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Skadden

Inside the Courts

A Quarterly Update From Skadden Securities Litigators

Trends and Filings That Matter

Spotlight

Supreme Court Hears Argument on Traceability Requirement in Circuit-Split *Slack v. Pirani*

Key Points

- Before the end of June, the U.S. Supreme Court is expected to issue a decision in a high-profile securities case that could have broad implications for whether and how plaintiffs can assert Section 11 and 12(a)(2) claims if they purchased securities offered to the public in a direct listing as opposed to a traditional initial public offering (IPO).
- At oral argument, some of the justices expressed concern that the SEC had not weighed in on the issues and focused on the paucity of case law addressing Section 12 claims.
- The Court alluded to the possibility that it would "split the baby" and rule on the traceability issue with respect to Section 11, but remand on the Section 12(a)(2) issue.

Introduction

The U.S. Supreme Court will likely decide in the next month whether plaintiffs asserting claims under Sections 11 and 12(a)(2) of the Securities Act must show that they purchased shares registered under the registration statement that they claim to be misleading. Section 11 of the Securities Act provides that when any part of a registration statement contains a material misstatement or omission, "[a]ny person acquiring *such security*" shall have an express right of action. 15 U.S.C. § 77k(a). Section 12(a)(2) provides that "any person who … offers or sells a security … by means of a prospectus or oral communication" which contains a material misstatement or omission may be liable to "the person purchasing *such security* from him." 15 U.S.C. § 77l(a)(2).

It is unclear whether "such security" under Sections 11 and 12(a)(2) should be interpreted in the same way, a major point of contention during the Supreme Court's oral argument. Courts have interpreted this phrase in Section 11 narrowly to mean that plaintiffs must show that their purchased shares were issued pursuant to the challenged registration statement. *See Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967).

Recently, the Ninth Circuit interpreted the term broadly, holding that both registered and unregistered shares in a direct listing were sufficiently traceable to the company's registration statement to sustain claims under Sections 11 and 12(a)(2). *Pirani v. Slack Techs., Inc.*, 13 F.4th 940 (9th Cir. 2021). The case arose from Slack's move to go public via a direct listing.

Direct listings, first approved by the SEC in 2018, allow a company to "go public" outside of the traditional IPO process. The filing of a registration statement is still required for a direct listing, but both registered and unregistered shares may be available for purchase on the first day of trading, making it difficult to tell whether shares being purchased were registered or not.

Slack's share price subsequently dropped and Pirani, who purchased shares offered to the public in the direct listing, brought claims under Sections 11 and 12(a)(2). However, because Slack's registered and unregistered shares were all offered through the same direct listing, Pirani did not know, and therefore could not allege, whether the shares he purchased were registered.

Slack moved to dismiss the claims, arguing that Pirani lacked standing because he could not trace his shares back to Slack's registration statement. The district court denied Slack's motion to dismiss, finding Pirani had standing.

The Ninth Circuit affirmed, holding that Slack's unregistered shares were "such securities" within the meaning of Section 11 because if not for the registration statement, no Slack shares — registered or unregistered — could be sold on the New York Stock Exchange. Therefore, Pirani need not "prove purchase of registered shares pursuant to a particular registration statement." Reading Section 11 together with Section 12(a)(2), Pirani also had standing because "Section 12 liability (resulting from a false prospectus) is consistent with Section 11 liability (resulting from a false registration statement)." 13 F.4th at 949.

Circuit Split

The Ninth Circuit's decision departed from its own precedent and created a split with other circuits. Before *Slack*, the Ninth, First, Second, Fifth, Eighth, Tenth and Eleventh Circuits all interpreted the phrase "acquiring such securities" under Section 11 to mean "acquiring a security issued pursuant to a registration statement." The Ninth Circuit distinguished those cases, reasoning that they involved multiple registration statements as opposed to a direct listing.

