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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

Cryptocurrency

Eleventh Circuit Reverses Dismissal of Claims Arising From Solicitation of Unregistered Security Through Online Videos

Wildes v. Bitconnect Int'l PLC, No. 20-11675 (11th Cir. Feb. 18, 2022)

The Eleventh Circuit reversed the dismissal of a putative securities fraud class action, holding that producers of online videos could be held liable under Section 12(a)(1) of the Securities Act for solicitation of an unregistered security. Section 12(a)(1) prohibits selling any unregistered security and provides a private right of action to purchasers against sellers for rescission.

This case arose from BitConnect's creation of a new form of cryptocurrency: the BitConnect coin. Company promoters made thousands of online videos encouraging consumers to purchase the coin and provided free online cryptocurrency courses, which helped viewers who wanted to invest create BitConnect accounts. These videos were popular and generated millions of views. However, when the coin's price fell, two plaintiffs sued under Section 12 to try to recoup their alleged losses from the promoters.

The district court dismissed the claim on the grounds that the plaintiffs based their case on having watched the videos, which were made for and viewed by millions of people. The court reasoned that for there to be liability under Section 12, there must be a direct or personal solicitation. As a result of that ruling, the plaintiffs amended their complaint to add additional plaintiffs who had allegedly purchased BitConnect through the promoters' referral links. The district court also dismissed the amended complaint, reasoning that the new plaintiffs, just like the original ones, had never received any "personal solicitation" or targeted communication from the promoters. The amended complaint still rested on having viewed public-facing content.

On appeal, the Eleventh Circuit reversed. The only issue before the court was whether a person can be liable for solicitation under Section 12 by promoting a security in a mass communication. The panel held that liability on that basis exists. The panel rejected the argument that liability under Section 12 is restricted to when a seller directs a solicitation of an unregistered security to a particular prospective buyer. The court noted that the Securities Act prohibits a person from using "any means or instruments of transportation or communication in interstate commerce" to sell an unregistered security and was contemplated when written to apply to circulars and radio. The panel reasoned that for purposes of liability, it does not matter whether a seller pitches a security in a letter or video. The court ultimately concluded that the plaintiffs alleged facts that, if taken as true, would make the videos constitute solicitations under the statute, noting that the promoters allegedly convinced the plaintiffs to buy the coin through their referral programs and received commissions for those purchases.

SDNY Dismisses Action Against Cryptocurrency Exchange Based On Defenses of Statute of Limitations and Extraterritoriality

Anderson v. Binance, No. 1:20-cv-2803 (ALC) (S.D.N.Y. Mar. 31, 2022)

Judge Andrew L. Carter dismissed a purported securities class action against a cryptocurrency exchange alleging that the company violated Section 12 of the Securities Act, Section 29(b) of the Securities Exchange Act and certain state laws by misleading investors about the status of certain digital tokens promoted and sold in the U.S. following initial coin offerings. The plaintiffs alleged that the company failed to inform investors upon purchase that the digital tokens were regulated "securities." The plaintiffs claimed that they were not apprised of the tokens' status as "securities" until the Securities and Exchange Commission (SEC) issued its "Framework for 'Investment Contract' Analysis of Digital Assets."

The court determined that the plaintiffs' federal claims were time-barred by the applicable statutes of limitations. The tokens at issue were either purchased by investors or solicited by the company more than a year before the complaint was filed, and therefore the Section 12 claims were untimely. Section 29(b) of the Exchange Act also has a one-year statute of limitations, but the period begins to run only upon "discovery that [the] sale or purchase involves [a] violation" of securities law. The court rejected the plaintiffs' argument that they could have discovered that the tokens were securities only after the SEC published the framework one year before the complaint was filed, reasoning that the framework did not reveal new facts or create new legal rights. Because the Section 29(b) claim was premised on the company allegedly operating an unregistered exchange, and the plaintiffs were aware that the company was unregistered at the time they purchased the tokens, their Section 29(b) claims were also time-barred.

The court also determined that the plaintiffs' claims failed due to extraterritoriality because the plaintiffs failed to show that the company was a domestic exchange or engaged in domestic transactions. The plaintiffs had not alleged sufficient facts to show that a "facility" of the company, which was headquartered in Malta, was "within or subject to the jurisdiction of the United States" and thus required to register as a domestic exchange. Allegations that the plaintiffs purchased the tokens while in the U.S. and that title passed through servers located in California that host the company's website were insufficient to render the transactions or the exchange itself "domestic."

Derivative Litigation

Northern District of Illinois Dismisses Shareholder Derivative Action, Holding Plaintiffs Did Not Allege Demand Futility With Specificity

In re Fifth Third Bancorp Derivative Litig., No. 1:20-cv-04415 (N.D. Ill. Mar. 30, 2022)

Judge Sarah L. Ellis granted the defendants' motion to dismiss a shareholder derivative suit against Fifth Third officers and directors. The suit was filed in the wake of a Consumer Financial Protection Bureau (CFPB) action against Fifth Third for alleged cross-selling and other improper sales practices. The plaintiffs alleged that the individual defendants breached their fiduciary duties to the company and violated Sections 10(b) and 14(a) of the Securities Exchange Act by ignoring and making misstatements about improper sales practices at the bank. The plaintiffs further claimed, as required by Rule 23.1(b)(3) of the Federal Rules of Civil Procedure, that a presuit demand on Fifth Third directors would have been futile. Looking to the substantive law of Ohio, Fifth Third's state of incorporation, the court held that the plaintiffs failed to show with particularity that a demand would have been futile and dismissed the case.

