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Inside the Courts
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Derivative Litigation

Fourth Circuit Holds That Settlements in the Best Interests of a Corporation Can Moot Similar Derivative Lawsuits

Star v. TI Oldfield Dev., LLC, Nos. 18-2202, 18-2205 (4th Cir. June 10, 2020)
Click here to view the opinion.

On June 10, 2020, the Fourth Circuit held, as a matter of first impression in that circuit, that a settlement that is in the best interests of a corporation, entered into by a disinterested board, can moot a derivative suit asserting identical or similar claims arising out of the same underlying facts.

The board of directors of Oldfield, a residential community in South Carolina, filed lawsuits related to Oldfield's development. Thereafter, Rob Star, an Oldfield resident, filed a derivative action, purportedly on Oldfield's behalf, alleging similar claims against the same defendants. The district court dismissed the suit filed by Star, and the Oldfield board settled the lawsuits it had brought. Star appealed the dismissal of the derivative case, and the Oldfield board and defendants moved to dismiss the appeal, contending that the settlement agreements in the lawsuits brought by the board rendered Star's similar action moot.

Star argued that his claims were not moot because the settlement agreements were invalid; according to Star, the board had a conflict of interest. The court acknowledged case law holding that corporations own claims arising out of an injury to the corporation and thus have the absolute right to resolve such claims short of the board having a conflict of interest. The court noted that it had not "specifically considered whether a company's settlement of a similar action renders a derivative action moot, particularly when the derivative plaintiff asserts that the settlement was entered by a conflicted board."

For guidance, the Fourth Circuit looked to the Third Circuit's decision in *Salovaara v. Jackson National Life Insurance Co.*, 246 F.3d 289 (3d Cir. 2001), a factually and procedurally similar case. In *Salovaara*, the Third Circuit observed that "[a] corporation may enter into a settlement despite the existence of a derivative action when doing so is in the corporation's best interests" and there is no conflict on the part of the corporate directors entering into the settlement. The *Salovaara* court evaluated the settlement to determine if it was in the best interests of the company and noted that while a conflict between a board member and shareholder had been flagged, it was "tenuous," and there was no evidence of improper collusion or bad faith. Accordingly, the *Salovaara* court ultimately dismissed the derivative appeal as moot.

The Fourth Circuit, following the lead of *Salovaara*, stated that there was no reason why settlements that are in the best interests of the company, entered by a disinterested board, should not moot a related derivative suit asserting identical or similar claims arising out of the same underlying facts. The court further concluded that Star's conflict of interest assertion was without merit because the conflicted board member had recused himself from decisions involving the litigation. Ultimately, the court held: "given that the settlements appear to be in the best interests of the [corporation] and there is no demonstration of improper collusion or bad faith, we conclude the settlement agreements are valid and thereby moot the derivative suit insofar as Star's claims were covered by the scope of the Boards' Complaints."

Fiduciary Duties

Delaware Court of Chancery Rejects Application of *MFW*

In Re Dell Techs. Inc. Class V S'holders Litig., Consol. C.A. No. 2018-0816-JTL (Del. Ch. June 11, 2020)
Click here to view the opinion.

The Court of Chancery denied the defendants' motions to dismiss except as to one outside director, holding that procedural protections under *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) [hereinafter *MFW*] (*i.e.*, approval by a disinterested and independent special committee and a fully informed, uncoerced majority of unaffiliated shares) did not apply to a redemption of shares.

Dell Technologies Inc.'s (Dell) alleged controllers sought to eliminate Dell's Class V shares, which were subject to a conversion right (the Conversion Right). To that end, Dell formed a special committee to negotiate a redemption of the Class V shares and conditioned any redemption on *MFW*'s procedural protections.

The court held that *MFW* did not apply for four reasons. First, the court held that Dell did not establish the twin-*MFW* conditions at the outset. The court explained that Dell deprived the special committee of the ability to "say no" because the special committee's mandate excluded the exercise of the Conversion Right from the definition of a potential Class V transaction. In addition, the court found that *MFW* did not apply at the outset because the complaint alleged that Dell bypassed the special committee by negotiating directly with certain large Class V stockholders to extract a price increase. Second, the court held that, by allegedly threatening the exercise of the Conversion Right, Dell engaged in coercive conduct that both undermined the special committee's ability to bargain effectively and stockholders' ability to vote down the transaction. Third, the court held that the complaint adequately alleged that the special committee was not independent. Finally, the court held that the

complaint alleged the stockholder vote was not fully informed based on material information that allegedly was either omitted or presented in a materially misleading way.

After finding that *MFW* did not apply at the pleading stage, the court found that the complaint supported an inference that two special committee members could have acted disloyally or in bad faith by "catering to the wishes" of the alleged controllers. With respect to a recused outside director, the court found that the complaint failed to allege that she acted disloyally or in bad faith because, after her recusal, she did not have any involvement in the negotiations.

SDNY Grants in Part, and Denies in Part, Bank's Motion for Summary Judgment

Commerzbank AG v. U.S. Bank Nat'l Ass'n,
No. 16cv4569 (S.D.N.Y. Apr. 28, 2020)
Click here to view the opinion.

Judge William H. Pauley III granted in part, and denied in part, a motion for summary judgment filed by the defendant, a trustee of residential mortgage-backed securities, to dismiss claims by the plaintiff, an investor, that the trustee violated its duty to monitor, notify and take action against necessary parties for any breaches committed under the documents governing the trusts.

First, concerning claims arising from a group of certificates that the plaintiff sold, the defendant argued that the plaintiff lacked standing. The court agreed, rejecting the plaintiff's argument that the plaintiff retained rights to the claims after the certificates were sold. The court analyzed the choice of law provisions governing the transfer of the certificates, noting that under New York law "claims travel with the security unless expressly reserved in writing," and determined that the plaintiff did not "expressly reserve any claims." Second, the defendant argued that substantially all of the plaintiff's claims were untimely because the certificates were governed by foreign statutes of limitations. The court rejected the plaintiff's argument that the court should apply the statute of limitations laws of the country where the certificates were purchased and held. Instead, the court determined that the statute of limitations laws of the location where the plaintiff actually held the certificates applied. Following this analysis, the court held that the plaintiff's claims arising from the German certificates were governed by Germany's three-year statute of limitations and thus untimely.

