusts' counsel emailed Saba stating that the nomination notices were invalid. Saba filed suit in the Delaware Court of Chancery seeking an injunction ordering that its nominees not be precluded.

In the case below, the Court of Chancery found that the bylaw provisions were adopted on a "clear day" and were clear and unambiguous. However, the Court of Chancery found that the trusts "went too far" and breached the bylaws because the questionnaire exceeded the scope of the information that the trusts could request under the relevant provision of the bylaws. The Court of Chancery issued a mandatory injunction prohibiting the trusts from invalidating Saba's nominees.

On appeal, the Delaware Supreme Court reversed, holding that "under the clear language of the Bylaws, Saba had an obligation to respond to the request before the expiration of the [five-business-day] deadline," and there was nothing in the record to suggest that the "over-breadth" of the questionnaire precluded a timely response. The Delaware Supreme Court explained that if stockholders could simply ignore deadlines and then raise belated objections, it "would create uncertainty in the electoral setting" and "potentially frustrate the purpose of advance notice bylaws."

Books and Records

Court of Chancery Limits Production of Books and Records to 'Formal Board Materials'

Lebanon Cnty. Emps.' Ret. Fund v. AmerisourceBergen Corp., No. 2019-0527-JTL (Del. Ch. Jan. 13, 2020)
Click here to view the opinion.

Vice Chancellor J. Travis Laster ordered the production of books and records sought for the "well-established" purpose of investigating wrongdoing or mismanagement by the company's directors and officers, but limited the scope of production to "formal board materials."

The plaintiffs' books and records demand, brought pursuant to Section 220 of the Delaware General Corporation Law, followed "the flood of government investigations and lawsuits" related to the company's role in the opioid crisis. In holding that the plaintiffs had established a credible basis to support their demand, the court explained that "[o]ngoing investigations and lawsuits can provide the necessary evidentiary basis to suspect wrongdoing or mismanagement warranting further investigation." In addition, the court rejected the company's argument that the plaintiffs' purpose was confined to investigating claims "with the sole objective of bringing litigation," explaining that under Section 220, "a stockholder need not both articulate a proper purpose" and "commit in advance to the ends to which it will put the books and records."

[1] Skadden represented BlackRock Advisors LLC and two trustees in the case.

The Court of Chancery limited the scope of production pursuant to a Section 220 demand to "formal board materials" concerning, among other things, the company's opioid distribution. The court explained that "board-level documents that formally evidence the directors' deliberations" are "[t]he starting point (and often the ending point) for an adequate inspection" under Section 220, and that a plaintiff must first make a "proper showing" to access informal board materials such as "emails and other types of communication sent among the directors themselves." The court found that the stockholder-plaintiffs did not make such a showing, and therefore were not entitled to informal board materials. However, noting that the company had refused to provide information about "what types of books and records exist, how they are maintained, and who has them," the court permitted the plaintiffs to take limited discovery into how the company maintained its books and records. The Court of Chancery subsequently certified an interlocutory appeal of the court's rejection of the purpose-plus-an-end test, rejection of the actionable wrongdoing requirement and grant of leave to take discovery.

Derivative Litigation

Court of Chancery Grants Derivative Plaintiff Access to Documents Relied Upon by Special Litigation Committee

In re Oracle Corp. Derivative Litig., No. 2017-0337-SG (Del. Ch. Dec. 4, 2019)
Click here to view the opinion.

Vice Chancellor Sam Glasscock III held that a derivative plaintiff could access documents a special litigation committee reviewed and relied upon when determining that the derivative action should be pursued by the lead plaintiff.

The lead plaintiff brought derivative litigation challenging the acquisition of NetSuite Inc. by Oracle Corporation.[2] After the case withstood a motion to dismiss, Oracle formed a special litigation committee (SLC) to evaluate the derivative claims. The SLC conducted an investigation and determined that it was in the corporate interest for the litigation to be prosecuted by the lead plaintiff.

The Court of Chancery held that the SLC's evaluation and investigation of the derivative claims enhanced the litigation asset and that documents relied on by the SLC pertained to the asset and must be available to the lead plaintiff, "subject to the privileges and immunities that may be raised by the individual Defendants and the special litigation committee in its business judgement." Specifically, the Court of Chancery held that the lead plaintiff was "presumptively entitled to the production of all documents and communications actually reviewed and relied upon by the SLC or its counsel in forming its conclusions that (i) it would not be in Oracle's best interests to seek to dismiss the derivative claims and (ii) it was in Oracle's best interests to allow the Lead Plaintiff (rather than the SLC) to proceed with the litigation on behalf of Oracle."

The Court of Chancery noted that "disclosure of even a part of the contents of a privileged communication surrenders" any claim to attorney-client privilege for that communication. As a result, the lead plaintiff could obtain access to Oracle's privileged communications that were reviewed and relied upon by the SLC to the extent that those communications were not redacted for attorney-client privilege when produced to the SLC.

Court of Chancery Dismisses Derivative Claims for Failure To Plead Demand Futility

In re LendingClub Corp. Derivative Litig., Consol. C.A. No. 12984-VCM (Del. Ch. Oct. 31, 2019)
Click here to view the opinion.