To plead demand futility under Ohio law, the plaintiffs had to show that a majority of Fifth Third's board members were not disinterested at the time the plaintiffs filed the complaint. The plaintiffs alleged that the director defendants were not independent because they had preexisting relationships and faced a substantial likelihood of liability on the breach of fiduciary duty and securities claims. The court held that the directors' prior business relationships did not defeat their independence, as the plaintiffs failed to plead facts supporting the inference that the directors "would be more willing to risk [their] reputation than to risk the relationship with the interested person."

The court further held that the directors did not face a substantial likelihood of personal liability on the plaintiffs' breach of fiduciary duty claims. It found that the facts pled by the plaintiffs did not show with clear and convincing evidence, as required by Ohio law, that the directors acted with reckless disregard for the corporation's best interest. For example, the plaintiffs failed to show the directors ignored red flags about sales practices issues.

The court held the same with respect to the directors' personal liability under Section 10(b), finding that the plaintiffs failed to sufficiently allege scienter. The plaintiffs argued that the directors must have known about the misconduct because of (i) the significance of the consumer business operations to the bank and (ii) a variety of alleged red flags, including the CFPB's investigation. The court found the first argument unpersuasive and held that the government investigation only alerted the directors to the investigation itself, not to the alleged underlying conduct.

Finally, the court held that the directors did not face a substantial likelihood of personal liability under Section 14(a) because the plaintiffs failed to identify specific statements rendered misleading by discussing Fifth Third's allegedly improper sales practices. The court did not find convincing the plaintiffs' argument that statements in Fifth Third's Code of Conduct were rendered misleading by the allegation that a small number of Fifth Third's employees violated it. Instead, the court held that the publication of a code of conduct was not a representation that all employees complied with it. The court therefore held that the plaintiffs failed to adequately plead demand futility and dismissed the complaint.

Fiduciary Duties – Bylaws

Court of Chancery Enforces Unambiguous Advance Notice Bylaw After Holding That Incumbent Directors' Decision To Reject Nomination Notice Satisfied Enhanced Scrutiny

Strategic Inv. Opportunities LLC v. Lee Enters., Inc., C.A. No. 2021-1089-LWW (Del. Ch. Feb. 14, 2022)

The Delaware Court of Chancery denied a request for declaratory and injunctive relief on behalf of a dissident stockholder attempting to run a slate of director nominees as part of a takeover attempt of Lee Enterprises, Incorporated. The court held that the plaintiff failed to comply with the terms of an advance notice bylaw, and therefore the company's rejection of the nomination notice was contractually proper. The court then conducted an equitable review of the board's rejection of the nomination notice and concluded that "the board acted reasonably in enforcing a validly adopted bylaw with a legitimate corporate purpose" and did not engage in manipulative or inequitable conduct.

The court began with consideration of whether the nomination notice complied with the requirements of the advance notice bylaw. Explaining that if a bylaw's language is unambiguous, it will be construed as written, the court concluded that the plaintiff's nomination notice failed to comply with the unambiguous terms of the advance notice bylaw in two respects: (i) the nomination was not made by a record holder and (ii) the company's form of questionnaire was not included with the nomination notice. The company's rejection of the nomination notice therefore complied with the terms of the bylaw.

Noting the Delaware Supreme Court's decision in *Schnell v. Chris-Craft Industries, Inc.*, which held that the court may invalidate board action that inequitably manipulates corporate machinery to impair stockholder rights, the court determined that the incumbent board's conduct should be analyzed under the enhanced scrutiny standard of review, given the "inherent conflicts of interest" present when conduct by an incumbent board prevents stockholders from replacing incumbent board members in a contested election. However, applying enhanced scrutiny, the court concluded that the incumbent directors were justified in rejecting the nomination notice. The court emphasized that the bylaw was validly enacted, had a legitimate purpose and was adopted on a "clear day" before any dissident threat surfaced. Furthermore, there was no evidence of manipulative conduct that suggested uneven enforcement of the bylaw or a lack of good faith. The court also highlighted that the dissident stockholder's "own delay is what ultimately prevented it from satisfying the Bylaws' record holder (and, by extension, form) requirements."

Material Misstatements and Omissions

SDNY Dismisses Action Against Chinese Residential Company Involving Alleged Undisclosed COVID-19 Risks

Wandel v. Gao, No. 1:20-cv-03259 (PAC) (S.D.N.Y. Mar. 14, 2022)

Judge Paul A. Crotty granted a motion to dismiss a complaint brought by a putative class of investors against a residential rental company based in China and with operations in Wuhan. The complaint alleged that the defendants violated Sections 11, 12(a)(2) and 15 of the Securities Act by misleading investors in its initial public offering (IPO) documents about the effect of the COVID-19 pandemic, rise in renter complaints, returned upfront lender payments and changes to sales and marketing strategies.