Third, the defendant argued that the plaintiff was unable to prove that servicer issues led to events of default (EOD) on each of the trusts that the defendant had the duty to police. The court disagreed, holding that the plaintiff produced ample evidence to prove that EODs did occur. For example, the court highlighted the fact that the pooling and servicing agreement governing each trust included a variation of an EOD provision such that there was a dispute of material fact whether the defendant breached its duty on many of the trusts. Moreover, the court also held that the plaintiff submitted enough evidence to prove that the defendant "failed to cure Mortgage File deficiencies and representation and warranty breaches." The court noted that to determine whether the defendant fulfilled its obligations was a question of fact to be decided by jury. Therefore, the plaintiff's Mortgage File and representation and warranty claims "for the Pre-EOD Duty Trusts may proceed to trial."

Delaware Court of Chancery Enforces Arbitration Clause in Agreement Between Parent and Subsidiary

Chemours Co. v. DowDuPont Inc.,
C.A. No. 2019-0351-SG (Del. Ch. Mar. 30, 2020)
Click here to view the opinion.

The Court of Chancery upheld the validity of a separation agreement entered into by a parent corporation and its wholly owned subsidiary, and enforced the delegation clause of a mandatory arbitration provision in the agreement.

In 2015, The Chemours Company (Chemours) was created as a wholly owned subsidiary of E.I. du Pont de Nemours and Company (DuPont) and spun off as an independent entity. The terms of the spin-off were governed by a separation agreement, which contained a mandatory arbitration provision. Four years after the spin-off, Chemours filed a lawsuit in the Court of Chancery seeking to invalidate or limit its obligation to indemnify DuPont (and others) under the separation agreement.

Pursuant to the mandatory arbitration provision, DuPont moved to dismiss Chemours' claims for lack of subject matter jurisdiction. In opposition, Chemours argued it was not required to arbitrate its claims because (i) it did not consent to arbitration, and (ii) the arbitration provision was unconscionable. The court rejected both of Chemours' arguments. The court held that agreements between a parent and subsidiary corporation do not fail for lack of contractual "consent" and are not procedurally unconscionable simply because the parent company dictates the terms of the contract. Under settled Delaware law, wholly owned subsidiaries are expected to operate for the benefit of their parent corporations, and Delaware will not invalidate contracts because the parties operate accordingly. The court also rejected Chemours' argument that the provision delegating questions of arbitrability of Chemours' claims was substantively and procedurally unconscionable.

Inside the Courts
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Court of Chancery Sustains Claims for Breach of Fiduciary Duty Under *MFW* and *Corwin*

Salladay v. Lev, C.A. No. 2019-0048-SG (Del. Ch. Feb. 27, 2020)
Click here to view the opinion.

The Court of Chancery denied a motion to dismiss claims for alleged breaches of fiduciary arising from a merger that did not involve a controlling stockholder. The court held that in order for an independent special committee to invoke the business judgment rule where at least half the board is conflicted, the special committee must be "sufficiently constituted and authorized *ab initio*," consistent with the requirements set forth in *MFW* and its progeny.

The merger at issue involved Intersections, Inc. and iSubscribed Inc. Prior to the transaction, three of Intersections' directors and Loeb Holding Corporation collectively owned large stakes that the company's Securities and Exchange Commission (SEC) filings recognized as potentially controlling. iSubscribed teamed up with two private equity funds and contacted Intersections to explore a potential transaction. Before Intersections formed a special committee, iSubscribed began due diligence and an iSubscribed representative met with Intersections' chairman of the board and CEO, who communicated that the Intersections board would be receptive to an acquisition offer of $3.50 to $4 per share. After negotiating with the special committee, iSubscribed increased its initial offer of $3.50 per share to $3.68 per share, which the special committee recommended. The merger was approved by the unaffiliated stockholders, and Loeb and the three blockholder directors rolled over significant portions of their equity.

After the merger closed, an Intersections stockholder filed suit, alleging that the three blockholder directors breached their fiduciary duties in connection with the transaction. The defendants, who comprised at least half of the board, conceded that they were interested in the transaction such that the merger was subject to entire fairness review, unless, under *MFW*, it was approved by an empowered and independent special committee and a fully informed, uncoerced majority of the unaffiliated stockholders.

With respect to the special committee approval, the court held the complaint adequately pleaded that the procedural protections were not in place *ab initio* based on the chairman and CEO's early price discussions with iSubscribed, which "formed a price collar that 'set the field of play for the economic negotiations to come.'"

The Court of Chancery likewise rejected the defendants' argument that the vote of the unaffiliated stockholders was sufficient to invoke the business judgment rule under *Corwin*. According to the court, the plaintiff adequately alleged that the Schedule 14D-9 contained material misstatements and omissions concerning (i) iSubscribed's ability to control the board if the stockholder vote was unfavorable and (ii) the reasons why one of Intersections' financial advisers terminated its engagement with the company.

Delaware Court of Chancery Rejects Application of *MFW* Due to Allegations That Special Committee Members Were Not Disinterested and Independent

In Re AmTrust Fin. Servs., Inc. S'holder Litig., Consol. C.A. No. 2018-0396-AGB (Del. Ch. Feb. 26, 2020)
Click here to view the opinion.

The Court of Chancery sustained breach of fiduciary duty claims against a controlling stockholder group and certain members of a special committee arising from a squeeze-out merger. The court dismissed claims against one director in his capacity as an officer, as well as aiding and abetting claims against private equity defendants that partially funded the acquisition vehicle.

The Karfunkel-Zyskind (K-Z) family controlled AmTrust Financial Services, a property and casualty insurance business. The K-Z family entered into a joint bidding agreement with a private equity company and submitted a proposal to acquire AmTrust that was conditioned on approval by a disinterested and independent special committee and a fully informed, uncoerced majority of the minority stockholders. The special committee extracted several price increases and recommended that the board approve the merger for $13.50 per share. Certain minority stockholders and commentators, including Carl Icahn and Institutional Shareholder Services, publicly opposed the deal, and Icahn later filed a breach of fiduciary duty action. Just before the scheduled stockholder vote on the merger, the company adjourned the special meeting for lack of support. In the days that followed, the K-Z family engaged in discussions with Icahn, and Icahn agreed to support the transaction and dismiss his claims if the buyer group increased its offer from $13.50 to $14.75 per share. The special committee approved of the price increase, and 67.4% of the minority stockholders voted in favor of the deal. Upon consummation of the merger, unrelated derivative claims against the AmTrust directors were extinguished.