Vice Chancellor Kathaleen St. J. McCormick granted a motion to dismiss breach of fiduciary duty claims against directors arising out of alleged oversight failures.

The plaintiffs, stockholders of LendingClub Corp., alleged that, following whistleblower allegations and an internal investigation, LendingClub self-reported issues relating to the sale of nonconforming loans, related party transactions and accounting practices to the SEC, which led to an SEC investigation. After corrective disclosures were issued, stockholders brought federal securities claims in the Northern District of California and derivative breach of fiduciary duty claims in the Delaware Court of Chancery.

The plaintiffs in the Delaware action alleged that demand was futile because a majority of the board faced a substantial likelihood of liability by failing to implement and monitor internal controls. Among other arguments, the court rejected the plaintiffs' theory that the board "utterly fail[ed]" to implement a reasonable compliance system, noting that "[t]he factual allegations in the Complaint indicate that LendingClub's Audit Committee both (1) existed, and (2) met monthly." The court also held that the plaintiffs failed to plead sufficient facts showing that the board ignored red flags with respect to the related party transactions, sale of nonconforming loans and accounting issues. In doing so, the court noted that the board took "remedial

[2] Skadden represented the special committee of the board of directors of Oracle Corporation in its acquisition of NetSuite Inc.

action immediately" after learning about these problems, and that although "actions taken after the fact do not absolve past transgressions," the pleaded facts demonstrated that "the Board implemented an oversight system and, when the Board first learned that it was not working, created a new one."

The Court of Chancery also addressed the plaintiffs' allegations that the board lacked independence from one of the directors who benefited from the related party transactions. The plaintiffs argued that one of the directors lacked independence because he "shared a 'thirteen-year working relationship'" with the alleged wrongdoer while they both worked for an investment bank. The court held that this argument failed to show a lack of independence because the plaintiffs failed to plead that the two individuals "worked in the same office, held positions that required them to work together, or otherwise knew each other while working" for their former employer. The court rejected another argument that two directors could not be "considered independent because they served on the same board." Finally, the court rejected the argument that "the *entire* Demand Board somehow lacked independence" from the alleged wrongdoer because the other directors did not exclude him from deliberations, terminate him or require him to divest his interests in a company benefited from the related party transactions.

Court of Chancery Finds That Presuit Communication Is Rule 23.1 Demand

Solak v. Welch, No. 2018-0810-KSJM (Del. Ch. Oct. 30, 2019);
Dahle v. Pope, No. 2019-0136-SG (Del. Ch. Jan. 31, 2020)
Click here to view the *Solak* opinion.
Click here to view the *Dahle* opinion.

Vice Chancellor Kathaleen St. J. McCormick of the Delaware Court of Chancery dismissed derivative claims challenging a company's nonemployee director compensation, holding that a presuit letter was a "demand" for purposes of Court of Chancery Rule 23.1.

In *Solak v. Welch*, the plaintiff sent a presuit letter requesting that the company's board of directors take remedial action to address allegedly excessive nonemployee director compensation (the "Demand").[3] The Demand contained a footnote stating, "[N]othing contained herein shall be construed as a pre-suit litigation demand under Delaware Chancery Rule 23.1." In discussing the letter, the Court of Chancery called the plaintiff's approach the "Magritte defense," referencing a painting depicting a pipe, but stating, "This is not a pipe." In response to the Demand, the board conducted an investigation and resolved to reject the Demand.

The court held that the Demand satisfied the definition of a "demand" under Delaware law because "although the Letter avoid[ed] expressly demanding that the Board commence litigation, the Letter clearly articulate[d] the need for 'immediate remedial measures,' propose[d] remedial action, and request[ed] that the Board take such action." In addition, the court observed that the complaint was "nearly a carbon copy" of the Demand and that the Demand requested remedial measures benefiting the company as a whole and "resemble[d] therapeutic benefits commonly achieved in derivative lawsuits challenging nonemployee director compensation."

In rejecting the plaintiff's "Magritte defense," the Court of Chancery explained that Delaware law's prohibition on a stockholder both making a demand and pleading demand futility "would become a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating 'this is not a demand' in his pre-suit communication."

After finding that the plaintiff had made a demand, the Court of Chancery held that the plaintiff failed to allege any facts supporting an inference that the board wrongfully rejected the Demand, warranting dismissal of the action.

In *Dahle v. Pope*, the same plaintiffs' counsel sent a "near identical" demand letter to another corporate board and raised an "identical defense" to dismissal.[4] Vice Chancellor Sam Glasscock III adopted the "well-reasoned analysis" of *Solak v. Welch* and granted the defendants' motion to dismiss because the plaintiffs made a demand and failed to allege wrongful refusal of that demand.

Middle District of Tennessee Dismisses Derivative Litigation for Failure To Make a Demand

In re Tivity Health, Inc., No. 3:18-CV-00087
(M.D. Tenn. Oct. 21, 2019)
Click here to view the opinion.

