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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

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Derivative Litigation

Second Circuit Reverses Summary Judgment Ruling in Derivative Lawsuit That Required Alleged Beneficial Owner To Disgorge $4.9 Million in 'Short Swing' Profits

Packer v. Raging Cap. Mgmt., LLC, Docket Nos. 19-2703, 19-2852 (2d. Cir. Nov. 23, 2020)
Click here to view the opinion.

The Second Circuit reversed a lower court's grant of summary judgment in a derivative lawsuit brought on behalf of an online flower company against a hedge fund that owned stock in that company and alleged that the fund violated Section 16(b) of the Securities Exchange Act. Under Section 16(b), when a beneficial owner of more than 10% of a company's shares purchases and sells that company's stock within a six-month period, the beneficial owner must disgorge such short-swing profits.

The Second Circuit determined that there was a factual question regarding beneficial ownership based on the unanswered question of whether the investment management agreement between the fund, its affiliates and its investment manager authorized the investment manager to commit the fund to make changes in or terminate the agreement and was therefore a complete delegation of the fund's authority. The fund argued that by delegating its voting and investment authority to its investment manager, it could not be considered a beneficial owner. The Second Circuit noted that while the investment manager had the authority to sign the investment management agreement on behalf of all the parties, it was not clear that he had the power to unilaterally alter or terminate the agreement. While the lower court found the fact that the manager could sign the agreement to be evidence of his ability to bind the fund and therefore control it, the Second Circuit, noted that "[a]uthority for an individual to sign a document on behalf of an entity ... does not necessarily carry with it authority to commit those entities to making changes in, or terminating, that document." Without determining the extent of the manager's authority, the effect of the delegation on the fund's ownership was not clear. The judgment was therefore vacated, and the case was remanded to resolve the question.

Northern District of Illinois Dismisses Shareholder Derivative Suit With Prejudice for Failure To Plead Demand and Refusal

Mims ex rel. Allstate Corp. v. Wilson, Case No. 20 C 1038 (N.D. Ill. Dec. 8, 2020)
Click here to view the opinion.

Judge Robert W. Gettleman dismissed a derivative suit brought by a shareholder of Allstate for failure to satisfy the demand requirement. The plaintiff shareholder alleged that Allstate's auto insurance claim frequency increased between October 2014 and August 2015, and company management made false statements to conceal the increase. On September 12, 2018, the plaintiff mailed a demand letter to the chairman of Allstate's board of directors requesting that the board investigate and commence a civil action against management. Due to an administrative error, the board never received the letter. Rather than reach out to check on how the board was handling the demand, the shareholder waited over a year, then filed suit — which was how the board became aware that a demand existed. After learning of the demand, the board appointed a special litigation committee to investigate and make a recommendation to the board. The committee retained independent counsel and conducted an investigation, ultimately determining that pursuing the litigation was not in Allstate's best interest and recommending the board reject the shareholder's demand. The board adopted a resolution accepting the recommendation and rejecting the demand.

The committee informed the shareholder of the decision and offered to provide the shareholder with the board's resolutions, but the shareholder indicated her intention to stand by her complaint. Thereafter, Allstate moved to dismiss the complaint. Allstate argued the complaint failed to meet the demand requirement of Rule 23.1 and Delaware corporate law, which requires that plaintiffs plead that the board wrongfully refused a demand. The shareholder argued the board's failure to take any action in the 17 months between when she sent the demand letter and when she filed suit constituted wrongful refusal. The court noted that the shareholder sent a single letter and made no effort to confirm receipt or follow up on her demand.

Moreover, the court held that dismissal with prejudice was appropriate based on Allstate's actions after learning of the demand. Because the board appointed a special litigation committee, which investigated the claims and recommended that the board reject the demand, amending the complaint would be futile. The court found that the committee's investigation satisfied the requirements of due care and good faith and that the plaintiff could not allege that the board failed to exercise proper business judgement. Accordingly, the court dismissed the complaint with prejudice.

Extraterritoriality

Second Circuit Affirms Dismissal of Securities Fraud Claims Brought by Bermudan Reinsurance Company

Cavello Bay Reinsurance Ltd. v. Shubin Stein, No. 20-1371 (2d. Cir. Jan. 25, 2021)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims brought by a Bermudan reinsurer against a Bermudan capital investment company and its owner alleging violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The reinsurer, which had purchased shares of the investment company in a private offering, alleged that the investment company had materially misrepresented its fee arrangement with its investment manager when it marketed itself to the reinsurer. The company had allegedly represented that the investment manager would be compensated based on profits when it was actually compensated based off of book value. The investment manager was thus allegedly paid millions of dollars in fees even though the company operated at a loss. Based on that alleged misrepresentation, the reinsurer sued for rescission under the U.S. securities laws. The company successfully moved to dismiss the claims before the district court, arguing that U.S. securities laws did not apply to this extraterritorial transaction.

