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Spotlight

Circuits Split Over Whether Targeting Is Necessary for Seller Liability

Key Points

- While courts have long held that solicitations must be tailored to a particular audience to precipitate statutory seller liability, recent decisions have declined to apply that requirement.
- In *Wildes*, the Eleventh Circuit reversed the dismissal of claims arising from the solicitation of unregistered security through online videos.
- Similarly, in *Pino*, the Ninth Circuit held that promotions made by a real estate investment fund across its social media accounts could qualify as solicitations under Section 12.
- This debated development adds a new layer of considerations for businesses seeking to raise capital through means other than a registered securities offering.

Section 12 of the Securities Act of 1933 imposes liability on persons who “offer or sell” unregistered securities or registered securities “by means of a prospectus or oral communication” containing material misstatements or omissions.[1] A person can qualify as a statutory seller if he or she passes the security’s title to the plaintiff or solicits the plaintiff’s purchase of the securities.[2]

Most courts have held that solicitations must be tailored to a particular audience to give rise to statutory seller liability.[3] However, some courts appear to be calling that long-standing requirement into question.

[1] 15 U.S.C.A. § 12(a) (West).

[2] *Pinter v. Dahl*, 486 U.S. 622, 643 (1988).

[3] *See, e.g.*, *Capri v. Murphy*, 856 F.2d 473, 478–79 (2d Cir. 1988) (finding that statutory seller liability failed to apply to the defendant coal mining venture because there was no evidence its promoters actually solicited the plaintiffs’ investment); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 636 (3d Cir. 1989) (noting that “[t]he purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller,” to incur seller liability within the context of an initial public offering); *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1307 (10th Cir. 1998) (dismissing the plaintiff investor’s Section 12 allegations due to a lack of evidence demonstrating the defendant promoters actively solicited his stock purchase).

Two recent decisions from the Ninth and Eleventh Circuits[4] suggest that under some circumstances mass communications made on social media can make a person a statutory seller. Both courts found that:

- A party could potentially be liable for solicitations under Section 12 by promoting a security in a mass communication made on social media.
- The complaint at issue alleged facts that, taken as true, made a social media post a solicitation under the statute.

Wildes v. BitConnect International PLC

The Eleventh Circuit's February 2022 decision arose from an alleged cryptocurrency platform's promotional videos. The defendant, BitConnect, minted a token — the BitConnect coin — and subsequently made thousands of online videos encouraging consumers to purchase the coin. These videos generated millions of views. Once the coin's price fell, however, two plaintiffs sued under Section 12 in an attempt to recoup their alleged losses from the company and its promoters.

The district court dismissed the plaintiffs' claim on the grounds that they based their case on having watched the videos, which were made for and viewed by millions of people. The court reasoned that a person was a statutory seller under Section 12 only if he or she made a direct or personal solicitation. The plaintiffs amended their complaint to add additional plaintiffs who allegedly purchased BitConnect through the promoters' referral links. The district court also dismissed the amended complaint, finding that the new plaintiffs, like the original ones, never received any "personal solicitation" or targeted communications from the promoters.

On appeal, the Eleventh Circuit reversed. The panel rejected the argument that liability under Section 12 is premised on a targeted solicitation to a specific, prospective buyer. It 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, when written, was meant to apply to circulars and radio.

Accordingly, the circuit court reasoned that it does not matter whether a seller pitches a security in a letter or video, as the liability would potentially attach either way. The court ultimately concluded that the plaintiffs' allegations, if taken as true, meant that the videos could constitute solicitations, making the defendants statutory sellers under Section 12.

[4] *See Wildes v. BitConnect Int'l PLC*, 25 F.4th 1341 (11th Cir. 2022), *cert. denied sub nom. Arcaro v. Parks,* 143 S. Ct. 427 (2022); *Pino v. Cardone Cap.*, LLC, 55 F.4th 1253 (9th Cir. 2022).

Pino v. Cardone Capital

Similarly, the Ninth Circuit's December 2022 decision derived from promotions made by a real estate investment fund across its social media accounts. Two private equity funds — Cardone Equity Fund V (Fund V) and Cardone Equity Fund VI (Fund VI) — were classified as emerging growth companies under the JOBS (Jumpstart Our Business Startups) Act and subject to Regulation A, a rule making certain offerings exempt from Securities and Exchange Commission (SEC) registration requirements.

Fund V raised $50 million in September 2019, prompting its parent's CEO to promote both funds' investment opportunities on the company's Instagram account and YouTube page.

Fund VI subsequently raised $50 million by June 2020. Investors filed a putative class action soon after, alleging that the fund and its members made material misstatements or omissions under Sections 12 and 15 of the Securities Act regarding the returns investors could expect to receive from the fund. Investors also claimed that statements in social media posts and offering circulars published by the company lacked cautionary language identifying the risks associated with the investments.

The district court dismissed the claims, holding that neither the CEO nor the parent qualified as a statutory seller under Section 12, thus precluding all claims. In its ruling, the district court, like the Eleventh Circuit district court, noted that the posts consisted entirely of general statements made on public social media accounts that highlighted the benefits of investing in Funds V and VI.