The court found that the plaintiffs had failed to establish a Section 11 claim and that none of the alleged misstatements or omissions were actionable. The plaintiffs failed to adequately allege that the company should have been aware by January 17, 2020 — the date the company filed its offering documents — that the COVID-19 pandemic posed a material risk to the company's operations, because the court reasoned that at the time there were only a few dozen cases of illness, and a pandemic was not imminent or certain. The court further found that the plaintiffs' allegations regarding renter complaints were unfounded because the offering documents disclosed the possibility that renter complaints could harm the company's business and reputation. With respect to the plaintiffs' allegation regarding omission of returned upfront payments in the fourth quarter of 2019, the court found that, since the IPO was in January 2020, the company did not yet have the duty to report financial data from the fourth quarter of 2019. Finally, the court found that the company had no duty to disclose specific strategy and marketing changes, and that a general disclosure was sufficient. The court dismissed the plaintiffs' claims under Section 12 and 15 for the same reasons.

The court also found that the plaintiffs had also failed to establish a claim under Items 105 and 303 of Regulation S-K because they had not adequately pled that the company had actual knowledge of facts that would undergird most of the alleged omissions, and that the offering documents provided adequate risk disclosures to the extent knowledge could be inferred.

District of Colorado Dismisses Securities Fraud Action Premised on Alleged Price-Fixing Conspiracy Involving Producer of Broiler Chickens

United Food and Com. Workers Int'l Union Loc. 464A v. Pilgrim's Pride Corp., No. 20-cv-01966-RM-MEH (D. Colo. Mar. 8, 2022)

Judge Raymond P. Moore dismissed a consolidated class action complaint by a class of investors alleging that a leading producer of broiler chickens violated Sections 10(b) and 20(a) of the Securities Exchange Act by touting its financial performance while participating in an allegedly undisclosed and illegal conspiracy to fix prices and rig bids for broiler chickens.

The court found that the plaintiffs' complaint failed to adequately plead falsity. Nearly all of the alleged conduct in the complaint concerning the bid-rigging scheme preceded the class period, and the complaint lacked particularized allegations connecting the alleged conduct to any specific statements made during the class period. The plaintiffs failed to adequately allege with particularity that the alleged bid-rigging scheme had such a significant impact on the company's bottom line or was driving its success during the class period. The court further found that the plaintiffs' complaint was devoid of any statements that were materially false or misleading. While the company generally attributed its financial results during the class period to a variety of factors, including its leading market position in the chicken industry, broad product portfolio and strong customer relationships, the bulk of these statements were not actionable because they constituted vague statements of corporate optimism. Finally, the court rejected the plaintiffs' contention that defendants had a duty to disclose its bid-rigging scheme and held that absent such a duty, silence alone cannot serve as the basis for liability on a securities fraud claim.

SDNY Grants in Part and Denies in Part Motion To Dismiss Fraudulent Misrepresentation Case Against Coal Company

In re Peabody Energy Corp. Sec. Litig., No. 20-cv-8024 (PKC) (S.D.N.Y. Mar. 7, 2022)

Judge P. Kevin Castel granted in part a motion to dismiss a purported class action alleging that an energy company violated Sections 10(b) and 20(a) of the Securities Exchange Act by allegedly misleading investors about a fire at one of its most profitable coal mines. The plaintiffs alleged that the company made false or misleading statements or omissions about its commitment to safety and the fire that occurred at one of its coal mines as well as the timeline for the mine's recovery.

The court found that the complaint plausibly alleged that statements made between September 22, 2018, when smoke was first seen "billowing from the mine" through September 28, 2018, when the coal company disclosed that a fire was ongoing at the mine, contained misstatements or omissions of material fact because they failed to disclose the fact that the mine was actually or likely on fire as of September 22, 2018. The court concluded, however, that statements made before smoke was visible were mere "vague expressions of enthusiasm or puffery" and, to the extent that they included specific data points, those data points were truthfully disclosed. Similarly, the court found that after the fire was disclosed, the allegedly false statements were nonactionable forward-looking statements or opinions. Accordingly, the court dismissed all claims except as they related to alleged misstatements from the period between September 22, 2018, and September 28, 2018.

Mergers and Acquisitions Litigation

Court of Chancery Deems Delaware a 'Pro-Sandbagging' Jurisdiction

Arwood v. AW Site Servs., LLC, C.A. No. 2019-0904-JRS (Del. Ch. Mar. 24, 2022)

In a post-trial opinion, the Delaware Court of Chancery found that a seller breached a representation in an asset purchase agreement, despite the seller's so-called "sandbagging" defense based on a buyer's extensive due diligence. The court awarded $3.9 million in damages for breach of contract but dismissed the buyer's fraud and fraudulent inducement claims.

The dispute arose from a buyer's acquisition of waste disposal businesses (collectively, Arwood Waste) built by the "alarmingly unsophisticated businessman," John Arwood. Arwood Waste did not keep any formal financials, had no official accounting system in place and used cash accounting. Because Arwood had not valued his businesses, he granted the buyer "unfettered access" to the businesses' raw financial and other records, including his personal finances, so that the buyer could value the businesses. The buyer conducted six months of extensive due diligence, and the transaction was memorialized in an asset purchase agreement (APA). Post-closing, profits were materially lower than the buyer had anticipated. The buyer concluded that Arwood Waste's preacquisition practices, including overbilling customers, charging mechanic's lien fees for unwarranted liens and failing to pay haulers, inflated revenue and decreased reported costs. As a result, the parties' relationship soured and the buyer refused to release any of the acquisition consideration that remained in escrow to Arwood.