Judge Waverly D. Crenshaw Jr. granted a motion to dismiss a derivative action brought by two shareholders of a health services company. The company, Tivity Health, operates as a fitness program broker. Tivity enters into contracts with fitness centers, offering access to members of select health insurance plans. Insurers pay Tivity a fee for this service. One of Tivity's largest customers was UHC, contributing $94.6 million in revenue to Tivity in 2017. On November 6, 2017, UHC announced that it would offer its own fitness benefit program, becoming Tivity's competitor. That same day, Tivity's stock dropped by 34%.

[3] Skadden represented the defendants in the case.

[4] Skadden represented the defendants in the case.

The plaintiffs sued the company, as well as its directors, bringing claims of securities fraud and breach of fiduciary duty. The plaintiffs alleged that the defendants approved and permitted disclosures that misrepresented the sustainability of Tivity's revenue stream. In response, the defendants filed a motion to dismiss, alleging that the plaintiffs lacked standing and did not meet the demand requirement for a derivative suit.

The defendants claimed that the plaintiffs lacked standing because they did not own Tivity stock at the time of the alleged misrepresentations. Federal Rule of Civil Procedure 23.1 requires that plaintiffs have ownership interest in the company at the time of the conduct at issue. The plaintiffs became Tivity shareholders in June 2017, but their complaint alleged that misrepresentations started in February 2017, and continued until October 2017. The plaintiffs argued that the defendants engaged in "continued wrongdoing," giving the plaintiffs standing to challenge statements made even before June 2017. Specifically, the plaintiffs alleged that Tivity began to flaunt its close relationship with UHC and never let on that UHC was becoming a direct competitor. The first time Tivity admitted it was misrepresenting its relationship with UHC was, the plaintiffs alleged, when UHC announced its own plan, five months after the plaintiffs became Tivity shareholders. The court agreed, holding that the plaintiffs sufficiently alleged that the conduct was so intertwined such that there was only one continuing wrong.

The defendants next argued that the plaintiffs' claim should be dismissed because the plaintiffs did not present a demand to Tivity's board of directors, nor did they meet the requirements for demand futility. To establish demand futility, the plaintiffs must allege facts establishing that the directors could not have viewed a demand in a disinterested manner. Delaware law provides that the interestedness of a board is a fact-based analysis specific to each director of the board. Here, the plaintiffs alleged facts sufficient to prove the interestedness of two of Tivity's directors, but not for the other seven. Instead, the plaintiffs alleged that the directors would have collectively been interested because they knew, but failed to disclose, that revenues would plummet when they lost their contract with UHC. The court disagreed, citing evidence from June and October 2017 board meetings projecting both membership and revenue growth. The court held that the plaintiffs could not allege the interestedness of the board at large, as the directors had reason to believe that revenue would continue to grow. Accordingly, the plaintiffs' derivative suit was dismissed for failure to make a demand.

Merger Litigation

Court of Chancery Dismisses Breach of Fiduciary Duty and Aiding-and-Abetting Claims

In re Essendant, Inc. Stockholder Litig., Consol. C.A. No. 2018-0789-JRS (Del. Ch. Dec. 30, 2019)
Click here to view the opinion.

Vice Chancellor Joseph R. Slights III dismissed breach of fiduciary duty and aiding-and-abetting claims arising from Essendant Inc.'s merger with Staples, Inc.[5]

Prior to the merger with Staples, Essendant and Genuine Parts Company had entered into a stock-for-stock merger agreement. Shortly after the announcement of the Genuine Parts merger, Sycamore Partners, Staples' parent company, delivered an all-cash offer of $11.50 per share to acquire Essendant. The Essendant board rejected this offer. Sycamore ultimately increased its offer to $12.80 per share. Essendant then terminated the Genuine Parts transaction and agreed to a transaction with Sycamore.

Certain Essendant stockholders filed suit alleging, among other things, that (i) the Essendant board breached its fiduciary duties when agreeing to the Sycamore all-cash offer, (ii) Sycamore breached its fiduciary duties as a controller of Essendant, (iii) the Essendant board aided and abetted Sycamore's breaches of fiduciary duty, (iv) Sycamore and Staples aided and abetted the Essendant board's breaches of fiduciary duties, (v) the Essendant board committed waste in agreeing to a $12 million termination fee in the Genuine Parts merger agreement, and (vi) Essendant's CEO breached his fiduciary duties as an officer of Essendant.

In holding that the plaintiffs failed to plead that Sycamore was Essendant's controlling stockholder, the court observed that "Sycamore did not (i) nominate any members of the Essendant Board, (ii) wield coercive contractual rights, (iii) maintain personal relationships with any of the Essendant Board members, (iv) maintain any commercial relationships with Essendant that would afford leverage in its negotiations, (v) threaten removal, challenge or retaliate against any of the Essendant Board members or (vi) otherwise exercise 'outsized influence' in Essendant's Board room."

[5] Skadden represented the individual defendants in the case.