The Ninth Circuit reversed. Adopting the Eleventh Circuit's reasoning from 10 months prior, the Ninth Circuit held the social media posts could qualify as solicitations under Section 12. The court found that "the advertisements at issue in this case — Instagram posts and YouTube videos — are the types of potentially injurious solicitations that are intended to command attention and persuade purchasers to invest in funds," even if they are generalized and do not target specific purchasers. Accordingly, the court held the investors plausibly alleged that the defendants were sellers under Section 12(a)(2).

A Circuit Split Emerges

The Ninth and Eleventh Circuit decisions appear to create a circuit split. While no other circuit has yet addressed whether use of social media makes a defendant a statutory seller, the Second Circuit, for instance, has held that a plaintiff must demonstrate

that the defendant "actually solicited" the plaintiff's specific investment in order for the defendant to qualify as a seller under Section 12.[5]

Likewise, the Third Circuit requires that a defendant engage in a "direct and active" solicitation of a plaintiff to qualify as a Section 12 seller.[6] Both decisions are in accord with the requirement in Section 12 that the defendant be liable only to the person who "purchas[ed] such security from him."[7]

In contrast, the courts in *Wildes* and *Pino* declined to follow these circuits and did not address the divergence.

Takeaways

In light of the split apparently emerging among the circuits, litigants will likely continue to dispute whether mass communications made over social media can make a person a seller. *Wildes* and *Pino*, in turn, add a new layer of considerations for businesses seeking to raise capital through means other than a registered securities offering.

Because social media communications have given rise to potential seller status in two of the 12 circuit courts across the U.S. in the past year, we are closely watching whether this split leads to forum shopping by plaintiffs seeking jurisdictions that follow the approach adopted by the Ninth and Eleventh Circuits.

[5] *See Capri v. Murphy*, 856 F.2d at 478–79.

[6] *See Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d at 636.

[7] *See Id.; Capri v. Murphy*, 856 F.2d at 478-79.

Cannabis

Western District of New York Rejects Dismissal of Claims Alleging Cannabis and Tobacco Company Failed To Disclose SEC Investigation

Noto v. 22nd Century Grp., Inc. (W.D.N.Y. Jan. 6, 2023)

What to know: A New York district court denied the dismissal of securities fraud claims against a cannabis and tobacco engineering company for allegedly failing to disclose an ongoing SEC investigation regarding an alleged material weakness in the company's accounting controls.

Judge John L. Sinatra Jr. denied a motion to dismiss claims against a cannabis and tobacco engineering company and certain of its officers under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder. The complaint alleged that the company concealed the fact that it was under an SEC investigation regarding an alleged material weakness in the company's accounting controls. The court found that the plaintiffs adequately alleged scienter, alleging sufficient facts indicating the company had motive and opportunity to commit fraud. The court reasoned that alleged bolstered capital collections from a specific stock offering is a concrete benefit sufficient to establish motive to commit fraud. The court also determined that the company executed multiple stock offerings, and the alleged misrepresentations before the final stock offering could have been motivated "by a desire to bolster capital gained from the stock offering."

The court also held that the plaintiffs sufficiently alleged the company knew or had access to information indicating that their statements regarding the SEC investigation were false. Specifically, the plaintiffs alleged that two of the company's senior officers were involved with the SEC investigation and knew it was ongoing. For example, the plaintiffs alleged one of the officers met with the SEC and, after the meeting, told a confidential witness that he "feared he could lose his CPA license or even be imprisoned," and also that he did not want to sign the company's SEC filings based on another officer's conduct related to the SEC investigation.

The court found the plaintiffs' allegations about the senior officers' knowledge were not based just on their positions or the certification of SEC filings. Rather, the complaint alleged specific information about their awareness, and those allegations were bolstered by evidence that the alleged misstatements were made to "placate the market" in response to the accounting practices inquires.

Cryptocurrency

Bitcoin Mining Company Denied Motion To Dismiss Claims of Misleading Investors on Business Model

Bishins v. CleanSpark, Inc. (S.D.N.Y. Jan. 5, 2023)

What to know: A federal judge in New York denied a motion to dismiss and allowed putative class claims to proceed on behalf of investors against a bitcoin mining company for allegedly misleading investors about the company's business model.

Judge Loretta A. Preska denied a motion to dismiss a putative class action complaint alleging an energy technology company shifted its business model from alternative energy and software to mining bitcoin. The plaintiffs alleged that, in executing that shift, the company omitted material information and misled investors in violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder.

In December 2020, the company issued a press release announcing it had acquired a bitcoin mining company and planned to expand power in its new facility by April 2021. In January 2021, a short-seller company published a report asserting the company made various allegedly fraudulent misrepresentations and omissions about the acquisition, including that another company had withdrawn an offer to acquire the bitcoin mining company because the mining company's subsidized power rate was going to expire in three years, making the acquisition economically feasible. The short-seller report also asserted that the company's statements about the due diligence it conducted of the bitcoin mining company were inaccurate.

