Skadden

Inside the Courts

A Quarterly Update From Skadden Securities Litigators

Trends and Filings That Matter

Spotlight

As Markets Grow More Volatile, Securities Class Action Filings Likely To Remain High

Key Points

- As the number of 2022 securities class action filings seems likely to track the 2021 total, plaintiffs are focusing on several areas and shifting away from others in ways that may shape securities litigation in the coming year.
- Securities Act litigation remains at decreased levels in state courts as they continue upholding federal forum provisions.
- SPAC- and cryptocurrency-related filings remain elevated.
- Merger objection class actions have declined as plaintiffs pivot toward individual actions.

Cornerstone Research reports that during the first six months of 2022, plaintiffs filed 110 securities class actions, a pace that is generally in line — 2.8% higher — with what we saw in the second half of 2021. Looking behind the numbers, plaintiffs are focusing their efforts in several areas while shifting away from others, in ways that are likely to shape securities litigation in the coming year.

State Courts Continue To Uphold Federal Forum Provisions, Further Diminishing Impact of *Cyan*

Plaintiffs filed a combined 22 federal and state Securities Act claims in the first half of 2022. State filings remain low and are now roughly one quarter of their 2019 levels.

This decline in state court filings suggests that the Delaware Supreme Court's endorsement of federal forum provisions (FFPs) in the 2020 *Sciabacucchi* decision is having its anticipated effect by persuading more corporations to add these clauses to their corporate charters or bylaws, thereby steering Securities Act cases away from state courts.

Trial courts in New York (*Hook v. Casa Sys., Inc.*) and Utah (*Volonte v. Domo, Inc.*) joined California and Delaware in approving FFPs. In May 2022, the first appellate court outside of Delaware — the California Court of Appeal — added to this string of victories by enforcing an FFP in *Wong v. Restoration Robotics*.

In practical terms, these rulings may weaken the effect of *Cyan, Inc. v. Beaver Cnty. Emps. Ret. Fund*, the U.S. Supreme Court decision that affirmed the right of state courts to hear Securities Act class actions and foreclosed defendants from removing such cases to federal court.

Because New York and California state courts are popular jurisdictions for Securities Act claims, corporations could be well positioned to avoid these courts by including FFPs in their charters, provided that doing so is otherwise viable and appropriate. That said, because FFPs have not been universally adopted, we expect state court Securities Act litigation to continue, though at lower levels than in previous years.

SPAC-Related Filings Remain Elevated as Courts Begin To Rule on Motions To Dismiss

SPAC-related filings for the year are on track to surpass the number of filings in 2021. While the market for SPAC IPOs has cooled, litigation is likely to persist due to the record numbers of SPAC IPOs and de-SPAC transactions conducted in 2021 and early 2022.

Nearly 500 SPACs are still searching for acquisition partners. These searches, if successful, will likely attract scrutiny as they move toward closing and beyond. In addition, Cornerstone recently observed that the median lag time between when a de-SPAC transaction takes place and when litigation ensues is long — 240 days. Given the large number of deals completed in 2021, this figure points to a pipeline of cases that may not dry up anytime soon.

In 2022, courts also started deciding SPAC-related motions to dismiss. So far, the results have been mixed. While it is too early to detect trend lines or draw definitive conclusions, several complaints involving claims under Section 10(b) of the Exchange Act have partially survived motions to dismiss — a result that may encourage plaintiffs to keep filing these lawsuits. At the same time, courts in these cases have rejected most of the alleged misstatements and omissions, leaving only a handful for further litigation.

Additionally, courts in several actions dismissed claims against SPAC officers and directors for lack of scienter. In *In re Stable Rd. Acquisition Corp.*, for instance, the court rejected claims against three out of four SPAC directors and officers, holding that the plaintiffs had failed to sufficiently plead the defendants' knowledge of — or reckless disregard for — information contradicting the target's public statements. The plaintiffs had argued that harmful information about the target should have been uncovered by the individual defendants through the due diligence process. The court, however, found that such generalized allegations could not support the strong inference of scienter demanded by the Private Securities Litigation Reform Act of 1995 (PSLRA).

We hope to gain more visibility into how courts are treating these and other SPAC-related allegations as more motions to dismiss are decided.

Cryptocurrency Remains Area of Focus

Cornerstone reports that cryptocurrency-related filings are on pace to exceed 2021 totals due to increased regulatory oversight and recent turmoil in the digital assets market. Suits against cryptocurrency exchanges in particular are up significantly. Since the start of 2020, almost half of all cryptocurrency-related class action filings have included claims against exchanges. This stands in contrast to filing activity between 2016 and 2019, when less than 10% of all cryptocurrency actions included exchange-related allegations.

On the case law front, the question of extraterritoriality — whether a plaintiff's transactions are domestic and therefore subject to U.S. securities laws — has been an area of focus. In a recent case involving the cryptocurrency platform Binance, Judge Andrew Carter of the Southern District of New York granted the defendants' motion to dismiss after concluding that the plaintiffs had failed to plead an adequate connection to the U.S., as required by the Supreme Court's decision in *Morrison v. Nat'l Australia Bank Ltd*.

In another recent ruling involving blockchain software developer Block.one, Judge Lewis Kaplan of the Southern District of New York rejected the plaintiffs' theory that the location of the token purchaser in the U.S. is dispositive under *Morrison*. Consistent with the holding in *Anderson v. Binance*, Judge Kaplan observed that such a theory "arguably is at odds with Second Circuit cases holding that the purchaser's location is not determinative."

How to apply *Morrison* to digital asset transactions is a novel and emerging issue, full of nuance and complexity, and highly dependent on the facts of each case. As a result, we expect it will remain a battleground for plaintiffs and defendants in the year to come.