Stockholders filed suit in the Court of Chancery, asserting breach of fiduciary duty claims against the AmTrust directors and one of its officers, as well as the K-Z family as a control group. They also asserted aiding and abetting claims against the private equity defendants. The defendants moved to dismiss, arguing that under *MFW*, the transaction was protected by the business judgment rule because it was conditioned on approval by an independent special committee and a majority of unaffiliated stockholders.

The court held that *MFW* did not apply because three of the four special committee members were interested in the transaction. The court observed that these directors were defendants in the derivative actions that were extinguished by the merger, one of which was alleged to be worth in excess of $300 million and to have a net settlement value of $15 to $25 million. The court dismissed claims against the fourth member of the special committee, who was not named as a defendant in the derivative actions.

The court dismissed claims against one director and member of the control group in his capacity as an officer because the complaint failed to allege any action that he had taken in his capacity as an officer.

The court also dismissed aiding and abetting claims against the private equity company that partnered with the K-Z family, holding that the plaintiffs failed to plead knowing participation in any alleged breaches of fiduciary duty.

Forum Selection Bylaws

Delaware Supreme Court Holds Federal Forum Selection Provisions Facially Valid Under Delaware Law

Salzberg v. Sciabacucchi, No. 346,2019 (Del. Mar. 18, 2020)
Click here to view the opinion.

The Delaware Supreme Court reversed the Court of Chancery and held that federal forum provisions (FFPs) are facially valid under Delaware law. The Supreme Court analyzed 8 Del. C. § 102, which governs matters contained in a corporation's charter. Section 102(b)(1) authorizes two broad types of charter provisions: "any provision for the management of the business and for the conduct of the affairs of the corporation" and "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders ... if such provisions are not contrary to the laws of this State." The court held that an FFP "could easily fall within either of these broad categories, and thus, is facially valid."

The Supreme Court further held that the 2015 amendments to the Delaware General Corporation Law (DGCL) to add Section 115, which explicitly allowed corporations to adopt forum selection provisions designating Delaware as the exclusive forum for internal corporate claims, further supported the view that FFPs are valid under Delaware law, and that the 2015 amendments did not implicitly amend Section 102(b)(1). The court also held that FFPs do not violate the policies of Delaware laws, given that the DGCL "allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance and governance of their enterprise." The court further held that FFPs do not violate federal law or policy. The court referred to the U.S. Supreme Court's decision in *Rodriguez de Quijas v. Shearson/American Express, Inc*., 490 U.S. 477 (1989), where the Court held that federal law does not prohibit provisions that preclude state litigation of Securities Act claims.

The Delaware Supreme Court noted that "the most difficult aspect of this dispute is not with the facial validity of FFPs, but rather, with the 'down the road' question of whether they will be respected and enforced by our sister states." The court held that the question of enforceability is a separate analysis that should not drive the initial facial validity inquiry but recognized it as a "powerful concern."

Investment Advisers Act

District of Colorado Denies Motion to Dismiss SEC Complaint Against Investment Advisers and Broker-Dealers Alleging Failure To Adequately Disclose Conflicts of Interest

SEC v. Cetera Advisors LLC, No. 19-cv-02461-MEH (D. Colo. Apr. 17, 2020)
Click here to view the opinion.

Judge Michael E. Hegarty denied a partial motion to dismiss claims brought by the SEC under Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 against two investment advisers and broker-dealers. The SEC alleged that the companies placed and kept their clients in higher-cost share classes despite knowing lower-cost share classes were available for the same fund because the companies stood to receive and share with its representatives the higher fees associated with the higher-cost share class. The SEC claimed that this was contrary to the companies' clients' interests and that they failed to appropriately disclose this conflict of interest to their clients. The court agreed that the SEC plausibly alleged a violation by contending that the defendants' use of the word "may" in its disclosures concerning mutual fund fees (*e.g*., "[a]ccounts may invest in load and no-load mutual funds that may pay the firm annual distribution charges, sometimes referred to as 12(b)-1 fees" and "'[t]he firm may have an incentive to promote' one program over another") were misleading because the defendants "in fact did so invest in funds that did pay the firm distribution charges, resulting in an actual conflict of interest."

The court further rejected the companies' argument that an SEC administrative order "simultaneously bringing and settling claims" concerning disclosures that used the terms "may" and "could" meant the SEC "tacitly acknowledged" that using "may" and "could" in a disclosure "would not alter the total mix of

information for a client." The court rejected that argument, finding "an order approving a settlement has less precedential value" and "a tacit approval in an administrative proceeding that is focused on a settlement of a case is not substantial authority." The court also rejected the defendants' argument that the term "fund" encompassed "share classes" within that fund, and therefore the use of the term "fund" sufficiently disclosed to the client information concerning the fund's share classes. The court agreed with the SEC that "disclosure of the various share classes, how they operate, and their respective impact on an investor's total return ... might be material information that affects the total mix of information available."

Loss Causation

Eleven Circuit Reverses Dismissal of Securities Fraud Complaint Against Maker of Flavored Beverage Products, Holds Plaintiff Adequately Pleaded Loss Causation

Luczak v. Nat'l Beverage Corp., No. 19-14081 (11th Cir. May 4, 2020)
Click here to view the opinion.

The Eleventh Circuit reversed the dismissal of a putative securities fraud class action, holding that the plaintiff adequately pleaded the element of loss causation through a series of partial disclosures.

The defendant, National Beverage, sells a portfolio of flavored beverage products, including LaCroix sparkling waters. In several press releases in 2017, National Beverage touted two sales metrics — velocity per outlet (VPO) and velocity per capita (VPC) — as "an important measure of growth and sales." In January 2018, the SEC wrote to National Beverage asking the company to explain VPO and VPC. National Beverage responded that VPO and VPC are "proprietary methods" but that the company does not use them "to manage the overall executional side of [the] business." The SEC responded on March 23, 2018, noting the inconsistency between that explanation of VPO and VPC, and the company's earlier statements in its press releases. National Beverage's stock price dropped following that SEC letter. Then, on June 26, 2018, *The Wall Street Journal* published an article detailing exchanges between the SEC and National Beverage. The article stated that "National Beverage declined to provide the requested figures" regarding these metrics to the SEC. The company's stock price dropped again.