The Second Circuit affirmed the district court's dismissal. The Second Circuit noted that, under the Supreme Court's decision in *Morrison v. National Austl. Bank Ltd*., "[u]nless a security is listed on a domestic exchange, a domestic transaction is a necessary element of a § 10(b) claim." Because the security here was not listed on a domestic exchange, the Second Circuit determined that the only question was whether the purchase of shares was sufficiently domestic under its precedent interpreting *Morrison*. The Second Circuit, "[a]ssuming (without deciding) that the transaction was 'domestic,'" determined that the "claims are predominantly foreign" under its test in *Parkcentral Global HUB Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014). The court observed that "the claims here are based on a private agreement for a private offering between a Bermudan investor ... and a Bermudan issuer," and that the shares were not listed on any U.S. exchange or "otherwise traded in the United States." The Second Circuit rejected the argument that the transaction was not so predominantly foreign because "the parties' communications executing the agreement were between New York and Bermuda" because "acts evincing contract formation do not resolve the question whether the claims are nevertheless so predominantly foreign."

The Second Circuit also rejected the argument that federal securities laws applied because of the defendants' conduct in the United States, including for example that the defendant company "made the misstatement from New York" and "had its principal place of business and CEO and directors in New York." The Second Circuit concluded that the plaintiff was a "sophisticated institutional investor," and that if the parties "had wanted the regulatory hand of U.S. law, they could have bargained for it and structured a U.S. transaction."

Fiduciary Duties

Second Circuit Affirms Dismissal of Claims That Banks Aided and Abetted Ponzi Scheme

Marybeth Heinert v. Bank of Am. N.A., Citizens Bank N.A., No. 20-0692 (2d Cir. Nov. 13, 2020)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims asserting aiding-and-abetting common law fraud, aiding and abetting a breach of fiduciary duty and conspiracy brought against two depository banks by a putative class of investors. The plaintiffs alleged that they were victims of a Ponzi scheme perpetrated by certain customers of the banks (the Individual Defendants). The Individual Defendants allegedly banked at local branches, using personal accounts for various shell companies, commingling plaintiffs' investment funds in the process. The plaintiffs alleged that the banks acquired actual knowledge of the fraud through the Individual Defendants' interactions with the banks.

The Second Circuit affirmed the dismissal of the claims against the banks because the complaint failed to plead fraud with particularity. The court rejected the plaintiffs' argument that the banks should have recognized that the Individual Defendants were engaged in fraudulent activity because of the high number of accounts they opened, their shuffling and commingling of investor funds and certain other red flags. The court determined that those activities at most gave rise to inferences of constructive knowledge, and that such red flags are not the same as actual knowledge. The court also determined that the banks had no duty to monitor fiduciary accounts maintained at their branches in order to safeguard funds in those accounts from fiduciary misappropriation. The court held that because the plaintiffs failed to show that the commingling was unauthorized and that the banks knew about the lack of authorization, they failed to sufficiently plead that the bank had actual knowledge of a breach of fiduciary duty.

Court of Chancery Sustains Breach of Fiduciary Duty Claim Against Officer

City of Warren Gen. Emps. Ret. Sys. v. Roche, C.A. No. 2019-0740-PAF (Del. Ch. Nov. 30, 2020)
Click here to view the opinion.

The Court of Chancery granted in part and denied in part a motion to dismiss breach of fiduciary claims brought against two officers of Blackhawk Network Holdings, Inc.

The decision addressed post-closing claims for money damages arising out of the acquisition of Blackhawk by Silver Lake Partners, L.P. and P2 Capital Partners. After demanding to inspect Blackhawk's books and records, the plaintiff, a stockholder of Blackhawk, filed a complaint alleging that Blackhawk's CEO and president, Talbott Roche, and executive chairman, William Tauscher, breached their fiduciary duties in their capacities as officers by (i) manipulating the board to favor the buyout in order to maintain their employment and earn equity in the post-buyout entity, and (ii) misleading stockholders through a materially misleading proxy statement.

The court explained that because the buyout constituted a sale of control of the company, enhanced scrutiny under *Revlon* "would ordinarily apply to a challenge to the Board's action in approving the Buyout." However, rather than challenging board action, the complaint challenged "the actions of Roche and Tauscher as officers," under "iconic cases" such as *Mills Acquisition Co. v. Macmillan, Inc*., 559 A.2d 1261 (Del. 1989), "premised on independent board members not receiving critical information from conflicted fiduciaries and where 'impartial board members did not oversee conflicted members sufficiently.'" To state a claim under that theory, the plaintiff was required to plead that Ms. Roche and Mr. Tauscher acted out of self-interest and deceived the board in approving the transaction.