Also on the case law front, the application of the so-called *Howey* test remains a developing area. In a recent ruling in *Audet v. Fraser*, Judge Michael Shea of the District of Connecticut reviewed the first-ever jury verdict that considered whether cryptocurrencies were securities. Notably, with respect to assets called "Hashlets," which allegedly represented shares in profits from the defendants' computing power, Judge Shea concluded that the jury's verdict (*i.e.*, that Hashlets were not securities under *Howey*) was not against the weight of the evidence due to a lack of a common enterprise or an expectation of profits based on the efforts of others.

In another first-of-its-kind case, the SEC filed a complaint in *SEC v. Wahi*, asserting insider trading claims against a Coinbase product manager, his brother and his friend. In doing so, the SEC alleged that nine of the digital assets that the defendants purchased and sold were securities under *Howey*. At the same time, a concurrent Department of Justice (DOJ) indictment alleged that the same defendants engaged in insider trading with respect to 25 digital assets. Additionally, the SEC's analysis regarding those nine digitals assets has left open numerous questions regarding how the SEC makes its determinations under the *Howey* framework.

Merger Objection Class Actions Decline as Plaintiffs Pivot Toward Filing Individual Actions

Merger objection cases have continued to decline in 2022, with only five actions filed during the first half of the year. This trend aligns with a decrease that we first observed in 2020. According to Cornerstone, federal M&A class action filings are now at less than 3% of their 2017 peak.

These figures do not tell the whole story, though. Merger objection litigation has not simply vanished. Instead, a select group of plaintiffs' firms are filing disclosure challenges in federal court as individual, rather than class, actions.

As an example, our analysis of PACER data shows that in 2022 alone, one repeat plaintiff, represented by the same law firm, has filed at least 21 individual merger objection actions in federal court. So far, 12 of these cases have been voluntarily dismissed — a sign that plaintiffs' counsel may have procured a so-called mootness fee in exchange for the company making supplemental disclosures in its proxy statement.

There are anecdotal reports that some defendants have pushed back, refusing to pay this "deal tax." That is what happened earlier this year in a legal challenge involving Microsoft's $19.7 billion acquisition of Nuance Communications. The defendant, Nuance, mooted the plaintiff's allegations by filing supplemental disclosures and rejecting counsel's $250,000 fee demand, forcing the plaintiff to seek relief from the court. In February 2022, Judge Paul Oetken of the Southern District of New York denied the application, holding that the disclosures were immaterial and had not conferred a "substantial benefit" on Nuance's shareholders.

Rulings like this may persuade more defendants to resist fee demands, but we consider it unlikely that such demands will be curbed in any meaningful way without legislative reform.

COVID-19

Biopharmaceutical Company Secures Dismissal of Claims Alleging COVID-19 Vaccine Trial Misstatements

In re AstraZeneca PLC Sec. Litig. (S.D.N.Y. Sept. 12, 2022)

What to know: The Southern District of New York dismissed securities fraud claims against a global biopharmaceutical company based on alleged misleading statements about its COVID-19 vaccine clinical trials, holding that the complaint did not adequately allege a misrepresentation or omission, or a strong inference of scienter.

Judge Paul Oetken dismissed a putative class action complaint alleging that a global biopharmaceutical company and certain of its executives violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder. The plaintiffs alleged that the company made misstatements and omissions concerning clinical trials of its COVID-19 vaccine.

With respect to the plaintiffs' allegations that information was omitted regarding the dosages used in the trials, the court determined that the plaintiffs failed to identify "any inaccurate, misleading, or incomplete statement" relating to vaccine dosage, but rather "identified only accurate statements describing the launch and historical progression of the … clinical trials." The court also held that various general statements were nonactionable puffery, including statements that the company was "moving quickly but without cutting corners," the clinical trial was "on track" and the company would "follow the science" and "put patients first." Finally, the court determined that the plaintiffs' allegation that the company failed to disclose that the vaccine was unlikely to receive regulatory approval in the near term was not actionable under the PSLRA's safe harbor provision for forward-looking statements.

The court additionally held that the plaintiffs failed to adequately allege a strong inference of scienter. The plaintiffs did not allege the required "concrete and personal benefit" from the alleged misrepresentations, as the only motives identified — such as increasing the stock price to facilitate the acquisition of another company — were insufficient and "common to most corporate officers." The court also rejected the plaintiffs' argument for scienter based on a theory of "strong circumstantial evidence of conscious misbehavior or recklessness." The plaintiffs did not adequately allege the company's access to any contrary omitted facts, and the company had disclosed facts that were contained in a Food and Drug Administration (FDA) report, which undermined an inference of scienter. The alleged failure to disclose certain trial data for which there was "room for disagreement" over the impact of that data on the trial also failed to support scienter.

Cybersecurity

Court of Chancery Holds Breach of Fiduciary Duty Claim Following Cyberattack Failed To Allege Facts Supporting Bad Faith

Constr. Indus. Laborers Pension Fund v. Bingle (Del. Ch. Sept. 6, 2022)

What to know: The Delaware Court of Chancery dismissed a breach of fiduciary duty claim against the board of an information technology company premised on an alleged lack of oversight relating to a cybersecurity attack, holding that the complaint failed to allege particularized facts supporting an inference that a majority of the directors acted in bad faith.

The Delaware Court of Chancery held that a breach of fiduciary duty claim failed to produce facts supporting bad faith from SolarWinds' board after the company's product underwent a cyberattack. SolarWinds is a provider of information technology infrastructure management software. SolarWinds' main product, Orion Platform, was the target of a cyberattack known as the "Sunburst Attack." The attack hid malicious code in SolarWinds' Orion software and used it to gain entry to the company's clients' systems, which allowed for extraction of proprietary information, confidential emails and intellectual property. In all, up to 18,000 of SolarWinds' clients were affected, and the company's stock suffered losses of 40%.