The Court of Chancery rejected the plaintiffs' argument that the Essendant board engaged in bad faith, finding that merely alleging that the Essendant board took a lower all-cash offer was not enough to state a claim. The court stated that the decision to choose "a cash transaction with Sycamore rather than a stock deal with [Genuine Parts]" was "a judgment call well within a board's prerogative when pursuing the 'highest value reasonably available to the [Essendant] shareholders.'"

The court also rejected the plaintiffs' disclosure claims, holding that the plaintiffs failed to plead sufficient facts to "allow any inferential explanation of why these fiduciaries would so abandon their duties as to engage in bad faith" in connection with the disclosures.

In addition, in addressing the plaintiffs' claim against Essendant's CEO, the court found that the only officer-specific action involving the CEO was a phone call with a representative from Sycamore. The court stated that this allegation, "without more, can[not] support a reasonably conceivable inference of a breach of the duty of care or loyalty."

The court also dismissed the plaintiffs' claim that the Essendant board committed waste, stating that "[i]t is not waste for a board to sign a merger agreement with one party after another party makes an overture of hypothetical interest."

Lastly, the court dismissed the aiding-and-abetting claim against Sycamore and Staples, holding that the plaintiffs failed to plead that Sycamore "knowingly participated" in any breach of fiduciary duty.

Registration Statement Liability

Northern District of California Grants in Part Motion To Dismiss Section 11 Claim, Dismisses Section 303 Claim

In re Restoration Robotics, Inc. Sec. Litig., No. 5:18-cv-03712-EJD (N.D. Cal. Oct. 18, 2019)
Click here to view the opinion.

Judge Edward J. Davila dismissed in part a claim brought under Section 11 of the Securities Act, holding that most of the statements alleged to be misleading in Restoration Robotics' offering materials were not actionable. The court also dismissed in its entirety the plaintiff's claim that Restoration Robotics violated Item 303 of SEC Regulation S-K.

Restoration Robotics is a medical technology company that develops and commercializes a mechanical system that assists physicians in hair restoration procedures. The company held an initial public offering in late 2017. The plaintiff claimed that the offering materials the company filed with the SEC in connection with the IPO contained various false or misleading statements, in violation of Section 11, and failed to disclose certain known trends, in violation of Item 303.

With respect to the Section 11 claim, the court held that three of the alleged misstatements were inactionable puffery. The court reasoned that statements about a company's "belief," "goals" or "intentions" are not actionable under the securities laws when they are accompanied by meaningful cautionary language. Next, the court dismissed the Section 11 claim to the extent it was based on statements in the offering materials that Restoration Robotics formed "strong relationships" with customers, provided "extensive training and coaching" to physicians, and provided "easily implemented marketing tools" to doctors. In dismissing these statements, the court explained that the plaintiff was not alleging that the company did not attempt to do these things, but rather that the company failed to do these things effectively. Thus, the "Plaintiff's argument essentially crumbles into an efficacy, but not a falsity, argument." That is not sufficient to state a claim because "it is Plaintiff's burden to show falsity, not inadequacy." After dismissing the Section 11 claim on those two bases, the court sustained the complaint as to two additional alleged misstatements. First, the court held that the plaintiff adequately pleaded falsity as to the statement that Restoration Robotics' system "provides targeted precision and a cleanly scored incision" because "there are adequate facts from which this Court can infer the needle did not provide targeted precision or a cleanly scored incision." Second, the court held that the plaintiff adequately pleaded falsity with respect to the company's statements about its "installed base growth" because a significant portion of the systems sold had not yet been installed.

With respect to the Item 303 claim, the court stated that, in the Ninth Circuit, an Item 303 violation is actionable under Section 11. However, the plaintiff here failed to state a claim for such liability. First, the plaintiff claimed that Restoration Robotics failed to disclose the trend that overseas distributors were bulk purchasing the Restoration Robotics system and then "warehousing" them. But the complaint alleged only one instance of such warehousing. Therefore, the complaint did not create "a plausible inference that this was a trend rather than an isolated event." Second, the plaintiff claimed that Restoration Robotics failed to disclose physicians' widespread discontent with the system due to lack of patient leads, effective marketing support and needle defects. But the complaint did not allege, or even allow the court to infer, that the defendants knew of any of those problems, and such knowledge is a required element of an Item 303 claim. Third, the plaintiff alleged that Restoration Robotics failed to

disclose the known trend of physicians stalling purchases of the system. However, the complaint did not plead that this trend was occurring at the time of the IPO, much less that the defendants knew of the trend at the time of the IPO. Because fraud by hindsight is not actionable, the defendants could not be liable for failing to disclose that trend.

Scienter

SDNY Holds That a Cosmetics Company Misled Shareholders Concerning Its Operations in Brazil

In re Avon Sec. Litig., No. 19 Civ. 01420 (CM) (S.D.N.Y. Nov. 18, 2019)
Click here to view the opinion.

Judge Colleen McMahon denied the dismissal of claims brought by a class of shareholders against a cosmetics company and certain of its officers alleging that they violated Sections 10(b) of the Securities Exchange Act by allegedly making false and misleading statements concerning the company's operations in Brazil and its purported concealment of the company's risk of bad debt.