The court held that the plaintiff failed to adequately plead that Ms. Roche and Mr. Tauscher were self-interested because activist stockholders threatened their employment with Blackhawk, explaining that the complaint failed to allege that any activist stockholder threatened to remove the officers. Further, the court rejected the plaintiff's argument that Ms. Roche and Mr. Tauscher were conflicted by the prospect of continued employment at Blackhawk and management equity after the buyout, since the complaint did not allege any employment offers or discussions prior to the closing of the transaction. The court also held that the complaint failed to adequately allege that Ms. Roche or Mr. Tauscher manipulated or deceived the board into approving the buyout.

The plaintiff also alleged that Ms. Roche and Mr. Tauscher breached their fiduciary duties in their capacity as officers by approving a materially misleading proxy statement. The court held that the complaint pleaded facts supporting a reasonable inference that Ms. Roche, but not Mr. Tauscher, was involved in preparing the proxy statement disclosures. The court noted that Ms. Roche, Blackhawk's CEO throughout the buyout process, was "an integral figure" during negotiations; the board resolutions approving the issuance of the proxy statement authorized the company's "executive officers" to prepare and issue the proxy statement; and "most significantly, Roche signed the Proxy." The court held that "[t]he same cannot be inferred, however, as to Tauscher," because the complaint did not allege that Mr. Tauscher was involved in preparing the proxy statement, nor did Mr. Tauscher sign the proxy statement. The court then held that the complaint stated a claim against Ms. Roche for breach of the duty of care by acting with gross negligence in approving materially misleading disclosures relating to the company's lowered projections and an inaccurate description of the go-shop period under the merger agreement.

Concluding that the plaintiff stated a disclosure claim, the court also held that the complaint was not subject to dismissal under the *Corwin* doctrine.

Books and Records

Delaware Supreme Court Affirms Court of Chancery's Grant of Books and Records and Post-Trial Deposition

AmerisourceBergen Corp. v. Leb. Cnty. Emps. Ret. Fund, No. 60, 2020 (Del. Dec. 10, 2020)
Click here to view the opinion.

The Delaware Supreme Court issued an opinion affirming the Court of Chancery's decision to grant the stockholder plaintiffs' demand to inspect certain of AmerisourceBergen's books and records and permit the plaintiffs to take a post-trial Rule 30(b)(6) deposition.

In May 2019, the plaintiffs served a Section 220 demand on AmerisourceBergen requesting books and records concerning certain settlements, acquisitions, investigations and other events related to AmerisourceBergen's operations and its potential involvement in the opioid crisis. The plaintiffs' demand set forth four purposes for the inspection of board materials: to investigate possible breaches of fiduciary duty, mismanagement and violations of law by the company's board and management; to consider any remedies to be sought regarding that conduct; to evaluate the independence and disinterestedness of the board; and to evaluate possible litigation or other corrective measures. AmerisourceBergen rejected the demand in its entirety.

After trial, the Court of Chancery found that the plaintiffs demonstrated a proper purpose for inspection and a credible basis to suspect wrongdoing. Of note, the Court of Chancery rejected AmerisourceBergen's argument that the plaintiffs had not established at trial that any purported wrongdoing would be actionable in later litigation. The Court of Chancery also ordered a post-trial Rule 30(b)(6) deposition of AmerisourceBergen to identify the location of responsive documents for inspection. AmerisourceBergen sought an interlocutory appeal, which the Court of Chancery certified and the Delaware Supreme Court accepted.

On appeal, the Delaware Supreme Court held that, while it is "advisable" for a books and records demand to set forth the intended end to which a stockholder's inspection is directed, "when the purpose of an inspection of books and records under Section 220 is to investigate corporate wrongdoing, the stockholder seeking inspection is not required to specify the ends to which it might use the books and records."

The Supreme Court also rejected AmerisourceBergen's contention that the demand at issue only sought to investigate potential *Caremark* claims. It further held that in order to demonstrate an entitlement to inspection, a stockholder need only "show, by a preponderance of the evidence, a credible basis from which the Court of Chancery can infer there is possible mismanagement or wrongdoing warranting further investigation." However, the Supreme Court noted that a court "may be justified in denying inspection" when "the stockholder's sole reason for investigating mismanagement or wrongdoing is to pursue litigation and a purely procedural obstacle ... stands in the stockholder's way such that the court can determine, without adjudicating merits-based defenses, that the anticipated litigation will be dead on arrival."

Finally, the Delaware Supreme Court found that the Court of Chancery properly exercised its discretion in authorizing a post-trial deposition directed to discovering the types and locations of books and records authorized for inspection.

Forward-Looking Statements

SDNY Dismisses Claims That Packaging Company Issued Misleading Proxy Statement in Connection With Merger

In Re: Bemis Co. Sec. Litig., 19 Civ. 3356 (JPC)
(S.D.N.Y. Jan. 12, 2021)
Click here to view the opinion.