The sole count in the complaint was a derivative claim for breach of fiduciary duty premised on the board's alleged failure to oversee SolarWinds' cybersecurity, a so-called *Caremark* claim. Considering whether demand on the SolarWinds' board was excused because a majority of the directors faced a substantial likelihood of liability with respect to the *Caremark* claim, the court noted that the plaintiff had not alleged a violation of positive law by the company due to the board's action or inaction. Rather, the plaintiff alleged a failure to oversee risks related to efforts to avoid cybercrime by third parties (*i.e.*, a business risk). For this reason, the court stated that it was not wholly clear that a cybersecurity incident involving crime by a malicious third party provided a sufficient nexus between the corporate trauma and the board to impose liability for corporate harm. The court concluded that, in any event, it could resolve the motion to dismiss based on a traditional analysis of the two prongs of the *Caremark* standard.

Assessing the plaintiff's allegations under the two prongs, the court considered whether the directors demonstrated a conscious disregard for their duties by intentionally failing to act in the face of a known duty to act either by (i) utterly failing to put into place a mechanism for monitoring or reporting risk or (ii) ignoring red flags "so vibrant that scienter is implied." Beginning with the second prong, the court rejected that the plaintiff's proffered red flags supported a reasonable inference of bad faith because the purported red flags were either conclusory pled or were not alleged to have been brought to the board's attention, meaning the board lacked the knowledge necessary to have acted in bad faith.

With respect to the first prong, the court held that it could not infer bad faith based solely on the plaintiff's allegations that neither of the board subcommittees responsible for cybersecurity oversight had made a report to the full board in approximately two years. The court concluded that "a subpar reporting system between a Board subcommittee and the fuller Board is not equivalent to an utter failure to attempt to assure that a reporting system exists" and that "[w]ithout a pleading about the Committees' awareness of a particular threat, or understanding of actions the Board should take, the passage of time alone under these particular facts does not implicate bad faith."

Fintech

Southern District of Florida Upholds Market Manipulation Claims in Securities Fraud Action

In re Jan. 2021 Short Squeeze Trading Litig. (S.D. Fla. Aug. 11, 2022)

What to know: The Southern District of Florida granted in part and denied in part a motion to dismiss securities fraud claims brought against a digital brokerage platform alleging the company manipulated prices in violation of the Exchange Act.

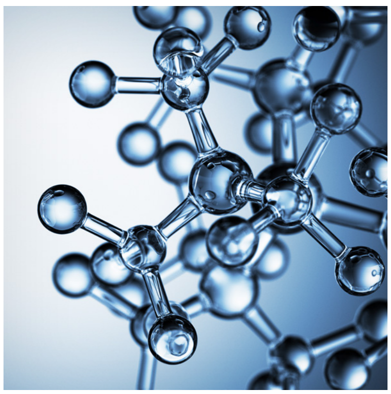
Judge Cecilia M. Altonaga of the Southern District of Florida granted in part and denied in part a motion to dismiss securities fraud claims alleging digital brokerage platform Robinhood manipulated prices in violation of Sections 9(a) and 10(b) of the Exchange Act. In 2013, Robinhood debuted an application-based retail trading platform that utilized a payment for order flow (PFOF) compensation model. In a PFOF-based system, investors bid on securities through a brokerage platform that places bids with a market maker rather than an exchange. Brokerage platforms utilizing PFOF models like Robinhood are required to post collateral for orders, which vary based on volatility, to the National Securities Clearing Corporation (NSCC).

Between 2020 and 2021, Robinhood experienced six weeks of volatile trading caused by investors purchasing stocks to try and boost the stock's price in order to force short sellers — investors attempting to sell borrowed stocks back to the market at a discount — to sell at now-inflated prices. On January 28, 2021, the NSCC demanded $3.7 billion from Robinhood as collateral for unsettled orders. Robinhood lacked the liquidity to satisfy this request, so it disabled purchase orders for eight affected stocks, triggering a price decline. It then released a statement attributing the pause to "recent volatility" without mentioning that existing options had been closed out and orders placed after January 27 had been cancelled. That same day, Robinhood's CEO made a press appearance denying the existence of a "liquidity problem."

Shareholders of affected stocks subsequently filed claims alleging the company had manipulated prices in violation of Sections 9(a) and 10(b) of the Exchange Act. In particular, the plaintiffs argued Robinhood violated Section 9(a)(2) by artificially depressing the stocks' prices; Section 9(a)(4) by misstating or omitting material facts about its liquidity; and Section 10(b) by raising margin requirements, cancelling purchase orders, closing out options and restricting stock purchases on its platform.

The court dismissed the Section 9(a)(4) claim, holding Robinhood's statements about its liquidity were not actionable because they addressed the financial well-being of a private company, not a publicly traded security. The court denied the motion to dismiss as to the Section 9(a)(2) claim, holding the company's alleged misstatements regarding cancelled purchase orders may be circumstantial evidence of its scienter. The court also denied the motion as to the Section 10(b) claim, concluding the company's alleged restriction of stock purchases could constitute market manipulation.

Health Care and Life Sciences



Sixth Circuit Affirms Dismissal of Securities Fraud Action for Failure To Plead Falsity

Plymouth Cnty. Ret. Ass'n v. ViewRay, Inc. (6th Cir. Sept. 1, 2022)

What to know: The Sixth Circuit affirmed the dismissal of securities fraud claims against a medical technology company and its officers that challenged the company's calculation of a backlog to estimate future revenue on orders received but not yet completed or paid.

The Sixth Circuit affirmed the dismissal of a putative securities fraud class action against the defendants — a medical device company and its officers — for failure to meet the heightened pleading burden under the PSLRA. The plaintiffs' fraud claims related to a "backlog" that the medical device company used to track orders of its MRIdian machines, which image and treat cancer using MRI-guided radiation. The medical device company used this backlog to estimate revenue from orders it considered valid, but for which the company had not yet recognized revenue. The plaintiffs alleged that the medical device company misled investors by failing to follow its publicly disclosed criteria for determining which orders to include in the backlog, thereby falsely inflating the backlog with orders that failed to meet this criteria.