The plaintiff, a purported National Beverage shareholder, filed suit, claiming that the company made false or misleading statements in its 2017 press releases, and that the truth regarding those misstatements were revealed in part in the March 23 SEC letter and then more fully with the publishing of the June 26 article. The district court dismissed the claim for failure to plead loss causation, holding that neither the SEC letter nor the article "reveal[ed] to the market the pertinent truth that was previously concealed or obscured by the company's fraud." The court reasoned that the March 23 letter "merely confirms the SEC's already established doubt of the veracity of the relevant VPC/VPO statements" and disagreed with the plaintiff's characterization of the March 23 letter as having "accused National Beverage of failing to cooperate" with the SEC. With respect to the June 26 article, the district found that the article did not contain any new information "beyond a summary of the already existing correspondence between National Beverage and the SEC."

The Eleventh Circuit reversed. The panel stated that the district court failed to analyze the complaint's allegations as a series of partial disclosures and also erred in its separate analysis of each alleged disclosure. The panel explained that the district read the two partial corrective disclosures too narrowly and failed to construe all inferences in favor of the plaintiff at the pleading stage. As a result, the district improperly concluded that the March 23 SEC letter "never accused National Beverage of failing to cooperate," and it improperly determined that the June 26 article was a "mere[] summar[y] of the earlier correspondence between the Company and the SEC staff."

The Eleventh Circuit declined to decide whether the Private Securities Litigation Reform Act's (PSLRA) heightened pleading standards apply to the element of loss causation, holding that the plaintiff's loss causation allegations satisfied its pleading burden regardless of which standard applies.

Material Misstatements and Omissions

SDNY Holds Certain Alleged Misstatements Protected by Bespeaks Caution Doctrine

Plumbers & Pipefitters Nat'l Pension Fund v. Davis, No. 1:16-cv-3591-GHW (S.D.N.Y. Apr. 14, 2020)
Click here to view the opinion.

Judge Gregory H. Woods denied in part a motion to dismiss a complaint brought by a putative class of shareholders against two executives of a public sports equipment company that had filed for bankruptcy in 2016. The plaintiffs alleged that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making material misstatements about the company's short-run sales and internal controls. Specifically, the plaintiffs alleged that the defendants stated that the company experienced "healthy sales growth" when really it artificially increased its short-run sales by allowing delayed payments by purchasers who posed known credit risks and flooding the market with discounted inventory. The plaintiffs cited

internal company documents to allege that the defendants knew about these practices but misled investors about the company's sales performance and internal controls.

The court held that the plaintiffs sufficiently alleged their claims about the company's sales growth because they had shown the defendants had knowledge at the time that directly contradicted their statements. The court also held that these statements were material because a reasonable investor could have relied on the statements about the sales performance. For the same reasons, the court also held that the plaintiffs sufficiently alleged the defendants misrepresented their internal controls.

But the court dismissed the plaintiffs' allegations that the some of the company's risk disclosures were false or misleading. The court explained that under the bespeaks caution doctrine, forward-looking statements that are accompanied by sufficient cautionary language are immaterial as a matter of law. The court noted an exception to this rule (the "*Rombach* exception") under which cautionary language cannot protect statements about risks that already occurred. *Rombach v. Chang*, 55 F.3d 164, 173 (2d Cir. 2004). "The bespeaks caution doctrine will not protect a defendant from liability for a disclosure that a house may be at an increased risk of fire damage if the house is already on fire." The plaintiffs argued that several of the defendants' risk disclosures fell within the *Rombach* exception. The court rejected that argument. For example, the court held that the company's statement that it may fail to collect payment from purchasers as a result of "[a]dverse conditions in the sporting goods retail industry" was not within the *Rombach* exception. The court reasoned that while the company also faced this risk because it advanced credit to risky purchasers, the statement independently could be true and was not a risk that had already occurred.

District of Connecticut Dismisses With Prejudice Complaint Alleging Material Misstatements as Inactionable Puffery

In Re Synchrony Fin. Sec. Litig., No. 3:18-cv-1818 (VAB) (D. Conn. Mar. 31, 2020)
Click here to view the opinion.

Judge Victor A. Bolden dismissed with prejudice claims brought by a putative class of shareholders against Synchrony Financial (Synchrony) and several of its executives alleging that they violated Sections 10(b), 20A and 20(a) of the Securities Exchange Act and Sections 11 and 15 of the Securities Act by misrepresenting changes to their credit card approval process and Synchrony's relationship with one of its most important clients. As part of its business, Synchrony partners with retailers to issue retailer-specific credit cards. Specifically, the plaintiffs alleged that Synchrony tightened its criteria for issuing retail credit cards for the client, causing fewer cards to be issued and leading the client to end its 20-year relationship with Synchrony and partner with another retail credit card provider. The plaintiffs alleged that the defendants materially misrepresented the changes made to Synchrony's underwriting process and the likelihood that its contract with the client would be renewed. The defendants argued that the alleged misstatements were taken out of context, were not false and would not be relied upon by a reasonable investor. The defendants also argued that they had no duty to provide ongoing updates concerning the contract renewal negotiations.

The court held that the plaintiffs failed to allege any actionable misstatements because the plaintiffs did not allege falsity and no reasonable investor would rely upon the alleged misstatements based on the total mix of information. For example, the court held that the alleged misstatements about its relationship with the client were inactionable puffery. The court explained that the statements at issue were expressions of hope accompanied by warnings that competition could cause Synchrony to lose business. Additionally, the court explained that the defendants had no duty to update these optimistic statements during the negotiations, stating that the defendants' "lack of clairvoyance [regarding the contract renewal] simply does not constitute securities fraud." Further, the court rejected the plaintiffs' claim that the defendants falsely stated the cause of the nonrenewal and cited exhibits to the complaint countering their theory.

The court dismissed the complaint with prejudice because further amendment would be futile, noting that "no further amendment could alter this 'total mix' of information based on [the plaintiffs'] purported claims."