Judge John P. Cronan dismissed claims by a putative class of shareholders that a packaging company violated Section 14(a) of the Securities Exchange Act and Rule 14a-9 thereunder by disseminating an alleged materially misleading proxy statement in connection with its sale to a food and consumer packaging company. The plaintiff alleged that the proxy statement included misleading information concerning (i) "the synergies projected to be achieved" from the deal that were jointly developed by the company and its acquirer, (ii) the defendants' good faith opinions and beliefs concerning the projected synergies, and (iii) potential conflicts of interests the company's financial adviser faced.

The court determined that the alleged misstatements concerning the projected revenue synergies were not actionable because they were forward-looking statements accompanied by meaningfully cautionary language and thus protected by the Private Securities Litigation Reform Act's (PSLRA) safe harbor. The court noted that "the discussion of the Forecasts was prefaced by language expressing [the company's] general reluctance to disclose financial forecasts because of the inherent uncertainty with such projections." The court held that "even if the Proxy had not contained the meaningful cautionary language," the complaint failed "to plead any facts supporting a finding that Defendants had actual knowledge that the statements were false." The court rejected the argument that the company officer's financial incentives to complete the deal supported actual knowledge, finding that those "allegations as to the motive of the individual Defendants only tenuously support an inference of scienter."

The court also determined that the defendants' opinions concerning the projected synergies were not actionable because they "were clearly forward-looking statements expressing a belief that the projections used were based on the best metrics available." Finally, the court found that the proxy statement sufficiently disclosed the financial adviser's potential conflict as it revealed that the financial adviser "may have an economic interest in any sale process that may need to be divested."

Loss Causation

Ninth Circuit Affirms Dismissal, Clarifies Standard for Forward-Looking Statements, Holds Stock Price Rebound Can Negate Loss Causation

Wochos v. Tesla, Inc., No. 19-15672 (9th Cir. Jan. 26, 2021)
Click here to view the opinion.

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action, holding that (i) the plaintiffs failed to plead that any of the challenged statements were false or misleading, and (ii) the plaintiffs' proposed amended complaint failed to plead loss causation. In doing so, the court clarified the standard for determining whether a statement is forward-looking under the PSLRA's safe harbor provision and held that a quick stock price recovery may negate allegations of loss causation.

In 2017, Tesla began ramping up mass production of its Model 3 sedan. Throughout the year, Tesla made various statements suggesting or stating that it was "on track" to be able to produce 5,000 Model 3s per week by the end of the year. In November 2017, Tesla announced that it would not be able to meet its production goals. Following that announcement, purported Tesla investors brought a putative securities fraud class action, alleging that Tesla had defrauded investors by expressing confidence in its ability to meet its 5,000-cars-per-week production goal while hiding various production setbacks that made that goal unattainable. The district court dismissed the plaintiffs' claims with prejudice for failure to sufficiently plead that any Tesla statement was false or misleading when made.

The Ninth Circuit affirmed. The court held that Tesla's statements that it was "on track" to meet its production goals were forward-looking and thus subject to the PSLRA's safe harbor provision for forward-looking statements accompanied by meaningful cautionary language. The court rejected the plaintiffs' argument that the "on track" statements were not subject to the safe harbor because they contained implied representations about present facts — namely, that Tesla was not experiencing any production difficulties that could prevent it from meeting its goals. Rather, the court reasoned that a "statement that a company is 'on track' to achieve an announced objective" is merely another way "of declaring or reaffirming the objective itself" and amounts to nothing more than a prediction "about how various future events will play out over the timeframe defined by" the statement. Because statements about management's future plans or objectives are explicitly protected by the PSLRA's safe harbor, the court held that the "on track" statements were not actionable.

The court also rejected the plaintiffs' request for leave to add a claim alleging that a Tesla statement that it had started production of the Model 3 was false and misleading in light of a *Wall Street Journal* article reporting that Tesla was still manufacturing parts of the Model 3 by hand at the time the statement was made. The court noted that, while Tesla's stock price dropped the day after the *Wall Street Journal* article was published, the price had almost entirely recovered a mere two days later. The court held that the "quick and sustained price recovery after the modest [initial] drop" refuted the inference that the revelation of Tesla's purported fraud "caused any material drop in the stock price." The court therefore held that the proposed amendment was futile because the new claim would necessarily fail to plead loss causation.

EDNY Dismisses Claims That Life Insurance Company Failed To Disclose Errors in Reserve Practices

Christopher Parchmann v. MetLife, 18 CV 780 (SJ) (RLM) (E.D.N.Y. Jan. 11, 2021)
Click here to view the opinion.

Judge Sterling Johnson Jr. dismissed claims brought by a pension fund under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder against a life insurance company that offers annuity and employee benefit products. The plaintiff alleged that the company made certain disclosures in December 2017 and January 2018 about its failure to pay 600,000 annuitants and as a result had to increase its reserves by more than $500 million (to account for reserves that were wrongfully released). The plaintiff further alleged that in the company's Form 10-K filed in March 2018, which included a restated financial statement, the company admitted that the errors were due to an "operational failure" and "material weakness in internal control." The plaintiff alleged that these disclosures revealed that the company's financial statements during the previous five years were materially misleading because the company had improperly recognized more than $500 million in profits due to the wrongfully released reserves.