Arwood filed suit in the Court of Chancery seeking specific performance of the APA and release of the escrow funds. The buyer counterclaimed, alleging, *inter alia*, fraud, fraudulent inducement and breach of contract. In analyzing the fraud claims, the court focused on the "unique and extensive level of access" Arwood granted the buyer during due diligence, the discrepancy in the parties' sophistication and Arwood's intent to remain business partners with the buyer. The court concluded the buyer had not demonstrated either the requisite scienter or justifiable reliance. The buyer's claim for breach of representations and warranties in the APA, on the other hand, did not require it to prove justifiable reliance. Rather, the buyer was entitled to rely upon the accuracy of Arwood's representations.

The court then considered whether a buyer who knows at signing that a representation is false, but instead of alerting the seller consummates the transaction and seeks post-closing damages against the breach — colloquially known as "sandbagging" — may recover under Delaware law. Noting the absence of definitive guidance from the Delaware Supreme Court, the Court of Chancery observed Delaware's strong public policy favoring private ordering. Indeed, the court noted, a pro-sandbagging rule "respects the freedom of parties in commerce to strike bargains and honors and enforces those bargains." However, sandbagging is only implicated where a buyer knows at closing that a representation is false, not where a buyer should have known — or as here, where the buyer's lack of knowledge was the product of reckless indifference. Because Arwood represented in the APA that he complied with all laws while unlawfully overbilling and placing false liens, the court determined he breached the contract. As a result, the buyer was entitled to compensatory damages, subject to the contract's cap, to be paid first from the escrow fund.

Court of Chancery Finds COVID-19 Pandemic Was Not a Material Adverse Effect and That Target's Responses to Pandemic Did Not Excuse Buyer From Closing

Level 4 Yoga, LLC v. CorePower Yoga, LLC, C.A. No. 2020-0249-JRS (Del. Ch. Mar. 1, 2022)

In a post-trial opinion, the Delaware Court of Chancery ordered a buyer to comply with an asset purchase agreement, ruling that the COVID-19 pandemic did not constitute a material adverse effect (MAE) under the agreement and that the target's responses to the pandemic did not breach a covenant to conduct the business in the ordinary course. In addition to ordering specific performance, the court awarded compensatory damages and prejudgment interest.

In May 2019, CorePower Yoga, LLC and CorePower Yoga Franchising, LLC (together, CorePower) exercised a preexisting contractual "call option" to require one of its franchisees, Level 4 Yoga, LLC (Level 4), to sell CorePower all of Level 4's assets, comprised mainly of yoga studios. The parties executed an asset purchase agreement (APA), under which CorePower's acquisition of Level 4's yoga studios would occur in tranches, with the first to close on April 1, 2020. However, in March 2020, as the closing date approached, businesses throughout the country began to shut down in an effort to stop the spread of COVID-19. Indeed, on March 15, 2020, CorePower instructed all of its franchisees, including Level 4, to close temporarily for two weeks. Level 4 closed its studios as directed. A few days later, CorePower alerted Level 4 that it believed that, because of the closures, Level 4 was not operating in the "ordinary course of business," as required under the APA. As a result, CorePower would not close the transaction.

On April 2, 2020, Level 4 filed suit in the Court of Chancery, alleging that CorePower failed to perform under the APA, seeking specific performance that would compel CorePower to close on all of the Level 4 yoga studios per the APA. The court began its analysis with the parties' presigning relationship, because "more so than usual" it influenced the timing and structure of the APA. Notably, the franchisor/franchisee relationship between CorePower and Level 4 was marked by CorePower's exercise of the call option. Level 4 had not been "looking to sell." Moreover, under the parties' franchise agreement, CorePower had the contractual right to direct how Level 4 operated its business pre- and post-signing.

Turning to the language of the contract, the court observed there were no conditions to closing or express rights to terminate, and the APA was effectively a "'one-way gate' through which the parties would pass on their way to inevitable closings." The court next rejected CorePower's argument that its performance was excused under common law because Level 4 materially breached the APA. The court found that Level 4's pandemic response practices did not breach the Ordinary Course Covenant because Level 4's operation of its CorePower-branded studios was almost entirely dictated by CorePower's system standard. It was CorePower that ordered the practices it now complained of. The court stated that "following the direction of the franchisor was entirely ordinary and consistent with past practice." In rejecting CorePower's MAE argument, the court noted that the appropriate time period to determine whether there was an MAE was at the time CorePower decided not to close. When CorePower walked away from the acquisition, its own words and actions indicated that on the date of the first closing it did not believe the COVID-19 pandemic would persist for any durationally significant period.

PSLRA

Northern District of Illinois Grants Motion for Reconsideration, Clarifying Prongs of PSLRA Safe Harbor Provision

Washtenaw Cnty. Emps. Ret. Sys. v. Walgreen Co., No. 15-cv-3187 (N.D. Ill. Mar. 2, 2022)

Judge Sharon Johnson Coleman granted Walgreens' motion for reconsideration of the court's order, denying in part Walgreens' motion for summary judgment. In the motion to reconsider, Walgreens contended that the court's initial summary judgment ruling erroneously conflated two independent prongs of the Private Securities Litigation Reform Act (PSLRA) safe harbor provision in finding that a statement by Walgreens' CFO was not protected by the PSLRA safe harbor. The court agreed, granted the motion to reconsider and entered summary judgment for Walgreens.