The plaintiffs alleged that the company failed to disclose its relaxed credit policies for new sales representatives in Brazil, which exposed the company to a greater risk of bad debt. The court held that because the company "promoted recent success" in recruiting efforts, it triggered a duty to disclose the cause of that trend: the company's decision to adjust credit terms in Brazil to hire less creditworthy sales representatives. The court also reasoned that, even though the Brazilian economy was struggling at the time the statements were made, the company's "truth on the market" argument was weak because such an argument requires a fact inquiry into whether the macroeconomic conditions in Brazil and its effect on the company's debt load was conveyed to the market. The court also held that the company's statements were not protected forward-looking statements under the Private Securities Litigation Reform Act (PSLRA) because the company had no basis to tell shareholders in May 2017 that the company did not expect a level of debt to materially impact their revenue when at the time the company had thousands of delinquent accounts on its books. The court further held that the company's statements regarding its recruiting strategies were not inactionable puffery, noting that the Second Circuit does not recognize "repeated representations on the same topic, even where those representation[s] would otherwise be puffery" because the repetition itself communicates to investors what may be important and those statements may be material to investors.

The plaintiffs also alleged that the company violated generally accepted accounting principles (GAAP) by recognizing revenue prematurely at the time of shipment to sales representatives instead of when the products were sold. The court agreed, relying on Second Circuit precedent that found allegations of accounting practices that recognized revenue "from the sale of undelivered equipment" to customers who were not creditworthy sufficient to survive a motion to dismiss. The plaintiffs also alleged that the company failed to disclose that it stopped training its sales representatives, which exposed it to a greater risk of its sales representatives' inefficiency. The court held that those statements were adequately alleged to be misleading because the company repeatedly referred to its training programs in public statements, thus requiring those disclosures to be complete and accurate. The court further noted that even though the company argued that the company's executives had no knowledge that sales representatives were not being trained at the time the statements were made, that does not "negate the inference that their statements were false when made."

Finally, the court held that the plaintiffs adequately alleged that the defendants acted with scienter. The plaintiffs alleged that the company's officers knew facts or had access to information suggesting that their public statements were not accurate. The plaintiffs alleged that the company's officers were "in charge" of the decision to lower credit standards to hire new representatives in Brazil. The court noted that because the company's officers received information about the true cause of the company's debt load, they had a duty to update their public disclosures "so as to not render their earlier representations misleading."

SEC Enforcement Actions

Fifth Circuit Holds That Supreme Court's Decision in *Kokesh v. SEC* Did Not Overrule Precedent Allowing District Courts To Order Disgorgement in SEC Enforcement Proceedings

SEC v. Team Res. Inc., No. 18-10931 (5th Cir. Dec. 30, 2019)
Click here to view the opinion.

On November 5, 2019, the Fifth Circuit held that the Supreme Court's decision in *Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017), which held that disgorgement in SEC proceedings is a "penalty" under 28 U.S.C. § 2462, did not overrule precedent recognizing district courts' authority to order disgorgement in such proceedings.

The SEC filed an enforcement action against Kevin Boyles and two companies he created (Appellants), alleging that Mr. Boyles was scamming investors. While the case was pending, the Supreme Court decided *Kokesh v. S.E.C.*, holding that disgorgement in SEC enforcement proceedings is a "penalty" under 28 U.S.C. § 2462 and therefore is subject to a five-year statute of limitations.

The matter involving Mr. Boyles settled, and the SEC moved for remedies and final judgment, seeking disgorgement. Appellants responded that the disgorgement amount requested was barred by the five-year statute of limitations under 28 U.S.C. § 2462, and that after *Kokesh*, district courts no longer have authority to order disgorgement in SEC proceedings. After the SEC amended the requested amount to seek only that within the five-year statute of limitations, the district court ordered disgorgement, noting that the *Kokesh* opinion itself stated that "[n]othing in [its] opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings." An appeal to the Fifth Circuit followed.

The Fifth Circuit rejected Appellants' argument that, because disgorgement is a "penalty" under 28 U.S.C. § 2462, it is not an equitable remedy that courts may impose in SEC enforcement proceedings. The Fifth Circuit reasoned that *Kokesh* made clear that the sole issue in the case was whether disgorgement is subject to the five-year statute of limitations; the Supreme Court did not purport to decide that disgorgement could never be classified as equitable. "We are thus not convinced that *Kokesh* quietly revolutionized SEC enforcement proceedings while at the same time explicitly stating it was not doing so." The Fifth Circuit held that, because *Kokesh* did not unequivocally overrule precedent that district courts have the authority to order disgorgement in SEC enforcement proceedings, the Fifth Circuit would not do so.

Appellants also argued that, even if the district court had the authority to order disgorgement, it erred by failing to give Appellants discovery or hold an evidentiary hearing. The Fifth Circuit held that the district court had, in fact, authorized discovery, but Appellants failed to seek any. It also held that the settlement agreement did not create the right to an evidentiary hearing, and Appellants never moved for one, so no rights had been violated by not holding one.