The court found the plaintiffs sufficiently pled that the December 2020 press release was false or misleading because it stated that (i) the due diligence analysis of the acquisition began in February 2020 but the bitcoin mining company was not formed until April 2020; and (ii) recent significant investments into bitcoin by such large, respected companies further validated its due diligence conclusions surrounding the acquisition but omitted any reference to the withdrawn offer to acquire the bitcoin company by another company, which was a much more relevant market comparison with greater impact on the company's due diligence conclusions. The court further held that the plaintiff adequately pled several misstatements or omissions regarding the estimated completion date of the capacity expansion project.

Cybersecurity

Ninth Circuit Upholds Dismissal of Section 14(e) Claims for Failure To Plead Subjective Falsity

In re Finjan Holdings, Inc. Sec. Litig. (9th Cir. Jan. 20, 2023)

What to know: The Ninth Circuit upheld the dismissal of securities fraud claims under Section 14(e) of the Exchange Act against a cybersecurity company and its executives in connection with a tender offer, holding that the plaintiffs failed to sufficiently plead subjective falsity.

A panel of the Ninth Circuit upheld the dismissal of securities fraud claims under Section 14(e) of the Exchange Act against a cybersecurity company and its executives in connection with a tender offer, holding that the plaintiffs failed to sufficiently plead subjective falsity. While affirming the dismissal, the panel held that a plaintiff bringing claims under Section 14(e) need not plead and prove scienter.

In March 2018, cybersecurity company Finjan Holdings, Inc. hired an investment bank to assist the company in a potential sale. Negotiations took place between Finjan and two suitors — a private equity firm and an entity known as Party B — for 21 months while Finjan's stock price fluctuated. In December 2019, Finjan's management conducted an investor presentation claiming the company would earn $200 million to $400 million in revenue from 2019 through 2022.

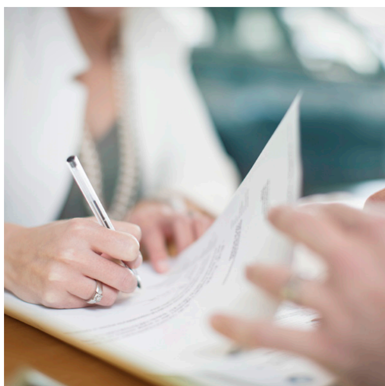
By the time the private equity firm purchased the company's shares for $44 million eight months later in a successful tender offer, the COVID-19 pandemic had significantly impacted Finjan's business, resulting in a revised projected revenue estimate of $166 million over the next four years.

Investors brought Section 14(e) claims against Finjan shortly after the sale, claiming the company knew its December 2019 projections were false and that it sold the company at a loss, to the shareholders' detriment. The district court dismissed the claim, holding the investors failed to plead scienter. In its dismissal, the district court distinguished existing Ninth Circuit precedent not requiring Section 14(e) plaintiffs to plead scienter by noting that the plaintiffs' claims were "sufficiently particular" to raise an inference of scienter, and that the court believed subjective falsity was a state of mind requirement.

The Ninth Circuit upheld the dismissal, but on different grounds. The court first held that plaintiffs do not need to plead scienter in order to state a Section 14(e) claim. Instead, Section 14(e) plaintiffs need only plead that there was "a reasonable inference that [defendants] believed that the revenue projections or share-value estimations provided to shareholders were inaccurate." The court also noted that subjective falsity is not a state of mind requirement because "an author could negligently state an opinion in which he does not subjectively believe."

Having articulated the proper pleading standard, the court held that the investors failed to satisfy it, as "it is not reasonable to infer from the allegations of the complaint that Finjan management still believed these figures were predictive post-COVID."

De-SPACS



Court of Chancery Expands *MultiPlan* Decision Relating to SPACs

Delman v. GigAcquisitions3, LLC (Del. Ch. Jan. 4, 2023)

What to know: A Delaware vice chancellor denied a motion to dismiss fiduciary duty claims against a sponsor and the SPAC's board of directors, finding that the case was governed by entire fairness.

The Court of Chancery denied a motion to dismiss fiduciary duty claims against a sponsor and the SPAC's board of directors, finding that the case was governed by entire fairness. GigCapital3, Inc. (Gig3 or the Company) — now Lightning eMotors, Inc. (New Lightning) — was a Delaware SPAC. Gig3's sponsor, GigAcquisitions3 (the Sponsor), was issued "founder's shares" for $25,000, nearly 20% of Gig3's post-IPO equity. The Company's Sponsor was controlled by the defendant and alleged "serial founder of SPACs" Avi Katz. Mr. Katz, through the Sponsor, effectively ran Gig3, including serving as its executive chairman, secretary, president and CEO. He also appointed Gig3's initial directors and officers, which included his wife and four other directors with ties to himself and other GigCapital entities.

Following the IPO, Gig3's officers and directors identified electric vehicle manufacturer Lightning eMotors Inc. (Old Lightning) as the merger target. Mr. Katz and his wife allegedly "dominated" the Company's negotiations with Old Lightning. Nomura Securities International, Inc. and Oppenheimer & Co. Inc. — Gig3's IPO bookrunners — were also hired to serve as Gig3's financial advisors but allegedly were not asked to provide a fairness opinion on the merger.