The plaintiffs brought a class action against Walgreens and two of its former officers alleging violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The claims concerned statements made by Walgreens on the impact of generic drug price inflation and reimbursement expenses on Walgreens' long-term financial targets in its merger with Boots Alliance GmbH. At issue in the motion for reconsideration were forward-looking statements made by Walgreens' former CFO, Wade Miquelon, during a May 2014 investor meeting. Following that meeting, Goldman Sachs issued an analyst report summarizing Miquelon's optimistic projections for fiscal year 2016 financial targets, including that Walgreens' adjusted earnings before interest and taxes (EBIT) target was still achievable.

At summary judgment, the court found that there was a triable issue of fact as to whether Walgreens or Mr. Miquelon knew the company could not meet its fiscal year 2016 EBIT goal when Miquelon made the May 2014 statements. Walgreens moved for reconsideration in part, arguing that by reaching the question of Mr. Miquelon's knowledge, the court improperly conflated the two independent prongs of the PSLRA's safe harbor provision. The first prong protects forward-looking statements accompanied by meaningful cautionary statements that identify factors that could cause actual results to differ from the forward-looking statement. The second prong protects forward-looking statements made without actual knowledge that the statement was false or misleading. According to Walgreens, there was no need to reach the second prong because Mr. Miquelon's statements were accompanied by meaningful cautionary language and thus protected under the first prong.

On reconsideration, the court agreed with Walgreens that if Mr. Miquelon's May 2014 statements were accompanied by meaningful cautionary statements, Mr. Miquelon's knowledge was irrelevant. The court then considered SEC filings made by Walgreens in 2014 to determine if they contained meaningful cautionary statements. The court found several risk factors identified in the filings, including statements regarding the risk of reduction in reimbursement levels and rates, the possibility that the Boots Alliance merger's anticipated benefits would not be realized and that changes in drug prices could affect the company's financial performance. Accordingly, the court found that Mr. Miquelon's May 2014 statements were accompanied by meaningful cautionary language, placing them within the first prong of the PSLRA safe harbor provision. The court granted the defendants' motion for reconsideration and entered summary judgment for Walgreens.

Securities Fraud Pleading Standards

Misrepresentations

Ninth Circuit Affirms Dismissal for Failure To Adequately Plead a False or Misleading Statement

Weston Family P'ship v. Twitter, Inc., No. 20-17465 (9th Cir. Mar. 23, 2022)

The Ninth Circuit affirmed the dismissal of securities fraud claims brought against Twitter and certain of its officers based on allegedly misleading statements about an advertising initiative, holding that the company was not under an obligation to provide real-time updates on a software issue and that temporal proximity is not sufficient to meet the particularity requirement of securities fraud.

Twitter's Mobile App Promotion (MAP) product allows advertisers to prompt users to download advertisers' apps onto the users' phones and tablets. Twitter relies on user data to make the MAP program effective and help connect users with advertisers' apps that the user may be interested in. Although MAP is a significant source of revenue for Twitter, the company allows any user to opt out of sharing their personal data with advertisers.

In May 2019, Twitter announced that it had discovered software bugs that led to some of its users' data being shared with the wrong advertisers, but that it had fixed the issue. On August 6, 2019, Twitter published in a web post that it had recently discovered "issues where [Twitter's] setting choices may not have worked as intended[,]" but that the company "fixed these issues on August 5, 2019." In order to protect user privacy, Twitter stopped sharing user data with the MAP advertising program altogether.

In its next quarterly earnings report, Twitter disclosed the software bugs in the MAP program that had led to the then-resolved privacy issues. Five days after disclosing the MAP bugs, the plaintiffs — purported shareholders of Twitter — filed a putative securities fraud class action alleging that Twitter knew about the MAP bugs earlier, and that failing to disclose them rendered statements in its July quarterly report and its announcement in August that it had "fixed" the issue misleading. The district court dismissed the action, finding that the plaintiffs failed to adequately plead (i) a material misstatement or (ii) facts giving rise to a strong inference of scienter.

The Ninth Circuit affirmed, concluding that the plaintiffs failed to adequately plead that Twitter's statements were false or misleading. The panel held that companies do not have an obligation to offer an instantaneous update of every internal development, especially when it involves the "oft-tortuous path of product development." A company must disclose a negative internal development only if its omission would make other statements materially misleading, and there were none in this case. The panel further explained that the plaintiffs did not adequately allege that the company knew of the bug in July when some of Twitter's supposedly misleading statements were made. The plaintiffs argued that because Twitter disclosed the bug in August, it must have known about it in July. The panel rejected this reasoning, holding that temporal proximity alone does not satisfy the particularity requirements for pleading securities fraud. Moreover, Twitter's claim that it had fixed the issue would be read by an ordinary investor to address the privacy issue rather than the software issue.

Second Circuit Affirms Dismissal of Investor Suit Against Automobile Manufacturer for Failure To Plead Material Misstatements or Omissions

Mucha v. Volkswagen Aktiengesellschaft, No. 21-1511-cv (2d Cir. Mar. 15, 2022)

The Second Circuit affirmed the dismissal of a lawsuit brought by two investors against an automobile manufacturer. The lawsuit had alleged that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false or misleading statements about their allegedly unlawful coordination with other automobile manufacturers in Europe to limit innovation and align on commodities pricing.