Securities Exchange Act

Second Circuit Upholds Dismissal of Securities Fraud Claim for Failure To Plead Underlying Criminal Conspiracy With Particularity

Gamm v. Sanderson Farms, Inc., No. 18-0284-cv
(2d Cir. Dec. 10, 2019)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims brought by a putative class of shareholders under Section 10(b) of the Securities Exchange Act against a poultry processing company, alleging that the company's statements that they competed with other companies was false because they allegedly colluded with other poultry companies in an anti-competitive conspiracy to affect the price of chicken.

The district court had previously found that the plaintiffs had failed "to support their allegation of a chicken supply reduction conspiracy with particularized facts." In upholding the lower court's ruling, the Second Circuit reasoned that the plaintiffs' securities fraud claims were subject to a heightened standard under the PSLRA, and required facts to be pleaded with particularity. The Second Circuit rejected the plaintiffs' argument they were only required to plead the underlying antitrust conspiracy with plausibility standard because the Section 10(b) claim was "entirely dependent upon the predicate allegation" of the company's participation in the price-fixing scheme. The Second Circuit thus determined that without pleading the underlying assertion with particularity, the plaintiffs "had not met the burden of explaining what rendered the statements materially false or misleading."

SDNY Dismisses Complaint Against Inverse Exchange-Traded Fund Company

In re ProShares Trust II Sec. Litig., No. 19cv0886 (DLC)
(S.D.N.Y. Jan. 3, 2020)
Click here to view the opinion.

Judge Denise Cote granted a motion to dismiss a putative class action asserting claims under Section 10(b) of the Securities Exchange Act against a short-term futures exchange-traded fund (ETF) company for allegedly misleading investors about the risks of potential losses in investing in the ETF. The plaintiffs

alleged that the registration for the ETF (which was designed to measure and compensate for the expected volatility of the S&P 500) omitted that the fund's own daily rebalancing through the purchase and sale of certain futures contracts could itself drive up the price of those futures contracts and the level of market volatility and thus drive down the value of the ETF shares.

The court concluded that the plaintiffs failed to adequately allege a material misstatement or omission. The court reasoned that "[r]eading the Registration Statement 'cover-to-cover,' the disclosures and representations 'taken together and in context' could not have misled a reasonable investor about the nature of the [ETF] and the risks associated with this complex financial product." The registration statement adequately disclosed that "substantially all" of the ETF's assets were invested in futures contracts, which can be "highly volatile," and that the large positions in these contracts that the fund could acquire increases the risk of illiquidity and the risk of "large losses when buying, selling, or holding such instruments." The court thus determined that the disclosures would have put a reasonable investor on notice that "the Fund's own conduct in purchasing and selling [] futures contracts could affect market liquidity and drive down the value of [ETF] shares."

Utah District Court Denies Motion To Dismiss Allegations That Company Operated an Illegal Pyramid Scheme

Smith v. LifeVantage Corp., No. 2:18-cv-00621 (DN) (PMW) (D. Utah Dec. 5, 2019)
Click here to view the opinion.

Judge David Nuffer granted in part and denied in part a motion to dismiss claims brought by distributors against a distribution company alleging that it violated Section 10(b) and Section 12(a) of the Securities Exchange Act by operating an illegal pyramid scheme and selling fraudulent unregistered securities.

The plaintiffs alleged that the combination of a compensation plan, policies and procedures, and a distributor enrollment form was "an offering for investment and a security under federal securities laws." The court held that the plaintiffs' distributorship in the company was a security. The court reasoned that investment into the compensation plan where profits predominantly originated from '"the efforts of others, namely of the downline members,' falls under the definition of an investment contract governed by securities laws." The court also held that the plaintiffs alleged enough plausible facts to state a claim under Section 10(b) via a scheme liability theory. The court reasoned that the plaintiffs had adequately alleged that the company participated in an "illegitimate, sham or inherently deceptive transaction where [their] conduct or role ha[d] the purpose and effect of creating a false appearance." The court pointed to the plaintiffs' allegations that the company hired professional marketers to pose as "success stories" to convince potential recruits that they can receive, though unlikely, great financial rewards.

The court also found that the plaintiffs had adequately alleged scienter. The plaintiffs alleged that seven out of the eight ways that distributors earned money were based on recruiting, and that method was designed by the company. The court determined that the plaintiffs had adequately alleged that the inherently deceptive act of presenting a pyramid scheme "as a legitimate business opportunity" supported the inference that the company knew it was engaged in a scheme.

Securities Fraud Pleading Standards

Seventh Circuit Holds RICO Bar for Actionable Securities Fraud Inapplicable to Tax Shelter

Menzies v. Seyfarth Shaw LLP, No. 18-3232 (7th Cir. Nov. 12, 2019)
Click here to view the opinion.

The Seventh Circuit affirmed, in relevant part, the district court's ruling that the Private Securities Litigation Reform Act's amendment to the Racketeer Influenced and Corrupt Organizations Act (RICO) barring a cause of action for conduct that would have been "actionable as fraud in the purchase or sale of securities" did not bar the plaintiff's RICO claim.