On appeal, the Sixth Circuit considered whether the plaintiffs sufficiently pleaded the element of falsity — whether the medical device company made material misrepresentations or omissions in its backlog orders. The court focused on the narrow issue of whether the disclosed backlog criteria objectively required every backlogged order to have a contract signed by an end-customer. Both parties agreed the criteria required a written agreement and a customer deposit or credit letter, "except when the sale is to a customer where a deposit is not deemed necessary or customary," such as in sales involving contracts signed by end-customers. However, the parties disagreed on how to read the "except when" clause. The plaintiffs maintained that the "except when" clause applied to the written contract and deposit requirement. The medical device company contended the clause applied to only the deposit requirement.

Interpreting the backlog criteria "as a reasonable investor would," the Sixth Circuit found that the medical device company had the better reading of the criteria. The court applied the last-antecedent rule of interpretation, reading the "except when" limiting clause only to modify the phrase it immediately follows. Having adopted this interpretation of the criteria, the Sixth Circuit found that the plaintiffs failed to allege any facts that would show the medical device company included invalid orders in the backlog. For this reason, the court concluded the plaintiffs failed to plead with particularity any theory of falsity based on the backlog.

First Circuit Upholds Dismissal of Claims Alleging Customer Base Disintegration Misstatements

City of Miami Fire Fighters' & Police Officers' Ret. Trust v. CVS Health Corp. (1st Cir. Aug. 18, 2022)

What to know: The First Circuit upheld the dismissal of securities fraud claims against a pharmacy health care company based on alleged misstatements concerning the disintegration of an acquired company's customer base that led to write-offs totaling $8 billion, holding that the plaintiffs failed to allege any actionable false statements or misleading omissions.

The First Circuit upheld the dismissal of claims under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5(a) thereunder against a pharmacy health care company concerning its acquisition of a company that provides pharmacy services to long-term care facilities. The plaintiffs alleged that the pharmacy company failed to disclose the disintegration of the acquired company's customer base over the course of three years, resulting in write-offs totaling $8 billion.

The district court had dismissed the complaint because it failed to allege any actionable false statements or misleading omissions, rejecting the plaintiffs' arguments that the company's disclosure of difficulties at the acquired company came too late to be meaningful to investors, and that positive statements by senior management misled investors by either misrepresenting or admitting material facts about the customer base. The First Circuit agreed, reasoning that a "[c]lose review of the complaint reveals that, despite its length, it fails to allege sufficiently specific facts about the state of [the acquired company's business] at a particular point in time to enable us to conclude that any of the goodwill write-downs were too late or that any of the defendants' alleged misstatements contradicted the state of that business as it then stood." The court also reasoned that the broad allegations in the complaint were "entirely consistent with [the company's] reporting."

First Circuit Affirms Dismissal of Securities Fraud Putative Class Action Complaint in Cancer Drug Efficacy Case

Thant v. Karyopharm Therapeutics, Inc. (1st Cir. Aug. 5, 2022)

What to know: The First Circuit affirmed the dismissal of securities fraud claims against a biopharmaceutical company based on allegedly misleading statements regarding the efficacy of its cancer drug, holding that the complaint did not adequately allege false or misleading statements.

The First Circuit affirmed the dismissal of a putative class action securities complaint alleging violations of Sections 10(b) and 20(a) of the Exchange Act against a biopharmaceutical company that allegedly misrepresented the efficacy of a leading drug candidate for the treatment of advanced cancers. The plaintiffs alleged that the company made material misrepresentations regarding its drug for the treatment of relapsed or refractory myeloma and myeloid leukemia. In particular, the plaintiffs alleged that the company made material misrepresentations about the drug's efficacy, including that the "success of the [drug] study [wa]s an important milestone for [the drug]" and "represent[ed] a significant step in establishing the efficacy and safety of [the drug]"; that the drug "demonstrated a predictable and manageable tolerability profile"; and other statements regarding adverse events resulting from the drug.

The First Circuit held that statements such as those regarding the drug as an "important milestone" or a "significant step" were nonactionable puffery. As for statements regarding adverse events, the court held that the information allegedly omitted from public statements was information of which the market was already aware. The court explained that the company had regularly informed investors through its Securities and Exchange Commission (SEC) filings about adverse effects experienced by some patients taking the drug and therefore were not materially misleading.

Eleventh Circuit Affirms Dismissal of Securities Class Action Claims, Holding Medical Technology Company's Statements Were Forward-Looking

Einhorn v. Axogen, Inc. (11th Cir. Aug. 1, 2022)

What to know: The Eleventh Circuit affirmed the dismissal of securities fraud claims brought against a medical technology company, holding that the company's alleged misstatements regarding the frequency of nerve injuries and nerve repair surgery were forward-looking statements and thus protected by the Securities Act's safe harbor provision.

The Eleventh Circuit affirmed the dismissal of Securities Act claims brought against medical technology company Axogen, finding the company's statements were covered by the Act's safe harbor provision. In its 2016 and 2017 Form 10-Ks, Axogen stated that it believed 1.4 million people in the U.S. suffered traumatic injuries to peripheral nerves each year, resulting in more than 700,000 extremity nerve repair surgeries. Axogen subsequently conducted two public offerings, which incorporated these statements by reference. After the offerings concluded, a short seller investigating the company published a research report challenging Axogen's statements, asserting instead that only 28,000 repair procedures took place each year. When the company's stock price dropped 38% three days after the report was released, shareholders filed a putative securities fraud class action asserting claims under both the Securities Act and the Exchange Act. The shareholders alleged that Axogen knew its statements concerning the size of the market and the frequency of nerve injuries and repairs were false at the time it made those statements in its Form 10-Ks and when it incorporated those statements in its offering documents.