The Company issued a proxy statement in connection with the Gig3 stockholder vote on the merger, which contained disclosures about stockholders' redemption rights. Approximately 98% of stockholders voted in favor of the merger, with 29% redeeming. The post-merger entity, New Lightning, saw its stock price crater, and litigation followed.

The defendants' motion to dismiss the plaintiff's claims was denied. In denying the motion, the court's opinion went further than last year's SPAC decision in *In Re MultiPlan Corp. Stockholders Litigation*, 268 A.3d 784 (Del. Ch. 2022), with various notable holdings. Among other things, the *Delman* court held that the plaintiff had pled two independent grounds for reviewing the merger under entire fairness.

First, the plaintiff sufficiently pled facts making it reasonably conceivable that the Sponsor, even though it controlled less than 25% of the SPAC's voting power, was a controlling stockholder.

The court observed that the Sponsor allegedly controlled all aspects of the Company from its creation until the de-SPAC merger, as is typical in a SPAC transaction. Moreover, the court determined that the Sponsor was conflicted because the economic structure of the SPAC allowed the Sponsor to extract unique value at the expense of the public stockholders in multiple ways. According to the court, the Sponsor's interest diverged from the public stockholders in the choice between a "bad deal" and a liquidation.

Second, the court held that a majority of the board was not disinterested or independent due to alleged connections with the alleged controlling stockholder.

On the stockholders' redemption right, the plaintiff alleged that the defendants acted disloyally, hindering the stockholders' ability to exercise their right. The court placed significant importance on the redemption right, explaining that "[t]he right to redeem is the primary means protecting stockholders from a forced investment in a transaction they believe is ill-conceived. It is a bespoke check on the sponsor's self-interest, which is intrinsic to the governance structure of a SPAC. It follows that a SPAC's fiduciaries must ensure that right is effective, including by disclosing 'fully and fairly all material information' that is reasonably available about the merger and target to inform the redemption decision."

The court also rejected a *Corwin* defense, not only because there were well-pled disclosure deficiencies but also "because the structure of the Gig3 stockholder vote is inconsistent with the principles animating *Corwin*." According to the court, "[u]nlike the vote on a typical merger or acquisition," the "stockholder vote on the de-SPAC merger could not reflect its investors' collective economic preferences" because stockholders' voting interests were decoupled from their economic interests.

Fintech

Southern District of Florida Rejects Investor Suit Over Business Model Transition

City of Hollywood Police Officers' Ret. Sys. v. Citrix Sys., Inc. (S.D. Fla. Jan. 3, 2023)

What to know: A Florida district court dismissed securities fraud claims against a workplace software provider and five of its officers, holding that the company's statements regarding the success of its business model transition were neither false nor misleading.

Judge Raag Singhal dismissed securities fraud claims against workplace software provider Citrix Systems, Inc. and five of its officers. The court held that the plaintiffs' allegations about the company's alleged misstatements regarding the success of its transition from software sales to a cloud-based subscription business model did not raise an inference of scienter because the company disclosed the transition's negative results in a timely manner, and its officers engaged in stock sales only pursuant to the preset terms of their Rule 10b5-1 trading plans.

Before 2019, Citrix sold perpetual, on-premise software licenses to clients who accessed the software through computer networks and client-maintained servers. In 2019, however, Citrix allegedly began to shift away from this traditional, localized model and into a new, cloud-based subscription model. Under that model, Citrix would license its software to customers but continue to host and maintain the software on its own servers.

During the two-year transition period from the traditional model to the cloud-based model, the defendants made public statements concerning the transition's status and its impact on the business' financial performance. At the same time, certain officers sold some of their company stock holdings pursuant to individualized Rule 10b5-1 trading plans. Shortly after the statements and these trades were made, Citrix revealed that the company had missed its earnings-per-share targets and revenue projections. Shareholders alleged that the statements fraudulently overstated the success of the company's transition and, as a result, unjustly enriched the defendant officers who sold stock during this period.

The court dismissed all claims, holding that the plaintiffs failed to adequately plead falsity or scienter. With respect to falsity, the court found the challenged statements were not misstatements at all. Rather, each contained a "general discussion of the reasons for the business model transition, the company's plans and efforts to execute the transition, and the projected results the transition will have on the company as a whole."

With respect to scienter, the court found there were no allegations demonstrating the officers knew or recklessly disregarded that their statements were false or misleading when made, especially when the executives were subsequently timely and forthcoming about the company's negative performance. Further, there was "nothing suspicious" about any of the officers' individual stock sales because they were all made pursuant to predetermined Rule 10b5-1 trading plans.

Health Care and Life Sciences

Court of Chancery Dismisses *Caremark* Claim Based on Related Federal Court Decision, Holding Company Did Not Violate Legal Obligations

Lebanon Cnty. Emps.' Ret. Fund v. Collis (Del. Ch. Dec. 22, 2022)

What to know: A Delaware vice chancellor dismissed a breach of fiduciary claim against a prescription opioid distributor's directors for lack of oversight, holding that a decision from a West Virginia federal court meant it was not possible to infer that a majority of the directors faced a substantial likelihood of liability.