District of Massachusetts Dismisses Complaint Alleging Material Misstatements

Leavitt v. Alnylam Pharm., Inc.,
Civil Action No. 18-12433-NMG (D. Mass. Mar. 23, 2020)
Click here to view the opinion.

Judge Nathaniel M. Gorton dismissed a complaint brought by a putative class of shareholders against a pharmaceutical company and its executives after the Food and Drug Administration (FDA) approved the company's drug for only a single indication, rather than a dual indication, including for cardiac use. The plaintiffs alleged that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making material misstatements about the drug's clinical trial and the drug's likelihood of FDA approval for dual-indication use, including for cardiac use. Specifically, the plaintiffs alleged that the clinical trial did not study cardiac patients and the company

did not submit any cardiac results to the FDA, and therefore that it would be impossible for the FDA to approve the drug for cardiac use. Additionally, the plaintiffs alleged that the company misrepresented the drug's safety data.

Judge Gorton dismissed the plaintiffs' claims that the defendants knew FDA approval was impossible because the plaintiffs failed to plead sufficient facts in support of this theory. For example, the court rejected the plaintiffs' theory that FDA approval was impossible because the company had not studied cardiac patients. The court held that the company had, in fact, studied these patients, citing the drug trial's protocol, the FDA's report and the European Medicines Agency's approval of the drug for cardiac use. Additionally, the court noted that the company's interpretations of the drug trial data were nonactionable opinions because "[w]ithout specific allegations of falsity, opinions interpreting the results of a clinical study are not actionable."

The court further held that the PLSRA forward-looking statement safe harbor protected the company's statements about the likelihood of the drug's dual-indication approval because they were accompanied by adequate cautionary language, including lengthy risk factors and specific warnings about the risks of deficient clinical trial data and the possibility of nonapproval. The court also dismissed the plaintiffs' claims that the company misrepresented safety data, holding that there were no material misstatements. The court noted that the FDA had reached the same safety conclusions as the company.

The court further concluded that the plaintiffs failed to plead scienter. The plaintiffs alleged that the timing of the defendants' stock sales demonstrated scienter. The court disagreed, finding that the sales at issue were made under Rule 10b-5 plans and were not particularly suspicious. He also noted that the plaintiffs' inference of scienter was undercut because one defendant did not trade during the relevant period.

SDNY Dismisses Complaint Against Shoe Company Alleging Misleading Statements in Financial Statements

In Re Skechers USA, Inc. Sec. Litig., No. 18 Civ. 8039 (NRB) (S.D.N.Y. Mar. 12, 2020)
Click here to view the opinion.

Judge Naomi Reice Buchwald dismissed claims brought by a putative class of investors against a shoe company and certain of its officers alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making certain statements in earnings calls and SEC filings that misled investors into believing that the company "would likely achieve leverage in the near future" even though planned expansions made achieving leverage impossible.

The court found that each alleged misstatement, taken in its full context, was not misleading. Instead, the court determined that a number of the statements were nonactionable puffery or forward-looking predictions rather than material statements of fact. Each statement did "not promise or guarantee the investors to achieve any specific level of leverage" but were simply "predictions and opinions" that were not misleading, even if they "could generate misleading impressions when read in isolation." The court also determined that the allegations "speak to only half of the story: the other half is completely missing." The statements were alleged to be misleading because expenses would prevent a healthy leverage ratio, but the plaintiffs failed to allege any facts related to sales and therefore could not prove that the statements would have been misleading or false even if the expenses had been fully disclosed. As such, with all the facts taken into account, the court determined that "each of the challenged statements is either a non-actionable prediction or puffery" or had not been established as false.

Pleading Standards

Seventh Circuit Holds Investor Failed To Plead Sections 10(b) and 14(e) Claims

Walleye Trading LLC v. AbbVie Inc., No. 19-3063 (7th Cir. June 22, 2020)
Click here to view the opinion.

The Seventh Circuit, in an opinion by Judge Frank H. Easterbrook, affirmed dismissal of securities fraud claims brought against AbbVie Inc. in relation to two press releases it issued regarding its recently closed tender offer. AbbVie conducted a Dutch auction tender offer to repurchase up to $7.5 billion of its outstanding shares in May 2018. In a Dutch auction, the buyer company sets a range of prices it is willing to pay per share, and selling shareholders offer to sell their shares at a price within the range. At the close of the auction period, the company adds up the number of shares at the lowest offered price, moving up to the higher offers until the total number of offered shares multiplied by the offered price reaches the total dollar amount the company is willing to spend. That offer level becomes the share purchase price, and the company buys only the shares offered at or below that level.

On May 30, 2018, the morning after the auction closed, AbbVie announced the preliminary results — it would purchase 71.4 million shares for $105 per share. At the end of the day, however, AbbVie announced it had received incorrect numbers from the third-party conducting the auction, and it would actually purchase 72.8 million shares at $103 per share.

Walleye Trading LLC sued AbbVie, alleging the two press releases on May 30 constituted violations of both Sections 10(b) and 14(e) of the Securities Exchange Act. The district court dismissed the complaint for failure to state a claim.

The Seventh Circuit agreed with the district court that Walleye failed to plead the essential elements of a Section 10(b) claim. Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder prohibit false or misleading statements of material fact made in connection with the purchase or sale of a security, and to bring a Section 10(b) claim a plaintiff must plead the alleged fraud with particularity. The plaintiffs must also allege the defendant's scienter in a manner at least as compelling as any opposing inference. The court found that the plaintiff pleaded neither of these essential elements. The plaintiff pointed to no false or misleading statement — although the morning press release's reported numbers were inaccurate, AbbVie was not required by statute or regulation to verify a third party's data before reporting it. In any case, AbbVie issued an updated statement later in the day, which the court found to be a reasonable length of time reflecting no ill intent.

The court held that Walleye's Section 14(e) claim similarly failed. The SEC can bring a Section 14(e) claim, as can private persons who can show they relied on false or misleading statements in documents filed with the SEC. Having not alleged that AbbVie's statements were filed with the SEC nor that it relied on the statements, the plaintiff fell under neither category. Section 14(e) provides no other private right of action. The court also noted that AbbVie's statements were made on May 30, the day after the tender offer closed. The court was clear — investors cannot use Section 14(e) to challenge statements made after a tender offer has closed.