The court found that the plaintiffs' allegations did not sufficiently allege a material misstatement or omission. Although the amended complaint repeatedly alleged the company's "illegal collusive activities," it did not allege with particularity how the defendants' conduct was allegedly illegal nor the manner in which this supposedly unlawful conduct occurred. To the extent that the amended complaint alleged that the company's statements were rendered false or misleading because the company engaged in anticompetitive conduct, it still failed to meet the heightened pleading standards of Rule 9(b) and the PSLRA. Generalized allegations referencing investigations by European authorities, the use of working groups and agreements regarding certain technical standards were insufficient. The court found that the plaintiffs failed to allege with sufficient particularity how the working groups facilitated the larger cartel that the plaintiffs asserted existed or what was agreed to in the working groups, and whether and how the companies' allegedly collusive conduct affected trade.

Second Circuit Upholds Dismissal of Securities Fraud Claim Against Pharmaceutical Company for Failure To Allege Material Misstatement or Omission

Arkansas Pub. Emps. Ret. Sys. v. Bristol-Myers Squibb Co., No. 20-3716-cv (2d Cir. Mar. 11, 2022)

The Second Circuit affirmed the dismissal of claims brought by a putative class of investors against a pharmaceutical company under Sections 10(b) and 20(a) of the Securities Exchange Act, alleging that the company made misleading statements about a failed clinical trial targeting a specific type of lung cancer. The plaintiffs alleged that the company obscured the risk of the clinical trial failing by allegedly not disclosing the threshold of PD-L1 expression — that is, the percentage of cancer cells containing the protein PD-L1 — targeted by the study and misrepresenting that the study focused on patients who "strongly" expressed PD-L1 when the study targeted a patient population with PD-L1 expression of at least 5%.

The court rejected the plaintiffs' allegations that the defendants' descriptions of the clinical trial were misleading because throughout the class period there was no general understanding on what constituted "strong" expression that would have contradicted the company's use of the term to mean 5%. The court further held that the plaintiffs failed to adequately allege facts suggesting that the company had any duty to disclose the precise expression threshold, and the company warned investors that it would not make that disclosure. Further, statements describing the trial as a study designed with "great care" and one that the company had "great confidence" in were not actionable because they were forward-looking statements predicting the trial's success and were accompanied by meaningful cautionary statements. The court also noted that the company fully disclosed the risk that the trial may fail and negatively impact the company.

The court further determined that the plaintiffs failed to allege a strong inference of scienter. The court found that the company did not act recklessly or with intent in disregarding the industry's consensus definition of strong PD-L1 expression because the complaint failed to allege that any such industry understanding existed. The plaintiffs' remaining scienter allegations, including stock sales by company executives and the departure of two-high level executives, were unavailing and insufficient.

Northern District of California Grants in Part and Denies in Part Motion To Dismiss Securities Fraud Action Over 'End-to-End Encryption'

In re Zoom Sec. Litig., No. 20-cv-02353-JD (N.D. Cal. Feb. 16, 2022)

Judge James Donato granted in part and denied in part a motion to dismiss securities fraud claims brought against Zoom Video Communications Inc. (Zoom) and several of its officers because Zoom did not allegedly offer "end-to-end encryption" within the most commonly accepted meaning of the term when a registration statement may have suggested otherwise.

On April 18, 2019, Zoom issued a registration statement and prospectus that read: "[w]e offer robust security capabilities, including end-to-end encryption[.]" The plaintiffs alleged that this statement was false because, in the plaintiffs' view, "end-to-end encryption" means that not even Zoom could access the cryptographic keys necessary to decrypt the end users' communications, but here the company maintained secret access to cryptographic keys such that Zoom could theoretically decrypt end users' communications if it chose to do so. On April 1, 2020, Zoom CEO Eric Yuan published a message to users, which linked to another officer's post stating, "[w]hile we never intended to deceive any of our customers, we recognize that there is a discrepancy between the commonly accepted definition of end-to-end encryption and how we were using it." The plaintiffs later sued for securities fraud.

The court denied the defendants' motion to dismiss claims against the CEO for the statement made in the April 18 registration statement, which he signed. On the allegation of falsity, the court found that the April 1 post conceded that the registration statement had incorrectly suggested Zoom meetings were capable of "end-to-end encryption" within the most common meaning of the term. On scienter, the court noted that the facts pled by the plaintiffs, if true, allowed for an inference of scienter, in part because of Mr. Yuan's impressive credentials: He holds an advanced degree in engineering, was a founding engineer at the videoconferencing platform WebEx and is named on several patents concerning encryption.

The court granted the motion to dismiss for all other statements challenged by the plaintiffs because the only identified speakers were "Zoom" or "Defendants." Thus, the complaint failed to allege the individual scienter necessary for securities fraud.