The district court dismissed both claims, holding that the challenged statements were forward-looking, nonactionable statements of opinion and thus protected by the safe harbor provisions in each Act. The district court also held that the plaintiffs failed to satisfy the heightened standard for pleading scienter under the PSLRA, rendering the plaintiffs' Exchange Act claims deficient for that additional reason.

The Eleventh Circuit affirmed the district court's decision, holding that the statements were forward-looking and thus covered by the safe harbor provision. The appeals court reasoned that the inclusion of the words "each year" signaled that the statements were intended to predict the number of injuries that would require nerve repair procedures in the future. The court further noted that the statements were made in the context of the company's predictions about the size of its potential market, making clear that the statements were forward-looking.

IPOs

Second Circuit Affirms Dismissal of Claims Alleging Flavoring and Fragrance Company Misled Investors on Anti-Bribery Compliance and Business Growth

Menora Mivtachim Ins. Ltd. v. Frutarom Indus. Ltd. (2d Cir. Sept. 30, 2022)

What to know: The Second Circuit affirmed the dismissal of securities fraud claims brought against a flavoring and fragrance products company based on allegedly misleading statements about its compliance with anti-bribery laws and business growth, holding that the plaintiffs did not have Section 10(b) standing to pursue their securities fraud claims.

The Second Circuit affirmed the dismissal of claims brought by a putative class of investors against a flavoring and fragrance products company and certain of its officers under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder, alleging that the company made misleading statements about its compliance with anti-bribery laws and the source of its business growth. The plaintiffs were purchasers of shares of a company that acquired the flavoring and fragrance products company. The acquirer subsequently disclosed that the flavoring and fragrance products company, now a wholly owned subsidiary of the acquirer, had allegedly engaged in bribery before the acquisition.

The Second Circuit rejected the plaintiffs' argument that they had standing because there was a sufficiently "direct relationship" between the company's misstatements and the price of the acquirer's shares. The Second Circuit held that the plaintiffs bought shares of the acquirer, not the company, and therefore violated the long-standing purchaser-seller rule adopted in *Blue Chip Stamps v. Manor Drug Stores*. The purchaser-seller rule requires a plaintiff to have bought or sold a security of the issuer, about which a misstatement was made, to have standing to sue under Section 10(b). The Second Circuit reasoned that the plaintiffs' "direct relationship" test would lead to an "endless case-by-case erosion" of the purchaser-seller rule.

The Second Circuit adopted a bright-line rule that "purchasers of a security of an acquiring company do not have standing under Section 10(b) to sue the target company for alleged misstatements the target company made about itself prior to the merger between the two companies." The Second Circuit further explained that "Section 10(b) standing does not depend on the significance or directness of the relationship between two companies," but "whether the plaintiff bought or sold shares of the company about which misstatements were made."

Southern District of New York Dismisses Claims Alleging Vape Company Failed To Disclose Potential Impact of Regulations Before IPO

Garnett v. RLX Tech., Inc. (S.D.N.Y. Sept. 30, 2022)

What to know: The Southern District of New York dismissed securities fraud claims against a China-based vape company alleging the company failed to disclose the potential impact of government regulations ahead of its IPO, finding that the plaintiffs failed to adequately allege a material misstatement or omission.

Judge Paul A. Engelmayer of the Southern District of New York dismissed a purported class action against a China-based vape company, its U.S. representatives and its underwriters. The complaint alleged that the company failed to disclose that Chinese regulators were considering tightening regulations on the vape industry in advance of the company's IPO, in violation of Sections 11, 12(a)(2) and 15 of the Securities Act.

The court concluded that the company's prospectus disclosed both the preexisting regulatory environment within the vape industry in China and that regulations could potentially be tightened further. The court found that "the Offering Materials, taken together and in context, did not misleadingly state or omit facts related to the prospect of more stringent regulation of e-cigarettes in China." The court also reasoned that the potential regulations were publicly known, and that investors in a vape company should have been aware of the potential risk of further regulation. The court rejected the plaintiff's argument that the company failed to disclose potential future risk, holding that the company's forward-looking statements were protected under the bespeaks caution doctrine. Because the statements were forward-looking and accompanied by sufficient cautionary language, the court found that a reasonable investor would not have been misled about the possibility of future regulation.

Eastern District of New York Dismisses in Part Claims That Mattress Company Misled Investors

Lematta v. Casper Sleep, Inc. (E.D.N.Y. Sept. 30, 2022)

What to know: The Eastern District of New York dismissed in part securities fraud claims against an online mattress and sleep aid company alleging that the company misled investors based on statements made in its IPO materials.

Judge Margo K. Brodie dismissed, in part, claims alleging that the company misled investors about its strength and potential for growth in violation of Sections 11 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act. With respect to the statements about pricing and promotional strategies, the court held that the registration statement was not misleading because it included language warning investors that "[l]aunching new products or updating existing products may ... leave [the company] with obsolete inventory that we may not be able to sell, or we may sell at significantly discounted prices." The court also held that the company's statements about growth and plans to expand its global operations were protected under the bespeaks caution doctrine because they were forward-looking and accompanied by sufficient cautionary language "highlight[ing] the risks that could prevent [the company] from achieving its forward-looking growth plans."

With respect to the statements about the company's profitability, the court held that "[b]ased on the information [the company] provided, a reasonable investor may have believed that [the company] was on a path to achieve profitability and implement its growth initiatives, when according to [the plaintiff's] factual allegations, [the company] was actually suffering accelerating losses, its core operations were not profitable, its revenue growth rate was not sustainable, and it had not positioned itself to achieve profitability." The court reasoned that "because [the company] chose to speak about the potential path to growth and profitability, [it] had an obligation to ensure its statements were both accurate and complete."