The Delaware Court of Chancery dismissed a breach of fiduciary duty claim against AmerisourceBergen's directors for lack of oversight. The company is one of three major wholesale distributors of prescription opioids in the U.S. and has faced numerous lawsuits relating to its alleged role as a contributor to the opioid epidemic. In 2021, the company agreed to pay $6 billion as part of a nationwide settlement to resolve multidistrict litigation. This was in addition to the hundreds of millions of dollars it had already paid to settle other lawsuits and the $1 billion it had incurred in defense costs.

The plaintiffs, stockholders of the company, sought to shift the responsibility for this corporate harm to the company's directors and officers by alleging a breach of fiduciary duty based on a lack of oversight of the company's legal obligations with respect to anti-diversion of its opioid products — a *Caremark* claim.

The plaintiffs advanced two breach of fiduciary duty theories:

1. The board had consciously ignored evidence, known as red flags, of legal noncompliance indicating the corporation was suffering or would suffer harm. Specifically, the plaintiffs alleged that the company's directors and officers were faced with a steady stream of red flags that the company was not meeting its legal obligations on anti-diversion: congressional investigations, subpoenas from prosecutors, lawsuits from state attorneys general and civil lawsuits. Using the parlance of a prior Court of Chancery decision, the court referred to this claim as a "Red-Flags Theory."
2. The company's officers and directors took a series of actions that, when viewed together, supported an inference that the company knowingly pursued a business plan that prioritized profits over legal compliance. Following the convention of prior case law, the court described this theory as a "*Massey* Theory," after the case that most famously laid out this theory of breach of fiduciary duty.

The defendants argued that demand on the board was not futile because the plaintiffs' allegations did not support a reasonably conceivable inference that a majority of the board faced a substantial likelihood of liability for breach of fiduciary duty. Considering the evidence in the record, which included corporate books and records obtained through a Section 220 demand, the court concluded that the record supported competing inferences about the board's knowledge of the company's compliance with its legal obligations, which typically would require the court to deny a motion to dismiss.

However, in a unique twist, the court considered the impact of a recent post-trial decision from a federal court in West Virginia that expressly determined the company had complied with its relevant legal obligations with respect to anti-diversion.

The court held that this final factor "fatally undermine[d] the complaint" because "[b]oth the Red-Flags Theory and the *Massey* Theory depend on an inference that the officers and directors knowingly failed to cause the Company to comply" with its legal obligations. Based on the federal court's decision, it was "not possible to infer that the Company failed to comply with its anti-diversion obligations, nor [was] it possible to infer that a majority of the directors who were in office when the complaint was filed face a substantial likelihood of liability on the plaintiffs' claims."

Therefore, demand on the board was not futile, and the court dismissed the complaint.

Northern District of Illinois Dismisses Securities Fraud Action Against Drug Company, Finding Its Statements Were Not Misleading

Goucher v. Iterum Therapeutics plc (N.D. Ill. Dec. 28, 2022)

What to know: The Northern District of Illinois dismissed the plaintiffs' complaint alleging violations of Sections 10(b) and 20(a) of the Exchange Act. The court held that the defendant's statements about its submission to the FDA, the agency's approval process and its commercial plans were not misleading, and that any allegedly omitted information was either disclosed or publicly available.

Judge Gary Feinerman dismissed the plaintiffs' claims alleging Iterum violated Sections 10(b) and 20(a) of the Exchange Act. Iterum is a clinical-stage pharmaceutical company focused on developing sulopenem, an antibiotic. At issue in this case were Iterum's disclosures regarding its development of oral sulopenem designed to treat uncomplicated urinary tract infections, which are increasingly antibiotic-resistant.

Iterum disclosed information about its clinical trials, the progress of the Food and Drug Administration (FDA) approval process and its plans to commercialize oral sulopenem, if approved, in press releases and SEC filings. Specifically, Iterum disclosed that it had submitted a new drug application to the FDA, which the agency accepted for review. However, the FDA ultimately rejected Iterum's application, recommending that Iterum conduct an additional clinical trial. Iterum's stock value dropped 44% after it announced this outcome.

The plaintiffs alleged that Iterum failed to disclose in its press releases and SEC filings that its Phase 3 clinical trials did not meet industry standards. The court held that industry standards were publicly known information that Iterum had no obligation to disclose, and that Iterum had provided enough information about its trials for investors to judge for themselves whether they complied with industry standards.

Moreover, Iterum had disclosed that the Phase 3 trials were conducted under Special Protocol Assessment agreements with the FDA, indicating that the agency concurred with the overall design of the trials and undermining the plaintiffs' claim that the trial design was so deficient it could not support FDA approval.

The plaintiffs further alleged that Iterum's opinions regarding the strength of its application and statements about its plans for sulopenem's commercialization were materially misleading. The court disagreed, holding that Iterum had disclosed sufficient details — including caveats and weaknesses with its trials — such that its statements about its new drug application, the FDA approval process and its future plans for the drug did not give the misleading impression that FDA approval was guaranteed. As a result, the court dismissed the complaint.