Scienter

Sixth Circuit Reverses in Part District Court's Dismissal of Securities Fraud Case, Finding Court Erred on Materiality and Scienter Determinations

City of Taylor Gen. Emps. Ret. Sys. v. Astec Indus., Inc.,
No. 21-5602 (6th Cir. Mar. 31, 2022)

The Sixth Circuit reversed in part a district court's dismissal of a class action lawsuit brought by a putative class of investors against Astec Industries Inc., an industrial equipment manufacturer of wood pellet-producing plants. The plaintiffs sued the company, its CEO and two other executives alleging, in part, violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. Pertinent to the case were Astec's product sales to two plants, which tied certain financial obligations to the plants' performance. Both plants faced production issues and failed to perform. The plaintiffs alleged that the defendants made fraudulent statements that the plants were progressing well and failed to provide fair disclosure of the negative financial consequences of the plants' failure to meet production benchmarks. The district court dismissed the complaint, holding that the plaintiffs failed to identify with specificity why the alleged statements were misleading and to plead facts sufficient to raise a strong inference that any defendant acted with the necessary scienter.

On appeal, the Sixth Circuit disagreed with the district court's findings on the elements of materiality and scienter as to Astec and its CEO, and reversed the dismissal of claims against those defendants. On materiality, the Sixth Circuit determined that the plaintiffs sufficiently pled fraudulent statements because the complaint answered the who, what, when and where questions about the statements and described why they were misleading. For example, the court noted that the plaintiffs identified specific statements from the CEO on a conference call about the plants' progress and explained why they believed the statements were misleading. In short, the court found that the plaintiffs' complaint contained a clear theory of liability — that the defendants painted a glowing picture of Astec's performance that failed to disclose the negative financial consequences of the plants' failures to meet certain obligations — and that dismissal based on failure to adequately plead a material misstatement or omission was in error.

The Sixth Circuit then assessed the district court's findings on scienter for Astec's CEO, another executive and the company. The court found that the complaint established a strong inference that the CEO recklessly misled Astec's investors because he made misleading statements, knew about issues at the plants and sold his own stock at a suspicious time. In particular, though the CEO was the main spokesperson to investors and talked to plant managers about their issues every week, the plaintiffs alleged that his statements did not disclose these problems but continued to channel "relentless, unfounded optimism that was contradicted by the undisclosed facts." In addition, the court noted the plaintiffs' allegation that the CEO sold over $3 million of stock shortly after he toured one of the plants and shortly before Astec first disclosed the full details of one of the unfavorable financial provisions in a major company contract. The Sixth Circuit concluded the district court erred in dismissing the Section 10(b) claims against the CEO. As to the other executive for which the plaintiffs preserved their appeal, the Sixth Circuit affirmed the district court's dismissal because, unlike for the CEO, the plaintiffs did not allege that the executive received internal reports contradicting his public statements, engaged in suspicious trading or disregarded known facts. Because the Sixth Circuit found the requisite scienter existed as to the CEO, it held Astec had the requisite state of mind by imputation, and the plaintiffs' claims against the company also should have survived the motion to dismiss.

SDNY Rejects CFO's Motion To Dismiss SEC's Securities Fraud Claims

SEC v. MiMedx Grp., No. 19 Civ. 10927 (NRB) (S.D.N.Y. Mar. 28, 2022)

Judge Naomi Reice Buchwald denied a motion to dismiss the SEC's claims against a former CFO of a biotechnology company. The SEC alleged that the company and certain of its officers violated Sections 17(a), 13(a), 13(b)(5), 10(b) and 20(a) of the Securities Exchange Act by improperly recognizing revenue and causing the company's financial statements to be materially misstated from 2013 through 2017.

The court determined that the SEC adequately pled scienter. Although the CFO argued that he did not supervise the accounting group that allegedly created false distribution agreements to inflate the company's revenue, the court found that the CFO received numerous emails with the company's daily purchase order totals and weekly revenue, which supported the inference that he was aware that the company's financial statements were false. The court further reasoned that an individual in the defendant's position — a CFO of a company — who received weekly revenue reports would have been aware that the company's payment structures with certain distributors were running afoul of the agreements with certain distributors.

The court also rejected the argument that the company's financial statements were not materially false and did not contain any material misstatements. The court reasoned that, following the company's disclosure of its improper revenue recognition practices, the company's stock price fell 73%, which indicated that investors found such information to be significant. Finally, the court rejected the CFO's argument that his statements regarding the company's financial results were nonactionable opinion, finding it to be "borderline risible." The court stated that the statements about the company's reported revenue were not matters of opinion and represented "historical income metrics that [did] not involve any inherently subjective valuations."

EDNY Dismisses, in Part, Complaint Alleging Fraud Against Clinical Lab Testing Company for Failure To Plead Scienter

In re Chembio Diagnostics, Inc. Sec. Litig., No. 20-CV-2706 (ARR) (PK) (E.D.N.Y. Feb. 23, 2022)

Judge Allyne R. Ross dismissed, in part, a consolidated class action lawsuit alleging violations of Sections 11, 12 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Securities Exchange Act against a diagnostic lab testing company and the underwriters of the company's secondary stock offering. The plaintiffs alleged that the company misrepresented the efficacy of its COVID-19 single-use antibody test ahead of its secondary offering in May 2020. In June 2020, the Food and Drug Administration (FDA) withdrew the company's emergency use authorization for the COVID-19 test, based in part on independent testing that suggested the test was not as effective as advertised.