The court dismissed the plaintiff's claims. He determined that none of the company's Securities and Exchange Commission filings at issue demonstrated a change in profits because while the company had increased reserves as a result of the failure to identify and pay annuitants, the company had also reduced reserves to account for an unrelated overstatement of reserves. The court determined that there was no negative change in adjusted earning or net income available to common shareholders. The court found that the plaintiff failed to show any economic loss attributable to the March 2018 disclosures, given that the plaintiff only alleged that the stock price dropped after the December 2017 statement and the January 2018 statement. The court also rejected the plaintiff's claim that the company materially omitted that their practice of locating pension annuitants (which practice allegedly resulted in the failure to pay 600,000 of its group annuitants) was different from the practice adopted by other group annuitants. Finally, the court concluded that the plaintiff failed to plead scienter because the complaint provided no evidence to infer that the company intentionally kept the flawed practice in place to defraud investors.

Mergers and Acquisitions Litigation

Court of Chancery Permits Buyer To Walk From $5.8 Billion Transaction

AB Stable VIII LLC v. Maps Hotels & Resorts One LLC,
C.A. No. 2020-0310-JTL (Del. Ch. Nov. 30, 2020)
Click here to view the opinion.

The Court of Chancery issued a post-trial decision arising from a sale and purchase agreement pursuant to which AB Stable agreed to sell Strategic, an asset that held interests in luxury hotels, to Maps Hotel for a total purchase price of $5.8 billion, holding that certain closing conditions were not satisfied such that Maps Hotels was not obligated to close the transaction.

The court held that the "Bring-Down Condition" in the purchase agreement — which extinguished the buyer's obligation to close if the seller's representations were not true and correct as of closing (unless the failure to be true and correct would not reasonably be expected to have a material adverse effect (MAE)) — was satisfied. The buyer asserted that Strategic had suffered an MAE due to the consequences of the COVID-19 pandemic. While both sides debated whether the effect was material and adverse, the court sidestepped the issue by assuming "Strategic suffered an effect due to the COVID-19 pandemic that was sufficiently material and adverse" under Delaware law, and it looked instead to whether the effect fell within one of the enumerated exceptions in the MAE definition. The court held, among other things, that the exception for "calamities" in the MAE definition "encompasse[d] the effects that resulted from the COVID-19 pandemic" and suggested that the COVID-19 pandemic "arguably" also fit the definition of "natural disaster." As a result, the court found that Strategic had not suffered an MAE as defined in the agreement, and the Bring-Down Condition was satisfied.

However, the court found that the buyer established that a condition requiring the seller to comply with its covenants (the Covenant Compliance Condition) failed because the seller breached its covenant to operate in the ordinary course of business consistent with past practice (the Ordinary Course Covenant). The buyer argued that the Ordinary Course Covenant required Strategic to "operat[e] in accordance with how the business routinely operates under normal circumstances," while the seller argued that it was permitted to engage in "'ordinary responses to extraordinary events.'" The court concluded that the seller breached the Ordinary Course Covenant by making "extraordinary changes to its business in response to the COVID-19 pandemic," even though those changes were "warranted" and "reasonable responses to the pandemic." Among other things, Strategic closed two hotels entirely and severely limited operations at 13 other hotels, placing them in a state of "closed but open," stopping food and beverage operations and shutting down or limiting all other amenities. It also "slashed employee headcount, with over 5,200 full-time-equivalent employees laid-off or furloughed" and reduced hotel operations to "skeleton staffing." The court found these changes "departed radically from the normal and routine operation of the Hotels and were wholly inconsistent with past practice." Accordingly, the court concluded that the buyer proved that the business of Strategic was not conducted only in the ordinary course, consistent with past practice, in all material respects.

The court also held that the buyer proved that a condition to obtain "clean" title insurance failed, also relieving the buyer of its obligation to close.

Misrepresentations and Omissions

New York Appeals Court Reverses Lower Court's Ruling in First State Court Securities Act Case Post-*Cyan*

Lyu v. Ruhnn Holdings Ltd., No. 2020-02555
(N.Y. Sup. Ct. App. Div. 1st Dep't. Dec. 3, 2020)
Click here to view the opinion.

The New York State Appellate Division for the First Judicial Department reversed the trial court's denial of a motion to dismiss and dismissed claims brought by a putative class of investors against a Chinese e-commerce startup company and its underwriters, alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act. The plaintiffs alleged that the defendants failed to disclose in offering materials issued in connection with the company's initial public offering (IPO) that the company had closed its online stores by about 40% and its full service model influencers by 44% before its IPO. The trialcourt rejected the defendants' argument that the alleged omissions were immaterial, finding that the company's disclosure that it was transitioning away from a "full service" model to a more profitable "platform model" as the primary generator of revenue was inadequate.