Pharmaceutical Company Secures Dismissal of Class Action Alleging Failure To Disclose Possible Link Between Implants and Rare Cancer

In re Allergan PLC Sec. Litig. (S.D.N.Y. Dec. 12, 2022)

What to know: A New York federal judge dismissed a purported class action against a global pharmaceutical company that alleged the company had failed to disclose a potential link between its implant product and cancer in patients.

Judge Colleen McMahon granted summary judgment in favor of a global pharmaceutical company in an action involving claims under Sections 10(b) and 20(a) of the Exchange Act. The complaint alleged the company was aware of studies showing a higher incidence of a rare form of cancer in patients that used the company's textured breast implants than those made by others. o The complaint alleged that despite that knowledge, the company failed to disclose that potential link and downplayed the fact that patients allegedly had a higher risk of developing the cancer if they used the company's implants.

The court found that the company was entitled to summary judgment dismissing the Section 10(b) claims. The court determined that the company's statement that the rare form of cancer has been reported in patients with textured breast implants from all manufacturers was true, and the company had no duty to disclose comparative incidence rates among various manufacturers of textured breast implants. In addition, studies showing a higher rate of incidence were publicly available to investors at the time the statement was made.

The company also did not make any false or misleading statements about the breast implants' safety profile because the product was FDA-approved and had been deemed safe in certain European markets. Finally, the court determined that the plaintiffs failed to produce sufficient evidence regarding a higher incidence rate because neither scientific studies nor any regulator had determined that the company's textured breast implants were more closely associated with the rare form of cancer than its competitors' products.

The court also found that the plaintiffs failed to establish materiality and loss causation. Because the company's textured breast implant sales constituted less than 1% of its global net revenue, the alleged misrepresentations about those products were presumptively immaterial. Additionally, the court found the fact that the breast implant operations were an important part of the company's business and the case concerned potential safety issues involving a rare form of cancer were insufficient to overcome the presumption.

Media and Entertainment

Telecommunications Giant Secures Dismissal of Class Action Alleging Company Failed To Identify Misleading Statements About Former Streaming Service

Steamfitters Local 449 Pension Plan v. AT&T, Inc. (2d Cir. Dec. 13, 2022)

What to know: The Second Circuit affirmed the dismissal of a securities fraud class action alleging Exchange Act and Securities Act claims against a telecommunications company for failure to identify any misleading statements in connection with its former streaming service.

The Second Circuit affirmed the dismissal of a putative class action lawsuit against a telecommunications company and several of its executives alleging they violated Sections 11 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act by making various misstatements regarding the subscriber growth and profitability of one of their former streaming services.

The plaintiffs alleged that statements regarding the streaming service's profitability were untrue because the product was not priced at profitable levels through the relevant time period. The plaintiffs also alleged that statements regarding the service's subscriber growth were untrue because those numbers were inflated by fraudulent sales tactics used by the company's retail sales staff.

With respect to the Exchange Act claims, the court held that of the 27 alleged material misstatements or omissions, 10 of them were inactionable as puffery. Four of the alleged misstatements were nothing more than general statements regarding the integrity of the company's employees, commitments to ethical behavior and code of conduct.

The court held that four of the six alleged misstatements regarding the service's profitability were made before, or within a few days of, the service's launch and thus were general statements of corporate optimism about a soon-to-launch product. The other two were also forward-looking, and one did not relate to the service at all.

Finally, the court held that the remaining 17 alleged misstatements about figures for the service's net subscriber growth were not misleading just because some degree of retail-level fraud or impropriety might be reflected in that data. The complaint also failed to allege with particularity that the reported subscriber figures were false.

With respect to the Securities Act claims relating to statements made by the company in its registration statement, prospectus and the Form 8-Ks, the court rejected the plaintiffs' arguments that (i) the defendants' failure to warn investors about the service's risk violated SEC Item 503; and (ii) all of these filings contained materially misleading disclosures regarding the service's subscriber growth and profitability. The court held that there was no plausible argument that a two-month-old product launched in a competitive field failing to live up to expectations was a risk unique to the company, or that it was one of the "most significant risks" facing investors during the relevant time period.

Southern District of New York Dismisses Class Action Alleging Sports Betting Company Failed To Disclose Merger Partner's Gambling Activities

In re DraftKings Inc. Sec. Litig. (S.D.N.Y. Jan. 10, 2023)

What to know: A New York federal judge dismissed a purported class action against an online sports betting company concerning the company's alleged failure to disclose a merger partner's purported black-market gambling activities.

Judge Paul A. Engelmayer dismissed a purported class action against a sports betting company alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder for allegedly failing to disclose that a company it had merged with had historical ties to "black-market gaming, money laundering and organized crime," and that the company generated half of its revenue from banned Asia-based markets.