Although the Ninth Circuit created a circuit split on the interpretation of "such security" in Section 11, many of the justices' questions at oral argument surprisingly focused on standing under Section 12(a)(2) and whether the "such security" language should be read the same for both Sections 11 and 12(a)(2).

Highlights From the Supreme Court Oral Argument

- **The Court alluded to the possibility that it would "split the baby" and rule on the traceability issue with respect to Section 11, but remand on the Section 12(a)(2) issue.**

At oral argument, the questions directed toward Slack's counsel were colored by a concern with the paucity of Section 12 case law and that a ruling could be premature. Justice Brett Kavanaugh pointed out his concern in "deciding that issue without the SEC [t]here, without more law out there, [and] without knowing more about the Section 12 issue." He asked Slack's counsel whether the SEC had expressed an opinion on Slack's Section 12 argument. Slack's counsel responded that the SEC's silence implicitly affirmed its prior position that "Section 11 provides a cause of action only for purchasers of registered shares." Pirani's counsel countered that the SEC's position did not translate to this case and went so far as to say that in the absence of the SEC's views, the Court may consider dismissing as improvidently granted.

Justice Clarence Thomas asked counsel for each party whether Sections 11 and 12 should "rise and fall together," signaling the possibility that the Court would rule with respect to Section 11, but perhaps not 12(a)(2). Justice Neil Gorsuch asked Slack's counsel, "[W]ould the sky fall should we answer the Section 11 question in your client's favor, vacate and remand, without addressing the Section 12 question?" This suggests that the Court is curious about the implications of ruling that Pirani must meet the traceability requirement under Section 11 without reaching the same question on the Section 12 claim.

- **The Court inquired about whether Sections 11 and 12(a)(2) should be considered in parallel, despite textual differences between the statutes.**

The justices also suggested that Section 12(a)(2) is broader than Section 11 because its reach goes beyond registered shares. Justice Ketanji Brown Jackson noted in her interpretation that Section 12(a)(2) is broader because it also includes some exempt shares. Justice Kavanaugh agreed that "there are differences between [Sections] 11 and 12 over the exact same language." Justice Elena Kagan went further, commenting that "everything about Section 12 reads differently from Section 11" and gave four "key differences," including the broader scope of Section 12(a)(2) in referring to sales by oral communication, taking it outside the scope of a registration statement.

- **The Supreme Court appeared unconvinced that *Gustafson* controlled in this case.**

In support of its argument that Sections 11 and 12 should "rise and fall together," Slack's counsel relied heavily on *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), arguing that *Gustafson* confirmed that because Sections 11 and 12 were intended to enforce the registration and prospectus requirements in Section 5, the term "such security" should have the same meaning under both sections. Justice Kavanaugh, however, expressed that having read *Gustafson* "a lot," he "didn't come away with…[a] clear answer to [the] Section 12 issue." Justice Kagan voiced that there are "contested views of what *Gustafson* means" and that the Court will "always look at the language of the statute."

Ultimately, the scope and impact of a decision in *Slack* is unclear. If the Court issues a decision confined to direct listings, then its impact may be limited given only a handful of companies have gone public via a direct listing since 2018. But, if the Court's decision extends beyond direct listings to other public offerings — such as IPOs and special purpose acquisition company (SPAC) transactions — its implications could be far-reaching in expanding liability. Some commentators have noted that a decision affirming the Ninth Circuit could eviscerate long-standing precedent establishing the need for Section 11 plaintiffs to trace their securities back to a registration statement. Others have argued, however, that a decision in favor of Slack would hurt investors by depriving them of Securities Act protections if companies go public in nontraditional ways, such as direct listings. Moreover, it is unclear whether the Court will rule on both the Section 11 and 12 issues. Either way, a decision has the potential to have profound implications on the traceability requirement and what plaintiffs must prove going forward in alleging Section 11 and 12(a)(2) claims.