In 2002, an insurance executive's financial advisors pitched him a strategy to avoid tax liability on capital gains from major stock sales. The IRS would later deem this strategy an abusive tax shelter. In 2006, the insurance executive sold over $64 million worth of stock in his company. He did not report the stock sale or any capital gains related to the sale on his 2006 tax return. Following a three-year audit and facing potential legal action and fines, the insurance executive entered a settlement with the IRS, under which he paid over $10 million in back taxes, penalties and interest. Alleging that his tax underpayment was the result of a fraudulent tax shelter, he later brought claims against his former tax lawyer, law firm and two financial services firms under RICO and Illinois law. The district court granted the defendants' motion to dismiss for failure to state a claim.

On appeal, the defendants argued that the RICO bar applies because the point of the tax shelter was for the insurance executive to avoid taxable gains on the stock sale, making the alleged fraud "in connection with" the sale of a security. The Seventh

Circuit rejected this argument because the complaint focused not on the stock sale, but on its tax consequences. The insurance executive's RICO claim was based on allegations related to the defendants selling him an allegedly fraudulent tax shelter. To bring a securities fraud claim, the insurance executive would have been required to plead alleged losses as a direct consequence of the defendants' misrepresentations related to the stock sale. Further the complaint did not challenge any aspect of the stock sale and represented that it was entirely lawful. Accordingly, the insurance executive's allegations did not amount to actionable securities fraud and the RICO bar does not apply.

Despite the RICO bar not applying to the plaintiff's claims, the court affirmed the dismissal of the RICO claim because he failed to plead a pattern of racketeering.

EDNY Dismisses Claims Against Tax Preparation Services Company for Failure To Meet Securities Fraud Pleading Standards

In re Liberty Tax, Inc. Sec. Litig., No. 2:17-CV-07327 (NGG) (RML) (E.D.N.Y. Jan. 16, 2020)
Click here to view the opinion.

Judge Nicholas G. Garaufis dismissed claims brought by a putative class of investors against a tax preparation services company and certain of its officers, alleging that the defendants violated Section 10(b) and Section 14(a) of the Securities Exchange Act by making false and misleading statements about the company's risk factors, internal controls, compliance efforts and executive compensation.[6] The plaintiffs alleged that the former CEO, who was also the controlling shareholder of the company, used his position to inappropriately advance his personal interests. The plaintiffs alleged that the company omitted information about the CEO's misconduct from its risk factors disclosures, and also failed to disclose other information about the CEO's other income.

The court dismissed the plaintiffs' claims, finding that they failed to adequately plead a material misrepresentation or omission, and loss causation. The court found that the defendants did not misrepresent the risks associated with the CEO's control of the board of directors because the CEO's alleged misconduct was entirely unrelated to his control of the board and the risk disclosures were too general for an investor to reasonably rely on. The court further found that the defendants' statements discussing their internal controls and commitment to ethics were inactionable "puffery." The court rejected the argument that the omissions met the standard for materiality under either Item 303 or Item 402 of SEC Regulation S-K. Lastly, the court held that, while the plaintiffs had alleged a causal connection between the CEO's misconduct and the diminished productivity of the company, they could not rely on allegations that the CEO set a "damaging Tone at the Top ... to explain with particularity how the concealment of [the CEO's] ethical lapses in Virginia caused independently run franchises across North America to process fewer tax returns." The court thus found subsequent disclosures about diminished productivity and increased losses did not "amount to corrective disclosures that revealed the truth about the company's underlying condition," and did not establish loss causation.

[6] Skadden represented a former officer of Liberty Tax, Inc. in the case.

SDNY Finds Statement Concerning Sexual Misconduct Materially Misleading

Constr. Laborers Pension Trust for S. Cal. v. CBS Corp., No. 18-7796 (S.D.N.Y. Jan. 15, 2020)
Click here to view the opinion.

Judge Valerie Caproni denied in part and granted in part motions to dismiss claims brought by a putative class of investors under Section 10(b) of the Securities Exchange Act alleging that a mass media company and several of its officers made materially misleading statements by failing "to disclose the risk that journalists would uncover and expose [the former CEO's] misconduct and force [the former CEO] out" during the #MeToo movement.

The court found that one of the alleged statements was materially misleading. The plaintiffs had alleged that the former CEO's statement that the company was still learning about the alleged sexual misconduct occurring at the company was misleading because at the time the statement was made the former CEO was "actively seeking to conceal his own past sexual misconduct" from the company and the public. The court found that it was "barely plausible that a reasonable investor would construe [the former CEO's] statement as implicitly representing that he was just learning of problems with workplace sexual harassment at CBS." The court found the misstatement to be adequately alleged to be material because the statement "could be construed as a representation that [the former CEO] had personally engaged in no sexual misconduct that could be a liability 'during a time of concern' when media executives were being scrutinized." The court also reasoned that a reasonable investor could have relied upon the statement as a representation of the former CEO's and the company's "lack of high-level exposure to the #MeToo movement."