Finding that the plaintiff failed to state a claim, the court affirmed dismissal of the complaint.

Second Circuit Affirms Denial of Leave To File an Amended Complaint Against Surgical Gown Manufacturers

Jackson v. Abernathy, No. 19-1300-cv (2d Cir. May 27, 2020)
Click here to view the opinion.

The Second Circuit affirmed the district court's denial of leave to file a second amended complaint against two manufacturers of medical equipment and several of their executives, alleging that they made materially misleading statements about the quality and infection-prevention capabilities of a surgical gown product, in violation of Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiff claimed that the companies misrepresented and touted the protective qualities of the medical gown even though the companies allegedly knew that the surgical gown had failed numerous quality-control tests.

The district court had dismissed the complaint, reasoning that the plaintiff failed to adequately allege scienter against the individual defendants and the corporate defendants. The plaintiff moved to set aside the judgment and file a proposed amended complaint that included new allegations based on a related consumer fraud case against the companies. In that case, three employees testified that they knew about the alleged issues with the surgical gown, and as a result, the companies were found to have intentionally misled consumers about the surgical gown's protective qualities. The district court denied the proposed amendment as futile and the plaintiff appealed.

The Second Circuit affirmed, holding that the plaintiff did not allege sufficient facts to raise a strong inference of collective corporate scienter. The Second Circuit determined that the plaintiff had not identified any individual whose scienter may be imputed to the corporate defendants. The Second Circuit reasoned that the plaintiff's reliance on the testimony of the employees in the consumer fraud action was misplaced, as the steps taken by those employees to raise concerns about the surgical gown's testing failures belied any inference of fraudulent intent. The Second Circuit further held that, although the complaint set forth "allegations that three employees knew of problems" with the company's surgical gown, it provided "no connective tissue between those employees and the alleged misstatements." The Second Circuit therefore held that it was left to "guess what role those employees played in crafting or reviewing the challenged statements and whether it would otherwise be fair to charge the Corporate Defendants with their knowledge." The Second Circuit also rejected the plaintiff's reliance on the core product theory, concluding that "[s]uch a naked assertion, without more, is plainly insufficient to raise a strong inference of collective corporate scienter."

Eighth Circuit Holds Shareholders Failed To Meet PSLRA Pleading Standards

Carpenters' Pension Fund of Ill. v. Target Corp. (*In Re Target Sec. Litig.*), No. 18-1831 (8th Cir. Apr. 10, 2020)
Click here to view the opinion.

The Eighth Circuit affirmed dismissal of securities fraud claims against Target Corporation related to allegations that Target misled investors about problems with its Canadian stores. In 2013, Target expanded its operations into Canada for the first time, opening over 100 new stores. Target developed new supply chain management and information technology systems to support the Canadian stores. The systems were riddled with problems that resulted in inventory and distribution issues.

Within two years of entering the Canadian market, Target announced plans to close all of its stores in Canada, and Target Canada filed for bankruptcy.

The plaintiffs sued Target and several of its executives, alleging claims of securities fraud under Section 10(b) of the Securities and Exchange Act and Rule 10b-5 thereunder. The district court dismissed the case, holding that the investors failed to state a claim.

On review, the Eighth Circuit applied the PSLRA's heightened pleading standards, which require plaintiffs to specify each allegedly misleading statement and the reason or reasons why the statement is misleading. The plaintiffs' complaint identified dozens of allegedly materially misleading statements. The court, however, found that none satisfied the PSLRA's mental state requirement of "reckless or intentional wrongdoing."

The plaintiffs' strongest argument related to May 2014 statements by executives claiming that the earliest stores opened in Canada outperformed newer stores, and that all were on an upswing. The plaintiffs pointed to Target's August 2014 disclosures, which showed that same-store sales had fallen by more than 11% from the previous year, in a sample that only included the earliest stores. Yet, absent more, this apparent incongruity was insufficient to prove the statement was false when there were other unrebutted benign explanations.

Additionally, the court held that statements by Target executives that they were "right where we want to be right now" and "feel really good about where we are today" were inactionable puffery.

First Circuit Upholds Dismissal of Securities Fraud Claim for Failure To Prove Fraudulent Intent

Mehta v. Ocular Therapeutix, Inc., No. 19-1557
(1st Cir. Apr. 9, 2020)
Click here to view the opinion.

The First Circuit affirmed the dismissal of claims brought by a putative class of shareholders against a biopharmaceutical company and certain of its officers under Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder, alleging that the defendants intentionally or recklessly misled investors about the defendant's manufacturing problems.

Specifically, the plaintiffs alleged that affirmative statements in the company's 2016 and 2017 Forms 10-K stating that the company manufactured a prescription drug "using current Good Manufacturing Practices" was intentionally or recklessly misleading because in 2016 and 2017 the FDA made inspectional observations in Form 483 detailing issues with the company's manufacturing facility. The First Circuit disagreed, holding that the allegations did not give rise to a strong inference of scienter. The First Circuit noted that in the company's 2016 Form 10-K, the company disclosed receipt of the 2016 Form 483 and warned of its implications. The plaintiffs also alleged that in a 2017 conference call, the defendants misled investors by twice stating that their manufacturing process was "fully developed" despite the receipt of a Form 483 the day before the conference call. The First Circuit disagreed, holding that the defendants' statements on the call regarding the 2017 Form 483 "made pellucid" that the defendant's "manufacturing process was considered deficient by the FDA."

Second Circuit Affirms Dismissal of Securities Claims for Failure To Allege Loss Causation

Axar Master Fund, LTD. v. Bedford, No. 19-1132-cv
(2d Cir. Mar. 23, 2020)
Click here to view the opinion.

The Second Circuit affirmed the dismissal claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act brought by investment funds and minority shareholders against two executives of a regional airline company that operates flights on behalf of several major airlines. The plaintiffs alleged that the executives made false and misleading statements about (i) the company's beliefs that a lawsuit between the company and a major airliner about a codeshare agreement was meritless, and (ii) the status of negotiations of its codeshare arrangements with several major airline partners in connection with a bankruptcy organization petition that permitted the company to restructure and negotiate new agreements with each major airline partner. The district court dismissed the complaint for failing to plead loss causation, and the plaintiffs appealed.