Cryptocurrency

SDNY Denies Motion To Dismiss Class Action Against NFT Issuer and CEO, Concluding NFTs Satisfied All Elements of *Howey* Test

Friel v. Dapper Labs, Inc. (S.D.N.Y. Feb. 22, 2023)

What to know: The Southern District of New York denied a motion to dismiss a putative securities class action against a creator and issuer of NFTs and its CEO, alleging the company offered for sale certain NFTs to the public without filing a registration statement with the SEC.

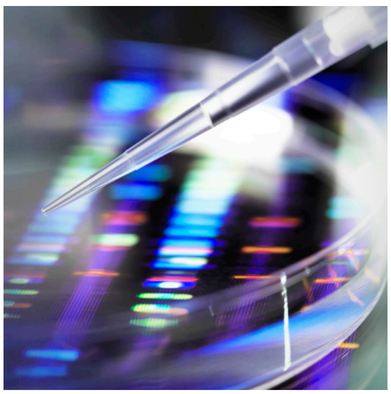
Judge Victor Marrero of the Southern District of New York denied a motion to dismiss a putative securities class action against a creator and issuer of nonfungible tokens (NFTs) and its CEO, alleging the company violated Sections 5 and 12(a)(1) of the Securities Act by offering for sale certain NFTs — NBA Top Shot Moments — to the public without filing a registration statement with the SEC.

The court concluded that the plaintiffs adequately alleged the NFTs at issue were "securities" because they satisfy all elements of the *Howey* test espoused in the seminal Supreme Court case *SEC v. W.J. Howey Co.* Under the *Howey* test, an investment contract exists when there is: (i) an investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profit derived from the efforts of others.

The first prong of the *Howey* test was not in dispute, and thus the court found it adequately pled. With respect to the *Howey* test's second prong, the court held that the plaintiffs had adequately pled a "common enterprise" because there was a pooling of funds that was tied to the overall venture's success. The court also concluded that the plaintiffs adequately pled that the fortunes of each purchaser were tied to the company's overall success because the company controlled the blockchain upon which the NFTs sat, and, once the NFTs were purchased, they could only be sold on the marketplace that the company controlled.

With respect to the *Howey* test's third prong, the court held that the plaintiffs adequately alleged that the company's public statements and marketing materials led purchasers to expect profits, pointing to — among other statements — tweets recounting statistics of the NFTs' market performance with rocket ship, money bag and stock chart emojis, which the court reasoned could "objectively mean one thing: a financial return on investment."

Health Care and Life Sciences



Fourth Circuit Affirms Dismissal of Class Action Over Cancer Treatment Trial Statements

Emps. Ret. Sys. of the City of Baton Rouge & Par. of E. Baton Rouge v. MacroGenics, Inc.
(4th Cir. Mar. 2, 2023)

What to know: The Fourth Circuit affirmed the dismissal of a securities fraud class action alleging a biopharmaceutical company made material misrepresentations, misleading statements or omissions concerning its new cancer treatment product's clinical trials.

The Fourth Circuit affirmed the dismissal of a securities fraud class action regarding MarcoGenics' statements about the clinical trials of its new cancer treatment product Margetuximab. The plaintiffs alleged that the defendants made material misrepresentations, misleading statements or omissions concerning Margetuximab in violation of Rule 10b-5; Sections 10(b) and 20(a) of the Exchange Act; and Sections 11, 12(a) and 15 of the Securities Act.

MacroGenics conducted a Phase III trial for Margetuximab, which compared the performance of the new Margetuximab treatment to that of the existing treatment using a drug called Trastuzumab. The trial first attempted to establish a "meaningful benefit" to patients taking Margetuximab as opposed to Trastuzumab in terms of "progression free survival" (PFS) and "overall survival" (OS).

On February 6, 2019, MacroGenics released results from its initial review of the trial. The company announced that the data showed a statistically significant PFS benefit to Margetuximab treatment, but stated only that the OS data was still "maturing." The company's stock price increased by 130% that same day.