The appellate court reversed, holding that the omission of data from the period immediately preceding the issuance of the final prospectus showing a reduction in the full service business did not "significantly alter the total mix of information" available to investors. The appellate court relied on the Second Circuit's decision in *Stadnick v. Vivint Solar*, 861 F.3d 31 (2d Cir. 2017), to conclude that the plaintiffs' view of the store closings was "myopic." The appellate court reasoned that, because the full service sector's revenue was not closely related to the number of stores or online influencers, "disclosure would not have given a more accurate picture of the status of the business."

District of Colorado Dismisses Most of Cannabis Investors' Claims Due to Illegality

Sensoria, LLC, et al. v. Kaweske, Civil Action No. 20-cv-00942-MEH (D. Colo. Jan. 12, 2021)
Click here to view the opinion.

Magistrate Judge Michael E. Hegarty granted in part and denied in part a motion to dismiss claims brought by a group of investors, alleging that several cannabis entities violated investment contracts by misrepresenting an opportunity to invest in certain Colorado cannabis businesses that eventually disintegrated.

The plaintiffs alleged that the investment vehicle used by the companies was a fraudulent scam. They alleged that they were misled to believe that they were purchasing shares in a legitimate business venture, and instead the companies had converted the funds for their own personal benefit. The companies argued that the affirmative defense of illegality applied because granting the plaintiffs' requested relief — "to recover the financial benefit of their investment" in a venture to grow and sell marijuana — would entail violating the federal Controlled Substances Act (CSA).

The court agreed, finding that "Plaintiffs' Amended Complaint makes plain that the purpose of the investment vehicle was to grow and sell marijuana." The court also noted that the plaintiffs failed to "identify any particular claim of relief that is unaffected by the affirmative defense" of illegality. The court noted that "the simple fact that marijuana is involved does not mean the Plaintiffs' claims must be dismissed automatically" and determined that the plaintiffs may amend their claims to plead theories of relief that do not implicate the CSA.

Securities Fraud Pleading Standards – Scienter

Illinois District Court Dismisses Securities Fraud Case for Failure To Adequately Plead Scienter

In Re Baxter Int'l Inc. Sec. Litig., No. 19 C 7786 (N.D. Ill. Jan. 12, 2021)
Click here to view the opinion.

Judge Sara L. Ellis granted a motion to dismiss a securities fraud claim against Baxter International as well as its current CEO, José Almeida, and former chief financial officer, James Saccaro. The plaintiffs alleged that Baxter misled the public regarding its accounting for foreign currency transactions.

Baxter generates most of its revenue outside of the United States but reports its financial figures in U.S. dollars. As such, it must convert the value of its foreign transactions to U.S. currency. Generally accepted accounting principles (GAAP) provide a framework for addressing this issue. The plaintiffs alleged Baxter did not adhere to this framework. Baxter's approach allegedly resulted in artificial gains to net income. On October 24, 2019, Baxter announced that it was investigating claims that certain transactions relating to foreign exchange gains were not booked in accordance with GAAP. Baxter stated that these transactions resulted in misstatements of its financials, and it expected to restate its financial statements.

The plaintiffs alleged that the defendants' misstatements, as well as information in Baxter's 2018 Form 10-K, amount to a violation of the Securities Exchange Act. The defendants filed a motion to dismiss for failure to state a claim. Specifically, they argued that the plaintiffs failed to adequately allege scienter for any of the challenged statements.

The court analyzed whether the plaintiffs adequately pleaded the management defendants' scienter. The plaintiffs made nearly a dozen arguments as to why they had adequately pleaded scienter. Notably, the plaintiffs invoked the core operations inference, under which corporate officers are presumed to have knowledge of important transactions that affect the company's performance, and argued that the defendants had motive to defraud investors. The court rejected each of the plaintiffs' arguments.

The court rejected the plaintiffs' core operations argument as overbroad. The defendants argued that the inference should not apply because Baxter's core operation is providing hospital products, not accounting for those sales. The court rejected this argument, holding that the core operations inference can apply to accounting errors when they are a "significant part" of a company's financial picture. Here, the court was willing to infer that the defendants knew that Baxter used a foreign currency conversion method. However, the court declined to infer that the officers knew that the conversion violated GAAP. Without an inference of knowledge that the conversion method was wrong, the plaintiffs had not adequately alleged scienter for the individual defendants.

The plaintiffs also argued that the individual defendants' compensation motivated them to defraud investors, supporting an allegation of scienter. Specifically, the defendants stood to make more money if the company did well. The court disagreed that the compensation package established scienter, noting the package was typical of nearly every corporation. Further, both the defendants were compensated largely through Baxter stock. Neither sold the stock, which cuts against a finding of scienter. Had they been trying to defraud investors and known the stock price was inflated, they would have likely sold at least some of their stock.