The court noted that the factual allegations in the plaintiff's complaint were "virtually entirely based" on a short-seller report that was "largely based on unsourced or anonymously sourced allegations," and that this represented "a global deficiency spanning the [complaint's] theories of fraud." The court also reasoned that the short seller had "an economic interest in driving down the company's stock price," and therefore the allegations within the report had to be considered "with caution."

The plaintiffs admitted they had been unable to verify any of the statements in the short-seller report that were then incorporated into the complaint. The court found that the plaintiffs had failed to plead any additional facts sufficient to show that the merger partner had conducted unlawful operations or that the company had failed to disclose such operations.

SEC

Northern District of Illinois Denies Motion To Dismiss SEC Complaint Based on Short Tendering Rule Interpretation

SEC v. Lupo Sec. LLC (N.D. Ill. Jan. 9, 2023)

What to know: The Northern District of Illinois found the SEC plausibly alleged a formerly registered broker-dealer violated Rule 14e-4 when it engaged in a partial tender offer. The court denied the broker-dealer's motion to dismiss the claim as well as each of the broker-dealer's constitutional challenges.

This case concerned Rule 14e-4, also known as the short tendering rule, which prohibits investors from tendering more shares of stock than the amount they own. At issue was whether Lupo, a formerly registered broker-dealer, violated Rule 14e-4 when it failed to count its call options as short positions and engaged in a partial tender offer.

According to the SEC's complaint, when Lupo's chief operating officer reviewed Lupo's tender offer to confirm it would comply with Rule 14e-4, the COO failed to subtract the short positions from the net amount that could be tendered into the partial offer. As a result, Lupo's tender exceeded the net amount it owned at the time, causing Lupo to receive more shares than it should have and $1 million of "ill-gotten gains."

The court recognized that some amount of regulatory interpretation was necessary to determine if the SEC had plausibly stated a claim. The question was whether the SEC's reading of a phrase under the definition of "short position" to encompass call options was plausible. The SEC asserted the terms "highest tender offer price" or "consideration" simply meant the amount the public company proposed as payment to induce the tender of its shares. Under that reading, Lupo's call options were a short position it was required to factor into its net share's calculation.

Looking at the rule's plain meaning and dictionary definitions of "consideration," the court found the SEC's interpretation of the rule credible and that the SEC plausibly alleged Lupo violated the rule. The court found Lupo's counter-interpretation, which was based on "industry custom around partial tender offers" as opposed to the text of the rule, unpersuasive.

Finally, the court found none of Lupo's constitutional claims availing. It found Rule 14e-4 was not unconstitutionally vague and that a person of ordinary intelligence, let alone a sophisticated party like Lupo, would have a reasonable ability to understand what the rule prohibited. Second, it found the SEC's enforcement action against Lupo did not constitute "unfair surprise" because Lupo had fair notice of Rule 14e-4's contents and the SEC applied the clear language of the rule. Lastly, the court decided *Auer* deference was not applicable, because the court determined Rule 14e-4 was clear on its face.

Other Notable Cases

DC Circuit Affirms Department of Labor Decision Holding That Whistleblower Protections Do Not Apply Extraterritorially

Garvey v. Admin. Rev. Bd., U.S. Dep't. of Lab. (D.C. Cir. Dec. 23, 2022)

What to know: The D.C. Circuit affirmed a Department of Labor decision holding that whistleblower protections under Section 806 of the Sarbanes-Oxley Act do not apply where the whistleblower was based outside the United States.

The D.C. Circuit held that the protections afforded to whistleblowers under Section 806 of the Sarbanes-Oxley Act of 2002 will not apply where the whistleblower was based outside the United States. Section 806 protects employees from retaliation by making it unlawful for a company to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of" the employee's protected activity.

In this case, a plaintiff filed a complaint with the Department of Labor (DOL) alleging violations of Sarbanes-Oxley Act provisions after he claimed he was retaliated against for reporting corporate fraud while employed at Morgan Stanley. The plaintiff alleged that the bank's foreign subsidiaries were engaged in "insider training, market manipulation, U.S. tax fraud, and other forms of corporate corruption" in violation of the U.S. securities laws.

An administrative judge at the DOL dismissed the plaintiff's complaint, concluding that the Sarbanes-Oxley Act did not apply extraterritorially where the plaintiff exclusively worked in Hong Kong. The plaintiff appealed.

The D.C. Circuit affirmed the dismissal, finding that the DOL was correct in holding that Section 806's text, context and legislative history did not indicate that the Act applied extraterritorially. In addition, the court determined that Section 806 also could not be applied where a plaintiff claimed his employer threatened his attorney, reasoning that the events giving rise to this claim took place after the plaintiff's employment had already been terminated and thus fell outside the ambit of the statute.

Defense Contractor and Officers Secure Dismissal of Claims Alleging Pervasive Fraud

Bajjuri v. Raytheon Tech. Corp. (D. Ariz. Nov. 18, 2022)

What to know: An Arizona district court dismissed claims that a defense contractor and three of its officers allegedly engaged in pervasive fraud over the four-and-a-half-year class period.