The Second Circuit affirmed the dismissal of the complaint on loss causation grounds, holding that the complaint failed to allege a plausible connection between the alleged misrepresentations and the plaintiffs' claimed investment losses. The Second Circuit rejected the plaintiffs' dilution theory — that the settlement agreements in the reorganization proceedings would dilute the equity recovery of the plaintiffs' existing investments in the company on a dollar-for-dollar basis, finding that the dilution theory was "fundamentally flawed." The Second Circuit reasoned that the plaintiffs failed to allege how the regional airline's reorganization plan "caused [the plaintiffs] any economic injury that is not wholly speculative."

SDNY Dismisses Securities Fraud Claims Alleging Misleading Statements

In Re Gen. Elec. Sec. Litig., Nos. 19cv1013 (DLC), 19cv1244 (S.D.N.Y. May 7, 2020)
Click here to view the opinion.

Judge Denise L. Cote dismissed claims brought by a putative class of investors against General Electric Company and several of its officers under Sections 10(b) and 20(a) of the Securities Exchange Act, alleging that the company made misleading statements about (i) a defect in the company's HA model gas turbine and (ii) the goodwill attributable to the company's power segment, which provides goods and services related to energy production.

The court dismissed the plaintiffs' claims, finding that their complaint had failed to adequately plead a material misrepresentation or scienter. The court noted that none of the statements made by the company during the class period about the HA turbine were materially misleading or false. Some of the statements were too general to constitute representations that an investor could reasonably rely on, others were statements of opinion for which the plaintiffs had not provided sufficient grounds to suggest that they were actionable and still others would have been understood as "glossy statements of praise for the company or its products and not as representations of fact." For example, the company's statement that the HA turbine was "available at more than 64 percent efficiency" and had "been successfully tested at full-load and full-speed" was not actionable because a "reasonable investor would not understand these factual statements to be broader than they were or to constitute a guarantee of success."

Although the court assumed for purposes of the opinion that the plaintiffs had adequately pleaded that the company had an obligation under Item 303 of Regulation S-K to report the risk that the defect might have a material impact on its revenue, the complaint did not raise a strong inference of scienter as to the omission. The nonculpable inference that the company had identified the defect and what it believed was a solution for the problem to avert a material impact on the company's financials was "decidedly more plausible." Finally, the court found that the plaintiffs had failed to plead either a misrepresentation or scienter as to the allegations concerning the company's power segment goodwill. The court reasoned that goodwill balances are opinion statements about accounting estimates produced through an exercise of judgment, and the plaintiffs' theory ultimately rested entirely on a disagreement about that judgment. The court also found that the plaintiffs had failed to adequately plead any facts demonstrating that the defendants were consciously reckless in reporting their estimates of goodwill.

SDNY Dismisses Securities Fraud Claims Against Pharmaceutical Company

Hou Liu v. Intercept Pharm., Inc., No. 17-cv-7371 (LAK) (S.D.N.Y. Mar. 26, 2020)
Click here to view the opinion.

Judge Lewis A. Kaplan dismissed claims brought by a putative class of investors against a pharmaceutical company under Sections 10(b) of the Securities Exchange Act, alleging that the company misled investors about its liver disease drug Ocaliva. The plaintiffs alleged that the company made false and misleading statements about the safety and tolerability of Ocaliva in light of serious adverse events that occurred in patients who were taking the drug for the treatment of a rare liver disease and who were prescribed a higher dose than that recommended in the label.

The court determined that the plaintiffs failed to allege a material misstatement or omission, holding that they had not shown that a reasonable investor would have viewed the reported serious adverse events — which occurred in fewer than 1% of patients who were taking the drug — as material. The court also discredited the plaintiffs' allegation that the company had knowingly caused doctors to prescribe patients a higher dose through the company's patient enrollment form, because it ignores that "physicians — not pharmaceutical companies — prescribe prescription drugs." The court also found that the plaintiffs failed to adequately allege scienter. There was no basis to infer that the company knew, at the time the statements were made, "that patients had been misdosed or of the existence, scope, or severity of the adverse events that had been reported."

Requests for Judicial Notice

Third Circuit Holds District Court Did Not Err in Taking Judicial Notice of FDA Memorandum

Spizzirri v. Zyla Life Scis., No. 18-2955 (3d Cir. Apr. 30, 2020)
Click here to view the opinion.

The Third Circuit held that the district did not err in taking judicial notice of an FDA Center for Drug Evaluation and Research (CDER) memorandum and, as a result, also did not err in granting the defendant's motion to dismiss.

The panel held that the district court did not err in taking judicial notice of the memo for two reasons. First, the memo was a matter of public record. On this point, the court found it important that "[t]he public has unqualified access to the CDER memo via the FDA's website." Second, the memo was an authentic

document that was integral to the claim. The court explained that the plaintiff's claims were based on the document, even though the complaint never cited it. In addition, "the complaint contains exact language found in the CDER memo." The court stated that a plaintiff "cannot prevent a court from looking at the texts of the documents on which its claim is based by failing to attach or explicitly cite them."

Scienter

Ninth Circuit Holds That Courts Should Scrutinize Economic Plausibility of Securities Fraud Complaints in Evaluating Scienter

Nguyen v. Endologix, Inc., No. 18-56322 (9th Cir. June 10, 2020)
Click here to view the opinion.

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action in a potentially significant decision for securi¬ties defendants, holding that the plaintiff's theory that a medical device manufacturer misled investors about its product's pros¬pects for approval by the FDA was too illogical to support the strong inference of scienter required to state a securities fraud claim. In so holding, the Ninth Circuit directed lower courts to carefully scrutinize the economic plausibility of a securities plaintiff's fraud theory and to reject allegations that do "not resonate in common experience."

Endologix is a medical device manufacturer focused on treating disorders of the aorta. In 2013, the company obtained approval from European regulators to market a stent-like device called Nellix, which was used to treat aneurisms, and subsequently began seeking FDA approval to market Nellix in the United States. Over the next several years, Nellix allegedly encountered problems with "migration" (*i.e.*, the device shifted its position within the body) in a subset of European patients with complex anatomies.