With respect to the actionable statements, the court found that the plaintiff had adequately alleged scienter and loss causation. Allegations from former employees that the company's corporate officers were aware of its unprofitability and undesirable prospects supported an inference of scienter. The court found that the plaintiff adequately pled a materialization of some of the risks that the company failed to disclose and rejected the company's argument that changes in its performance and growth were attributable to COVID-19 because those competing theories were not referenced in the complaint.

M&A

Court of Chancery Dismisses Breach of Fiduciary Duty Claims Involving Reverse Spin-Off Transaction

In re Match Grp., Inc. Derivative Litig. (Del. Ch. Sept. 1, 2022)

What to know: The Delaware Court of Chancery dismissed breach of fiduciary duty claims, holding that a reverse spin-off transaction involving a controlling stockholder complied with MFW's dual procedural protections and thus warranted business judgment review.

The Delaware Court of Chancery dismissed breach of fiduciary duty claims in a case involving a reverse spin-off transaction. IAC/InterActiveCorp (Old IAC) controlled Match Group, Inc. (Old Match). In 2019, Old IAC proposed to separate its online dating business (*i.e.*, Match.com and other websites) and certain exchangeable debt obligations from the rest of its business (the Separation). The Separation was achieved by way of a reverse spin-off, wherein Old IAC formed a subsidiary (New IAC), spun its nondating business sectors to New IAC, reclassified its high- and low-vote stocks into one class of publicly traded common stocks and renamed itself Match Group Inc. (New Match). Old Match then merged with and into a New Match subsidiary, and the minority Old Match stockholders received New Match stock.

In the subsequent litigation, it was undisputed that the reverse spin-off was an interested transaction in which a controller obtained a nonratable benefit at the expense of the minority, presumptively subject to entire fairness review. Thus, the central dispute before the court was whether the transaction satisfied the prerequisites of the Delaware Supreme Court's landmark *Kahn v. M&F Worldwide Corp.* (*MFW*) decision, which allows for business judgment review of conflicted controlling stockholder transactions under certain circumstances. Six conditions must be satisfied for a transaction to obtain business judgment review under *MFW*: (i) the transaction is conditioned *ab initio* on the approval of a special committee and a majority-of-the-minority vote; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisers and to say "no" definitively; (iv) the special committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority. The plaintiff only challenged conditions (ii)-(v) with respect to the reverse spin-off.

Beginning with the special committee's independence, the court found that just one of the three committee members lacked independence because the controller or its affiliates were his primary employer for two decades, and he made at least $58 million from those relationships. However, the court declined to find that this board member had infected or dominated the other two committee members. The court then concluded that the special committee was sufficiently empowered to choose its own advisers and to say "no." Next, the court rejected the plaintiff's three duty-of-care arguments that the committee (i) had a "controlled mindset" and negotiated poorly; (ii) hired a conflicted financial advisor; and (iii) structured the separation to extinguish derivative claims. Finally, the court determined that the minority vote on the Separation was fully informed. Because the Separation satisfied all of the *MFW* prerequisites, and the plaintiff did not even attempt to allege a claim for waste, the court dismissed the plaintiff's breach of fiduciary duty claims.

District of Massachusetts Dismisses Class Action Claiming Bank's Proxy Solicitations Contained False or Misleading Statements

Savoy v. Boston Private Fin. Holdings, Inc. (D. Mass. Aug. 26, 2022)

What to know: The District of Massachusetts dismissed a putative class action claiming that a bank's proxy solicitations regarding shareholder approval of a merger with another bank contained false or misleading statements in violation of the Exchange Act.

Judge Patti Saris of the District of Massachusetts dismissed a putative class action claiming that a bank's proxy solicitations contained false or misleading statements in violation of Sections 14(a) and 20(a) of the Exchange Act. The plaintiffs alleged that the bank disclosed that it had entered into a plan of merger with a large commercial bank. The bank's fourth-largest shareholder issued public letters and press releases opposing the merger, and a proxy battle ensued. The plaintiffs alleged that the bank (i) failed to disclose that other entities were interested in exploring merger opportunities; (ii) misrepresented the recommendation of an independent proxy advisor (ISS); and (iii) falsely represented the fair value of the merger.

The court held that statements made by the shareholder in its competing proxy statements were part of the "total mix of information available to the reasonable investor" and thus must be considered in assessing whether the bank's statements were materially false or misleading to shareholders. The shareholder's proxy material disclosed information about (i) other entities that may have expressed an interest in a merger with the bank; (ii) ISS' recommendation; and (iii) the shareholder's fair value assessment of the merger. The court held that the "total mix" of information available to shareholders was sufficient to allow them to reach their own independent conclusions regarding this disclosed information, and therefore the bank's omissions were not actionable.

Options and Futures Trading

Seventh Circuit Affirms Dismissal of Securities Fraud Action Involving Alleged Flaws in 'Fear Index'

Barry v. Cboe Glob. Mkts., Inc. (7th Cir. July 27, 2022)

What to know: The Seventh Circuit affirmed the dismissal of a securities fraud claim and a Commodities Exchange Act (CEA) claim brought against a U.S. equities market operator based on alleged flaws in its Volatility Index formula and the options and futures based on that formula. The Seventh Circuit held the complaint failed to adequately allege scienter for securities fraud or intentional bad faith for the CEA claim.

The Seventh Circuit affirmed the dismissal of accusations that equities market operator Cboe negligently designed a real-time index and made ineffective efforts to thwart trade manipulators.

Cboe runs an options and futures exchange. The plaintiff traders' claims arose from Cboe's attempt in 2003 to improve VIX — an index representing the market's expectations of near-term price changes for the S&P 500 and popularly known as the "Fear Index" — by increasing the number of options in its formula from four to 130. Cboe created futures contracts based on VIX in 2004 and options contracts in 2006.