The court found the remaining statements to be inactionable. Statements about the company's business conduct and ethics code were "inactionable puffery" because they stated the company's beliefs and were not facts. The court rejected the plaintiffs' argument that the company's risk disclosures were misleading because they did not allege that the company was aware of the risk of the former CEO's termination for sexual misconduct at the time it made the disclosures. Finally, the court determined that Item 303 did not create a duty to disclose the former CEO's alleged misconduct because "the chain of causation between the alleged [misconduct] and [the company's] future financial performance is far too tenuous."

D. Mass Dismisses Claims Against Biopharmaceutical Company for Failure To Adequately Plead Falsity and Scienter

LSI Design & Integration Corp. v. Tesaro Inc., No. 18-cv-12352-LTS (D. Mass. Nov. 13, 2019)
Click here to view the opinion.

Judge Leo T. Sorokin dismissed claims brought by a putative class of investors against a biopharmaceutical company, alleging that the company violated Section 10(b) the Securities Exchange Act by purportedly misleading investors about the company's cash flow and ability to fund its operations in 2017 in SEC filings and statements made at a health care conference.

The court found that none of the alleged misstatements were false or misleading. The plaintiffs failed to adequately allege that the company's existing cash and cash equivalents would be insufficient to fund the company's operations in 2017, and that the plaintiffs admitted that the company's ending cash position in 2016 was stable and sufficient. The court also found that the statements made at a health care conference were "immaterial as a matter of law" because they fell squarely within the PSLRA's "statutory safe harbor for certain forward-looking statements," including "statement[s] of future economic performance."

The court also determined that the complaint failed to adequately allege a strong inference of scienter. The court determined that the complaint offered no facts showing that the company intended to defraud investors. While the company likely had actual knowledge about the company's financials, this knowledge was not indicative of an intent to deceive investors and did not demonstrate a high degree of recklessness.

Northern District of California Allows Claims To Proceed in Case Arising Out of Alleged Price-Fixing in Generic Drug Industry

Evanston Police Pension Fund v. McKesson Corp., No. 18-cv-06525-CRB (N.D. Cal. Oct. 30, 2019) (order clarifying decision Dec. 19, 2019)
Click here to view the October 30, 2019, opinion.
Click here to view the December 19, 2019, opinion.

Judge Charles R. Breyer denied in part a motion to dismiss filed by McKesson Corporation, finding the plaintiffs adequately alleged that McKesson was aware of, or was reckless in not knowing about, purported price-fixing agreements in the generic drug industry, and that such awareness rendered McKesson's statements about its business and the industry in which it operates false or misleading.

The case arose out of government investigations into purported anti-competitive agreements in the generic pharmaceutical industry, which led the attorneys general from 49 states to file a complaint alleging that the generic drug industry is rife with price-fixing and market-allocation agreements. McKesson, for the most part, is a generic drug wholesaler, not a generic drug manufacturer. Nevertheless, the plaintiffs asserted that McKesson either participated in the alleged anti-competitive conduct or, at a minimum, was aware of and profited from the illegal agreements. They further claimed that McKesson's knowledge of the price-fixing arrangements rendered certain of its public statements false or misleading.

The court dismissed the plaintiffs' claims to the extent premised on McKesson's actual involvement in the price-fixing conspiracy, holding the complaint failed to adequately plead McKesson's participation. The court reasoned that even if the complaint alleged the type of "parallel conduct" that can be indicative of price-fixing, it failed to sufficiently allege the additional circumstantial conduct, or "plus factors," that the Ninth Circuit requires in order to create a plausible inference of McKesson's participation in the unlawful agreement.

With respect to McKesson's awareness of the agreement, however, the court found that the plaintiffs adequately pleaded their claim. Citing alleged statements by McKesson executives touting their knowledge of the generics market, as well as the magnitude of the price-fixing conspiracy and the importance of generics pricing to McKesson's revenues, the court concluded

that the company's executives knew or were reckless in not knowing about the price-fixing conspiracy. Given that knowledge, the plaintiffs sufficiently alleged that three categories of statements by McKesson were false or misleading.

First, McKesson executives repeatedly attributed the company's increased profitability to generic drug price increases driven by "supply disruptions." McKesson identified the reasons for such disruptions, but did not disclose the alleged price-fixing conspiracy. The court held that, because McKesson undertook to explain *why* generic drug prices had increased, it was obligated to disclose the true reasons, including that at least some portion of the price increase was due to the price-fixing conspiracy. McKesson's failure to do so rendered its statements misleading.

Second, McKesson executives described the generic drug market as competitive, which was false in light of their awareness that the market was tainted by extensive anti-competitive price-fixing.

Third, the plaintiffs claimed that McKesson's financial results were misleading because McKesson failed to disclose that its results were in part based on the industrywide price-fixing. The court rejected the plaintiffs' broad theory that all financial statements are rendered false any time a defendant fails to disclose alleged company fraud. However, where a company explains the *source* of its revenue and the *reasons* for its performance, it is bound to do so in a way that is not misleading. Here, the court held that McKesson's statements that its financial performance was due to "legitimate market forces" was misleading because, by affirmatively attributing its performance to certain factors, it was required to also attribute its performance to the alleged price-fixing conspiracy.

Inside the Courts
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