The court next turned to whether the plaintiffs adequately pleaded Baxter's scienter. Corporations do not have a mind of their own, so this determination is made by looking at the scienter of their agents. Given that the plaintiffs had not pleaded scienter against the individual defendants, and the complaint did not include any allegations linking other Baxter employees to an alleged misstatement, the court granted the defendants' motion to dismiss.

SDNY Grants in Part and Denies in Part Publicly Traded Data Analytics Company's Motion To Dismiss

In Re: Nielsen Holdings PLC Sec. Litig., 18-CV-7143 (JMF) (S.D.N.Y. Jan. 4, 2021)
Click here to view the opinion.

Judge Jesse M. Furman granted in part and denied in part a motion to dismiss claims brought by a putative class of investors against a publicly traded data analytics company and several of its officers under Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiffs alleged that the company made false and misleading statements concerning (i) the company's "Buy" segment that focuses on measuring and analyzing consumer purchasing behavior, and (ii) its "Watch" segment, which focuses on measuring and analyzing audience media consumption.

The court determined that certain statements concerning the company's "Buy" segment were adequately pleaded with scienter, but others were not. For example, the court determined that the company's October 25, 2016, statement that it "had[d] not seen [a strong discretionary environment] since [the fourth quarter]" was knowingly false and misleading because by that time the company was aware that its clients were decreasing their discretionary spending throughout 2016 to a degree that warranted a change in business practices. The court similarly determined that a July 2016 statement that "discretionary spending can be a little lumpy" and that it was "not uncommon to see these dynamics from time to time" was knowingly misleading because the company was aware of the steady decline in its revenue growth beginning in the fourth quarter of 2015. On the other hand, the court determined that all of the company's statements about revenue forecasts in 2016 and 2017 were not actionable because despite being "unduly optimistic and even negligent," they were not pleaded to be made with actual knowledge of their falsity or recklessly.

The court also determined that certain statements concerning the company's "Watch" segment that were made surrounding the European Union's General Data Protection Regulation (GDPR) were sufficiently pleaded with scienter, but others were not. Statements that assured the public that the company was ready for GDPR were actionable because the company later revealed that, on the day GDPR was enacted, the company's clients cut its access to their data. The court, however, dismissed the plaintiffs' pre-GDPR-related claims for alleging "nothing more than fraud by hindsight."

Illinois District Court Dismisses Securities Fraud Case for Failure To State a Claim

Yash Venture Holdings, LLC. v. Moca Fin. Inc., Case No. 4:19-cv-04176-SLD-JEH (C.D. Ill. Dec 14, 2020)
Click here to view the opinion.

Judge Sara Darrow granted a motion to dismiss a securities fraud claim brought by a potential investor in the defendant company, Moca Financial. In December 2018, Moca approached Manoj Baheti to become an investor. It provided Baheti with a memorandum of understanding, stating that Mr. Baheti would receive 15% equity in exchange for software development work. Mr. Baheti agreed and formed Yash Venture Holdings, which would own the 15% equity. In March 2019, Moca provided Mr. Baheti with a term sheet, which changed his investment from development work to $600,000 in cash. In June 2019, Moca sent Mr. Baheti a capitalization table that diluted Mr. Baheti's equity from 15% to 7.5%. Mr. Baheti objected to this dilution and said he did not agree to it. As a result, Moca informed Mr. Baheti that he had forfeited his rights to Moca ownership.

On July 29, 2019, the plaintiff filed suit against Moca, its CEO, and its chief operating officer. On September 18, 2019, the plaintiff filed an amended complaint alleging, among other things, a claim of federal securities fraud under Section 10(b) of the Securities Exchange Act. The defendants moved to dismiss the amended complaint for lack of personal jurisdiction and for failure to state a claim.

As an initial matter, the court considered whether it had personal jurisdiction over the defendants with respect to the federal securities fraud claim. The plaintiff alleged that the defendants violated the Securities Exchange Act, which provides for nationwide service of process. Here, the key question was whether the defendant had minimum contacts with the United States, not with the forum state specifically. Moca was incorporated in Delaware, its CEO was a resident of Texas and its COO was a resident of North Carolina. As such, the court held that the defendants had sufficient contacts for the court to exercise personal jurisdiction over them.

The court next considered whether the plaintiff stated a claim under the Securities Exchange Act. The plaintiff alleged that the defendants solicited his services in exchange for 15% equity. Afterward, the defendants sought to dilute the plaintiff's ownership share and never informed the plaintiff of this possibility. The plaintiff argued that this conduct constituted an omission of a material fact and violated Section 10(b) of the Securities Exchange Act. The court dismissed the plaintiff's Securities Exchange Act claim for two reasons: The plaintiff failed to adequately allege the existence of a contract between the plaintiff and the defendants, and plaintiff failed to adequately allege scienter.