The plaintiff traders alleged Cboe negligently had constructed its VIX and failed to take proper preventative and remedial measures to stop others from engaging in manipulative trades. The traders claimed that these options and futures allowed market manipulators to make quick money by strategically making last-minute option trades that moved the index at a small cost to the manipulators.

The traders attempted to bring intent-based claims under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and the CEA. However, the Seventh Circuit found the traders had not alleged that Cboe knew in 2003, 2004 or 2006 — when it made the changes to VIX and offered the new products — that others would manipulate the formula. Noting that the PSLRA requires dismissal of a fraud claim unless "the complaint shows that the forbidden intent is at least as likely as its absence," the court found the plaintiffs' silence on this matter telling. The Seventh Circuit noted that it was "difficult to see more than negligence on Cboe's part" based on the traders' accusations, which were insufficient to support the requisite scienter under the Exchange Act. The Seventh Circuit also found that the traders' secondary liability claim — that Cboe could not successfully stop market manipulators — was moot because private litigants cannot pursue claims based on a theory that the company aided and abetted a wrongdoer.

Finally, the Seventh Circuit affirmed the dismissal of the traders' CEA claim because they alleged only negligence and not the necessary mental state of intentional bad faith.

SEC

Fifth Circuit Denies Petition To Rehear SEC Administrative Enforcement Proceedings Case

Jarkesy v. SEC (5th Cir. Oct. 21, 2022)

What to know: A divided Fifth Circuit panel denied a petition to rehear *en banc* a case involving the SEC's use of in-house administrative proceedings in securities enforcement actions.

Attorneys for the government filed a petition with the Fifth Circuit seeking *en banc* review of a case in which a three-judge panel majority rejected the SEC's use of administrative enforcement proceedings on multiple constitutional grounds. The Fifth Circuit declined to rehear the case, leaving the panel decision in place.

The original 2-1 panel decision held that the SEC had violated hedge fund manager George R. Jarkesy Jr.'s constitutional right to a jury trial with its in-house adjudication of a securities fraud enforcement action against him and his advisory firm, Patriot28 LLC. The panel majority also ruled that the SEC proceedings relied on unconstitutionally delegated legislative power and were overseen by an unconstitutionally removal-protected administrative law judge.

In a dissent from the denial of rehearing joined by four others, Judge Catharina Haynes wrote that she agreed with the dissent in the original panel opinion and would have granted a rehearing for the government. .

Ninth Circuit Affirms Civil Penalties and Injunctive Relief for Violations by Unregistered Brokers

SEC v. Murphy (9th Cir. Oct. 4, 2022)

What to know: The Ninth Circuit held that three investors violated Section 15(a) of the Exchange Act by trading securities on their client's behalf without registering as broker-dealers, and that one of these investors also violated Section 10(b) by using a fraudulent zip code to facilitate these trades.

The Ninth Circuit rejected appellants' arguments alleging that transactions made by three investors did not rise to the level of broker-dealer activities. In the late 2000s, the investors joined an asset management group to trade securities on their client's behalf. The principal gave the appellants capital and instructed them to purchase new-issue municipal bonds so that they could sell those bonds back to the secondary market immediately afterwards for a profit. The plaintiffs executed thousands of such transactions without registering as broker-dealers. To obtain first priority on certain municipal bond offerings, one of the plaintiffs used a fraudulent zip code when executing these transactions. The SEC argued that all of the appellants violated Section 15(a) by executing these transactions without registering as broker-dealers, and that one of the plaintiffs also violated Section 10(b) by using a fraudulent zip code to obtain priority orders.

The district court agreed with the SEC and found all investors liable. The appellants then sought review in the Ninth Circuit, arguing that the transactions did not rise to the level of broker-dealer activities because they were conducted under the direction and supervision of the client, and that using a fraudulent zip code in conjunction with a securities transaction was not manipulative or deceptive enough to constitute a Section 10(b) violation.

The Ninth Circuit rejected both arguments, holding that a Section 15(a) violation may occur when an investor conducts securities transactions exclusively on another person's behalf without being registered as a broker-dealer. The court also held that using a fraudulent zip code to obtain priority orders from bond underwriters was a material misrepresentation under Section 10(b) because that information was significant to the issuers when allocating retail order priority for the bonds. The court reasoned that even if the underwriters had access to her real zip code on other documents, they would be left "with no apparent basis to discern truth from fraud."

Ninth Circuit Affirms Finality of SEC Enforcement Action Upholding FINRA Penalties

Saliba v. SEC (9th Cir. Aug. 31, 2022)

What to know: The Ninth Circuit upheld in part and declined to enforce in part the SEC's decision to affirm FINRA sanctions against an investor for alleged regulatory and discovery violations and backdating compliance forms.

The Ninth Circuit upheld in part and declined to enforce in part three FINRA sanctions findings against investor Trevor Saliba. In 2011, a capital group owned by Mr. Saliba purchased a securities firm that was a member of FINRA, a nonprofit organization authorized under Section 15 of the Exchange Act. FINRA discovered, upon review of the firm's application for ownership change, that the SEC was investigating Mr. Saliba's capital group. FINRA then imposed interim restrictions on the firm, prohibiting it from (i) allowing Mr. Saliba to act as a principal; (ii) adding new lines of business, offices or personnel; and (iii) conducting securities transactions on behalf of entities controlled by Mr. Saliba.

After these restrictions were imposed, Mr. Saliba allegedly signed agreements with clients on the firm's behalf and participated in its hiring processes. In 2013, FINRA asked Mr. Saliba to produce the computers he used in the firm's business. Mr. Saliba had two business computers, but produced only one. That same year, FINRA also discovered Mr. Saliba had purportedly backdated compliance forms.