Judge John C. Hinderaker dismissed securities fraud claims against defense contractor Raytheon Technologies and three of its officers, finding the shareholders failed to sufficiently allege that the:

- defendants engaged in pervasive fraud;
- defendants acted with scienter by making false statements about its contracts throughout the four-and-a-half-year class period; and
- alleged misstatements were causally connected to the plaintiffs' losses.

In 2020, the Department of Justice (DOJ) commenced an investigation into Raytheon's financial accounting practices for its Missiles & Defense business. Shortly after the defense contractor disclosed the investigation in an investor report in October 2020, its stock dropped 7%. That same month, investors filed a complaint against Raytheon and three of its officers asserting a variety of securities violations.

In particular, the plaintiffs alleged that the company defrauded the U.S. government — its main client — by intentionally overcharging its contracts and violating various statutes and processes designed to control government costs. To support these allegations, investors offered testimony from seven confidential witnesses, excerpts from the DOJ investigation and an admission from Raytheon's CEO acknowledging the company's wrongdoing in four government contracts. The complaint also alleged that Raytheon's stock drop was triggered by the company's disclosure of the DOJ investigation and the alleged fraud it uncovered.

The court dismissed all claims against the company, holding that even though the complaint's allegations seem serious when "[s]een from 40,000 feet," upon closer inspection both the complaint and the unedited samples of the documents it incorporated present a "more benign view of the facts." Specifically, the court found that the 7% stock drop allegedly spurred by the DOJ investigation announcement did not demonstrate loss causation because the stock price recovered within four trading days and coincided with the company's disclosures about the impact the COVID-19 pandemic had on its business.

The court also dismissed claims of widespread fraud, holding that the alleged wrongdoing was connected to only four contracts out of the "tens of thousands" the company processed annually — an impact it believed a reasonable investor would not view as significantly altering the total mix of information available about the company's performance. Finally, the court found that the complaint's allegations of scienter failed because of the confidential witnesses' inconsistent testimony and secondhand knowledge of the company's alleged misconduct.

Western District of New York Dismisses Claims Alleging Aerial Vehicle Company Made Regulatory Approval Misstatements

In re: EHang Holdings Ltd. Sec. Litig. (S.D.N.Y. Dec. 15, 2022)

What to know: A New York district court dismissed securities fraud claims against a China-based autonomous aerial vehicle (AAV) company alleging it had made numerous misstatements regarding regulatory approvals. The court found that the plaintiffs failed to adequately allege a misleading statement.

Judge George B. Daniels dismissed a purported class action against a China-based autonomous aerial vehicle company and certain of its officers under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder. The complaint alleged that the company made numerous misstatements about its vehicles, regulatory approvals, manufacturing facilities, customer contracts, research and development efforts and revenues.

The plaintiffs' claims centered around three alleged misstatements: (i) The company "Obtained World's First Commercial Pilot Operation Approval of Passenger-grade AAVs for Air Logistics Uses" (according to a company press release headline); (ii) the company "took the lead on the world's first commercial pilot operation approval of passenger-grade AAVs for air logistics uses"; and (iii) the company's aircraft had received "flight approval from the Federal Aviation Administration."

The court determined that the statements were not adequately alleged to be misleading. It reasoned that the plaintiffs' investigation did not reveal that the company had not received regulatory approvals for passenger-grade AAV flights, just that it had received conditional approvals for trial test flights. The court also held that, based on the complete context of the statements, "a reasonable shareholder would not have received a false impression" of the company's regulatory approvals.

The court noted that the company clarified the scope of the approvals, such as describing that one approval was for a "trial permit" for "unmanned flights." It further determined that the company regularly disclosed in its public filings that it was "not aware of any operator having been granted *all required approvals* for the commercial operations of passenger-grade AAVs in China or the United States."

The court also rejected the plaintiffs' claim that the company's statements regarding its new facility were misleading because the facility was "non-operational" at the time it was made. The court reasoned that the company's statements did not suggest the facility was operational but instead merely stated that the company had "started" to ramp up its production "capacity" in its new facility.

Southern District of New York Dismisses Case Against Beverage Company, Finding Plaintiffs Failed To Identify Misleading Statements

Siegel v. Boston Beer Co. (S.D.N.Y. Dec. 5, 2022)

What to know: The Southern District of New York dismissed a putative securities fraud class action against a Boston-based beverage company for failure to identify any misleading statements concerning one of the company's hard seltzer products.

Judge Denise Cote dismissed a putative class action complaint by a class of investors alleging that a beverage 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 misleading statements concerning the sales and growth of the company's product in the hard seltzer market in 2021. The court held that the plaintiffs failed to identify any misleading statements and dismissed the case with prejudice.

The court held that the challenged statements were inactionable expressions of opinion or forward-looking statements concerning the company's performance. For example, the court reasoned that statements made by a company executive when asked to make predictions in May 2021 about the hard seltzer market as the country emerged from the COVID-19 pandemic were "quintessential statements of opinion about the future" and thus not actionable.

The court also reasoned that a statement quoted in a June 2021 article about the company's "confidence" was an expression of general corporate optimism and thus not actionable. Notably, the court also found that the plaintiffs' characterization of several statements as misleading was unfounded given the company reported accurate financial results.

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