First, the plaintiff was unable to allege the existence of a contract. The plaintiff argued that it was promised 15% equity in Moca in exchange for software development work. However, neither the memorandum of understanding nor the term sheet qualified as a binding contract. The memorandum expressly stated that any proposal was in the initial stages. The court noted that, even if the term sheet could be considered an offer, the plaintiff did not agree to it, as it changed the plaintiff's investment from development work to cash. Absent further allegations, the court held that the plaintiff did not plead sufficient facts showing the existence of a contract.

Second, the plaintiff failed to plead scienter. Here, the relevant inquiry was whether the defendants' failure to disclose that the plaintiff's interest would be diluted was done with the intent to deceive. The plaintiff's only response was that nothing in the memorandum or term sheet stated that the plaintiff's equity would necessarily be diluted. The plaintiff did not allege any facts that suggested the defendants acted with intent to deceive. Thus, the plaintiff did not adequately allege scienter. Accordingly, the court granted the defendants' motion to dismiss the Securities Exchange Act claim.

District of Colorado Dismisses Class Action Against Beverage Company for Failure To Prove Scienter

In re Molson Coors Beverage Co. Sec. Litig., No. 1:19-cv-00455-DME-MEH (D. Colo. Dec. 2, 2020)
Click here to view the opinion.

Judge David M. Ebel dismissed claims brought by a putative class of investors alleging that a beverage company and certain of its officers violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder. The plaintiffs alleged that the company's financial statements during the class period were materially misleading because the company concealed an accounting error that caused the company to significantly understate its tax liabilities.

The court concluded that there was insufficient evidence of scienter. It determined that, while the size of the accounting error did give rise to some inference of scienter, this consideration was insufficient when weighed against other relevant considerations, including the complexity of the error, the involvement of independent auditors and the lack of any direct evidence of the defendants' knowledge of the error. While the existence of a simple error would be indicative of scienter, the court concluded that the error in question was "complex, technical, and not obvious." The court reasoned that the company's independent auditor conducted annual audits of financial reporting and failed to identify the error, and that the plaintiff did not bring any claim against the auditor or allege that defendants attempted to conceal the error from the auditor. Observing that the opinion of an independent auditor does not, in itself, insulate against liability for accounting errors, here, in light of the complexity of the error at issue, and the lack of any other evidence of the defendants' knowledge of the error, "[the independent auditor's] involvement weighs against an inference of scienter."

Settlements

Court of Chancery Determines Stockholder Vote Not Required To Approve Private Foreclosure

Stream TV Networks, Inc. v. SeeCubic, Inc., C.A. No. 2020-0310-JTL (Del. Ch. Dec. 8, 2020)
Click here to view the opinion.

The Court of Chancery granted a motion for preliminary injunction filed by SeeCubic, Inc. prohibiting Stream TV Networks and its controllers from taking actions inconsistent with a settlement agreement that called for the transfer of assets pledged as collateral on debts, functioning as a private foreclosure.

The action involved a dispute over the intellectual property and other assets of Stream TV, a Delaware corporation aimed at developing technology that would make 3-D viewing possible without the need for special 3-D glasses. By early 2020, Stream had defaulted on debts owed to its two largest creditors. One creditor filed a foreclosure action in Delaware Superior Court seeking to foreclose on Stream's assets, which had been pledged as collateral on the debt. In the course of negotiations, Stream's controllers agreed to appoint four new independent directors to Stream's board. When negotiations broke down, three of those newly appointed directors voted to form a "Resolution Committee" empowered to settle Stream's debts. The Resolution Committee then executed the settlement agreement on behalf of Stream, which called for the transfer of all of Stream's assets in satisfaction of the debts to Stream's creditors into a newly created entity, SeeCubic.

The company's controllers disputed the validity of the agreement, arguing, among other things, that under Section 271 of the Delaware General Corporation Law (DGCL) and the company's certificate of incorporation, a stockholder vote was required to transfer Stream's assets. The court rejected that argument, explaining that while Section 271 of the DGCL requires stockholder approval for a sale of "substantially all" of a Delaware corporation's assets, Section 272 provides that stockholder approval is not required to mortgage or pledge the corporation's assets. In a detailed account of the legislative history of Sections 271 and 272, the court explained that "the origins of Section 271 demonstrate that the General Assembly did not intend for the statute to govern a transfer of assets by a failing firm," and "[t]he statute has never referred to forgiveness of debt as a form of consideration." The court also noted public policy considerations, including that "interpreting Section 271 as applying to a creditor's efforts to levy on its security would undercut the value of the security interest."

Stream also argued that a provision in its certificate of incorporation, which largely tracked the language of Section 271, also required a stockholder vote. The court concluded that its interpretation of Sections 271 and 272 also applied to the certificate and that no vote was required.

Inside the Courts
An Update From Skadden Securities Litigators

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