In 2016, FINRA filed a complaint against Mr. Saliba alleging that he violated its regulations by failing to follow its interim restrictions, violating its discovery request and backdating the compliance forms. After a FINRA panel found Mr. Saliba guilty of all three violations, Mr. Saliba appealed to the National Adjudicatory Council (NAC), FINRA's disciplinary appellate forum. The NAC sustained the FINRA panel's findings and imposed three penalties on Mr. Saliba, one for each violation. Mr. Saliba then appealed those findings and their associated penalties to the SEC. The commission affirmed all three violations, but upheld penalties only for the regulatory and compliance violations, electing to remand the penalty associated with the discovery violation for additional proceedings. Mr. Saliba then petitioned the Ninth Circuit for review, arguing that all three SEC determinations were wrong and seeking judicial review as to whether the commission's opinion constituted a final order.

The court held that the discovery violation was not final and accordingly remanded it for further proceedings. On the regulatory and compliance violations, however, the court found that the record supported the SEC's findings and affirmed both penalties.

Fifth Circuit Affirms Cherry-Picking Scheme Violates Securities Laws

SEC v. World Tree Fin., L.L.C. (5th Cir. Aug. 4, 2022)

What to know: The Fifth Circuit affirmed a judgment entered against an investment advisory firm and its principals for perpetrating a fraudulent cherry-picking scheme, joining other circuits to hold for the first time that such schemes violated securities laws.

The Fifth Circuit held for the first time that cherry-picking can be a violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, Section 17(a)(1) of the Securities Act and Sections 206(1) and (2) of the Investment Advisers Act of 1940. This case arose from an SEC enforcement action against appellants-defendants World Tree and its principals. The district court found that principal Wesley Perkins and World Tree had engaged in a fraudulent "cherry-picking" scheme in which they allocated favorable trades to themselves and favored clients and unfavorable trades to disfavored clients. The district court also found that the defendants had made false and misleading statements about the firm's allocation and trading practices. The court entered permanent injunctions against Mr. Perkins and World Tree, ordered them to disgorge ill-gotten gains and imposed civil penalties on each defendant. The Fifth Circuit affirmed.

The Fifth Circuit concluded that the "[t]he failure to disclose cherry-picking constitutes material misrepresentations or omissions because there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest." It also held that cherry-picking can occur "'in connection with the purchase or sale of any security' (Rule 10b-5) and 'in the offer or sale of any securities' (Section 17(a))."

The Fifth Circuit also held that the SEC did not need to introduce direct evidence of cherry-picking to prove its claims and could instead rely on statistical evidence, particularly "[b]ecause cherry-picking is difficult to detect," and "determining whether it has occurred often requires drawing inferences from a pattern of behavior, irregularities, and trading data." The court also held that cherry-picking could satisfy the scienter element because it involves the knowing conduct of picking certain accounts over others. Here, the court found that the CEO had acted with scienter in engaging in the cherry-picking.

The appeals court further found that the district court did not abuse its discretion in ordering disgorgement based on an expert's estimation of excess first-day profits derived from cherry-picking.

Contacts

New York
One Manhattan West
New York, NY 10001
212.735.3000

Alexander C. Drylewski
212.735.2129
alexander.drylewski@skadden.com

Lara A. Flath
212.735.3717
lara.flath@skadden.com

Robert A. Fumerton
212.735.3902
robert.fumerton@skadden.com

Jay B. Kasner
212.735.2628
jay.kasner@skadden.com

David Meister
212.735.2100
david.meister@skadden.com

Daniel Michael
212.735.2200
daniel.michael@skadden.com

Scott D. Musoff*
212.735.7852
scott.musoff@skadden.com

Patrick G. Rideout
212.735.2702
patrick.rideout@skadden.com

Susan L. Saltzstein*
212.735.4132
susan.saltzstein@skadden.com

George A. Zimmerman
212.735.2047
george.zimmerman@skadden.com

Boston
500 Boylston St.
Boston, MA 02116
617.573.4800

James R. Carroll
617.573.4801
james.carroll@skadden.com

Eben P. Colby
617.573.4855
eben.colby@skadden.com

Michael S. Hines*
617.573.4863
michael.hines@skadden.com

Alisha Q. Nanda
617.573.4804
alisha.nanda@skadden.com

Chicago
155 N. Wacker Drive
Chicago, IL 60606
312.407.0700

Matthew R. Kipp
312.407.0728
matthew.kipp@skadden.com

Marcie Lape (Raia)*
312.407.0954
marcie.lape@skadden.com

Chuck Smith*
312.407.0516
charles.smith@skadden.com

Houston
1000 Louisiana St., Suite 6800
Houston, TX 77002
713.655.5100

Noelle M. Reed
713.655.5122
noelle.reed@skadden.com

Los Angeles
300 S. Grand Ave., Suite 3400
Los Angeles, CA 90071
213.687.5000

Virginia Milstead
213.687.5592
virginia.milstead@skadden.com

Peter B. Morrison*
213.687.5304
peter.morrison@skadden.com

Jason D. Russell
213.687.5328
jason.russell@skadden.com

Palo Alto
525 University Ave.
Palo Alto, CA 94301
650.470.4500

Jack P. DiCanio
650.470.4660
jack.dicanio@skadden.com

Washington, D.C.
1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

Anita B. Bandy
202.371.7570
anita.bandy@skadden.com

Bradley A. Klein*
202.371.7320
bradley.klein@skadden.com

Wilmington
One Rodney Square
920 N. King St.
Wilmington, DE 19801
302.651.3000

Cliff C. Gardner
302.651.3260
cgardner@skadden.com

Joseph O. Larkin
302.651.3124
joseph.larkin@skadden.com

Paul J. Lockwood
302.651.3210
paul.lockwood@skadden.com

Edward B. Micheletti*
302.651.3220
edward.micheletti@skadden.com

Jenness E. Parker
302.651.3183
jenness.parker@skadden.com

Jennifer C. Voss
302.651.3230
jennifer.voss@skadden.com

*Editors