Throughout 2016, Endologix executives made a number of opti¬mistic public statements predicting that the FDA would approve Nellix in a matter of months, allegedly in spite of knowing that Nellix's migration issues would pose an obstacle to approval. In late 2016, Endologix announced that the FDA had decided to require two years of additional clinical data before considering Nellix for approval, causing Endologix's stock price to drop. Several months later, Endologix abandoned its efforts to obtain FDA approval for Nellix altogether, resulting in another stock price drop.

After the second stock drop, an Endologix stockholder sued for securities fraud. The district court dismissed the complaint for failure to plead allegations creating a strong inference of scienter. The Ninth Circuit affirmed. The court held that the "central theory of the complaint" — "that defendants knew the FDA would not approve Nellix, or at least that it would not do so on the timeline defendants were telling the market," but deliberately misled the market about Nellix's prospects for approval — did "not make a whole lot of sense." The court found it implausible that the "company would promise FDA approval that it knew would not materialize," particularly where the company had spent significant time and money to develop Nellix and secure its approval, and where there were no allegations that the individual defendants sold stock or otherwise capitalized on the alleged fraud before the "inevitable fallout."

The court held that the plaintiff's confidential witness allegations did not cure these deficiencies where the witness statements were long on "alarming adjectives" but lacked "any detail about the supposed device migration problems that Nellix encountered in the European channel." Taking the complaint's allegations holistically, the court held that the plaintiff's theory of fraud did "not resonate in common experience" and therefore did not satisfy the scienter requirement. The court further reasoned that the PSLRA "neither allows nor requires [courts] to check [their] disbelief at the door," and that courts should carefully scrutinize the economic plausibility of the alleged fraudulent scheme where the plaintiff fails to plead any motive to commit fraud.

Settlements

Seventh Circuit Affirms $1.875 Million Derivative Suit Settlement

Dorvit ex rel. Power Sols. Int'l, Inc. v. Winemaster,
No. 19-2755 (7th Cir. Feb. 28, 2020)
Click here to view the opinion.

The Seventh Circuit affirmed district court approval of a $1.875 million settlement in a shareholder derivative suit against Power Systems International, Inc. (PSI). PSI became a publicly traded company in 2011, and its share price subsequently jumped dramatically. Later, in 2015, PSI admitted it needed to restate two full fiscal years' financial statements, its auditor resigned, the government began investigating the company and its share price plummeted. In 2017, PSI's former chief operating officer filed a whistleblower complaint alleging he had been unlawfully terminated in retaliation for reporting PSI's accounting practices, and in 2019 the federal government charged the company's founder and former CEO with multiple criminal fraud counts.

In 2017, PSI announced that a Chinese manufacturer, Weichai America Corp., planned to buy a 20% equity stake in the company. As part of the deal, Weichai could appoint two addi-

tional directors to PSI's previously existing five-member board. In the months following announcement of the deal, four of the original five directors resigned. By the end of the turnover, six of the seven remaining directors had been unaffiliated with PSI during the time period of the alleged misconduct.

Several parallel suits were brought in both state and federal courts. In 2017, the plaintiffs filed a derivative suit in federal court on behalf of PSI against a number of PSI officers and directors alleging fiduciary breach and unjust enrichment, and in 2018 the suit was merged with a second derivative suit, adding claims against five of PSI's new directors. In October 2018, both the individual defendants and PSI moved to dismiss, and in May 2019 the parties reached an initial settlement agreement. The settlement provided for a payment to PSI of $1.875 million, half of which would go to the plaintiffs' counsel and half of which would go to expenses associated with the government's investigation of PSI, and required the formal enactment of 17 corporate governance reforms. In November 2018, a parallel state court derivative action was dismissed. Gary McFadden, the named plaintiff in that case, intervened in the federal action and objected to the settlement on the grounds that the settlement understated the value of the case. The district court granted final approval over the objection, and McFadden appealed.

The Seventh Circuit held that the district court appropriately considered the weakness of the plaintiffs' claim in assessing the settlement's fairness. The district court noted that, because the majority of the directors were new, the plaintiffs would likely not have been able to prove an essential element of their claim — demand futility — and their claim would have likely been dismissed. The court approved of this reasoning, explaining that demand futility is a "substantive *sine qua non* of derivative suits." Demand futility is not a matter of procedure but a required substantive element.

Finding that the district court adequately weighed the strength of the parties' claims, the court affirmed the finding that the settlement was fair and reasonable.

Short-Swing Liability

Second Circuit Affirms Dismissal of Section 16(b) Claim Brought Against Client of Investment Advisory Firm

Rubenstein v. Int'l Value Advisers, LLC, No. 19-560-cv (2d Cir. May 20, 2020)
Click here to view the opinion.

The Second Circuit affirmed a lower court's dismissal of claims brought under Section 16(b) of the Securities Exchange Act alleging that the client of an investment advisory firm "became a member of a Section 13(d) group with his investment advisor and the advisor's other clients merely because he and the other clients had delegated discretionary investment authority to the advisor and the advisor had purchased for the client's account shares of the same issuer that was the subject of the advisor's Schedule 13D filing."

Under Section 16(b), certain insiders of an issuer (including 10% holders) must disgorge to the issuer any profits they realize from short-swing trading in the issuer's securities. The plaintiff, a holder of stock of an educational company, argued that because the advisory firm owned 19.5% of an educational company's stock — a figure that included shares held in discretionary accounts for the advisory firm's clients — the adviser's clients were members of a "group" for Section 16(b) purposes and were required to disgorge profits.

The Second Circuit determined that, notwithstanding an investment management agreement between the advisory firm and the client, the advisory firm and client had not formed a group because there was no agreement to act together in the purpose of transaction in the securities of a specific issuer. The investment management agreement at issue gave the advisory firm discretionary authority to trade securities but did not identify the securities of any specific issuer. As such, no "group" had been formed. Absent a group, the client did not qualify as an insider for Section 16(b) purposes, and there could be no liability.

The Second Circuit summarized its holding: "An investment advisory client does not form a group with its investment advisor by merely entering into an investment advisory relationship. Nor does an investor become a member of a group solely because his or her advisor caused other (or all) of its clients to invest in securities of the same issuer."

Inside the Courts
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