The court found that the plaintiffs failed to plead scienter against the company. Generalized allegations of a desire to raise the company's stock price or increase media exposure was insufficient to plead a motive to commit fraud. The plaintiffs also failed to plead that the company had sufficient knowledge of contradictory facts to plead recklessness. Even assuming that the company knew that its COVID-19 test was not 100% accurate, the court found the plaintiffs failed to adequately plead facts permitting an inference that the company knew, or was reckless in failing to warn, that the FDA would revoke the test's emergency authorization. The plaintiffs also failed to plead that the company knew about contradictory data when it made the allegedly misleading statements about the test's accuracy. The plaintiffs failed to plead corporate scienter, as the company's employees' knowledge of an increased risk that the test would be revoked was insufficient. The court also dismissed the plaintiffs' Section 11 and 12 claims against the company.

The court declined, however, to dismiss the plaintiffs' Section 11 and 12 claims against the underwriters. The plaintiffs adequately alleged that the offering documents contained a material omission because the documents stated that the COVID-19 antibody test was 100% accurate after 11 days of the onset of symptoms, even though the company possessed data that indicated a lower accuracy. The court therefore concluded that the plaintiffs sufficiently pled an actionable failure to disclose under Item 105 regarding a significant risk to the company's business.

Short-Swing Liability

Ninth Circuit Affirms Dismissal of Section 16(b) Claim Under Board Approval Exception

Alpha Venture Cap. Partners v. Pourhassan, No. 21-35274 (9th Cir. Apr. 8, 2022)

The Ninth Circuit affirmed the dismissal of an action brought under Section 16(b) of the Securities Exchange Act by CytoDyn, Inc. shareholders against the company's CEO for failing to disgorge profits from a short-swing transaction, holding that the transaction was not subject to Section 16(b) because it had been approved by the company's board of directors.

Section 16(b) requires officers, directors and large shareholders to return to the company any profits they make from short-swing transactions, defined as purchasing and selling company stock within a six-month period. However, the SEC under its rulemaking authority promulgated Rule 16b-3(d)(1), which exempts from Section 16(b) any transaction where the corporate insider buys and sells the company's stock if it is approved by the company's board of directors.

In December 2019, CytoDyn's board voted to approve an award of stock options and warrants to the company's CEO, which gave the CEO the right to purchase a sizeable amount of company stock. During the relevant board meeting, a quorum of four out of five board members was present and a majority of the board (three out of four, with the CEO abstaining) voted to approve the options and warrants award.

Less than six months later, the CEO exercised the options to buy 2 million shares of company stock and sold nearly 5 million shares at a profit. Thereafter, a group of shareholders brought suit to require the CEO to disgorge to the company the profits he made from selling the shares he obtained through the 2019 option and warrant award. The shareholders argued that because the 2019 award and the subsequent sales were within six months of one another, they were short-swing transactions under Section 16(b). The district court dismissed the complaint, concluding that the transactions were proper under SEC Rule 16b-3(d)(1).

The Ninth Circuit affirmed, rejecting the plaintiffs' arguments that the CEO could not benefit from Rule 16b-3(d)(1)'s board approval exception because all five of the company's directors had not approved the options and warrants award. The panel held that nothing in the rule's text required unanimous board approval. The court instead noted that the rule is silent about what procedures must be used to obtain proper board approval. To fill this gap, the court turned to Delaware law, where CytoDyn is incorporated. Under Delaware law and the company's bylaws, a quorum of the board can take action by a majority vote, and thus there was nothing improper or inadequate about the board approval that preceded the CEO's short-swing transaction.

Statutes of Repose

SDNY Dismisses Securities Action Brought by Chinese Investor Seeking Investment Visa as Untimely

Bai v. Tegs Mgmt., LLC, No. 20cv4942 (DLC) (S.D.N.Y. Mar. 1, 2022)

Judge Denise Cote dismissed a Chinese investor's claims under Section 10(b) and 20(a) of the Securities Exchange Act against a specialty grocery store chain and his immigration lawyer arising from a $1 million visa-based investment in a U.S. company. The plaintiff was a Chinese citizen who sought to invest $1 million in a U.S.-based specialty grocery store in an effort to obtain an EB-5 immigrant investor visa. In 2013, the plaintiff executed an operating agreement with the company pursuant to which the plaintiff would receive stock in exchange for a $1 million investment. The operating agreement also included a redemption clause that permitted the plaintiff to redeem his investment if his visa petition was denied. After the plaintiff's visa petition was denied, the plaintiff alleged that the company and the lawyer engaged in a fraudulent scheme between 2013 and 2019 to obtain and retain the plaintiff's investment by sabotaging his visa petition, using the funds for other investments and preventing him from redeeming his investment.

The court found that the plaintiff's claims were time-barred under the applicable five-year statute of repose. The court reasoned that the only allegedly fraudulent statements or omissions that were also connected to the purchase or sale of a security were those made in connection with executing the operating agreement, which occurred in 2013, more than five years before the complaint was filed in 2020. The court also rejected the plaintiff's argument that the alleged fraudulent scheme tolled the statute of repose until 2019, when the last fraudulent act of the scheme allegedly occurred. The court reasoned that the material omission regarding how the government would treat the redemption clause in the operating agreement in adjudicating the visa occurred in 2013, when the agreement was executed; the company's silence in future years about the risk of the redemption clause did not operate to extend the statute of repose.

Inside the Courts
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