After a secondary public offering and over the next few months, MacroGenics continued to publicize its positive PFS data while declining to comment on its OS data, except to mention the data was still maturing. On May 15, 2019, MacroGenics disclosed initial interim OS data for the first time. On June 4, 2019, MacroGenics presented interim trial data at a conference and, also for the first time, presented graphs of OS data showing that the clinical trial data was not on track to demonstrate that Margetuximab would result in a meaningfully higher overall survival rate than Trastuzumab. Two days after the conference, the price of MacroGenics stock fell more than 21%, representing an overall 43% decline since its February 6, 2019, high.

The plaintiffs brought suit, alleging that the defendants caused them to buy MacroGenics stock at "artificially inflated prices" and suffer losses after the "full truth" about the study emerged. The defendants moved to dismiss, and the district court granted the defendants' motion.

On appeal, the Fourth Circuit affirmed. The court concluded that the defendants lacked a duty to disclose the interim OS results because the written and oral statements at issue did not speak to the OS data, and the defendants' "mere reference" to full trial data in a discussion of top-line results did not trigger a duty to disclose the full results of the study. The court found that the defendants' statements — which used the words "positive," "excited" and "promising" — constituted "textbook examples" of puffery. The court also found that the defendants consistently qualified each of their optimistic statements with risk warnings that the OS endpoint could fail, and that the defendants' positive statements about the interim OS data merely represented a difference of opinion about the interim data results and thus were inactionable opinions. The court also found that, considered as a whole, the defendants' statements sufficiently warned investors and the public that the interim OS data was not final, and that they could not yet draw conclusions about Margetuximab's performance compared to Trastuzumab.

Global Pharma Company Wins Dismissal of Investor Lawsuit Alleging False, Misleading Statements Made During Alzheimer's Drug Launch

Okla. Firefighters Pension & Ret. Sys. v. Biogen Inc.
(D. Mass. Mar. 29, 2023)

What to know: The District of Massachusetts dismissed a plaintiff's claims against a global pharmaceutical company alleging it misled investors following the FDA approval of a novel drug treatment for Alzheimer's disease.

Judge William G. Young of the District of Massachusetts dismissed a plaintiff's claims against a global pharmaceutical company alleging it violated Sections 10(b) and 20(a) of the Exchange Act for misleading investors following the FDA approval of a novel drug treatment for Alzheimer's disease. The plaintiff alleged that at the time of the drug's launch, the company made false or misleading statements concerning the number of health care sites ready to treat patients, diagnostic capacity, price, a presumption of Medicare coverage, a potential partnership with the Veterans Health Administration and discussions with the Food and Drug Administration (FDA). The plaintiffs alleged that after the FDA approved the drug under an accelerated approval pathway, health care providers took a skeptical view of the drug, which purportedly led to limited sales and effective discontinuation of the drug for commercial sales.

The court held that the plaintiff failed to adequately plead that any of the challenged statements were false or misleading. In particular, the court held that the plaintiff's allegations regarding several of the challenged statements were simply too generalized to establish falsity, and that they did not adequately quantify the scope of purported "inaccuracies" or "discrepancies" that the plaintiff claimed rendered those statements false or misleading. As to other challenged statements, the court held that the plaintiff had misinterpreted and misconstrued them, and — when read in proper context — none of those statements were actually false or misleading at all. In doing so, the court stated that "[a] securities fraud complaint cannot rest on a house of cards made of mischaracterized statements."

The court also found that the plaintiff failed to adequately plead that the individual defendants acted with the requisite level of scienter. The court gave no weight to the plaintiff's confidential witness accounts, which were based on statements made by eight low-ranking former employees who were at least four levels removed from the company's senior management and not alleged to have directedly interacted with any of the individual defendants. The court also found the plaintiff's scienter allegations inadequate because they failed to show that any defendants were aware of adverse information rendering the challenged statements misleading at the time they were made, including because they were based on mischaracterizations of the challenged statements.

SDNY Dismisses Class Action Alleging Biopharmaceutical Company Intentionally Delayed FDA Approval To Avoid Billion-Dollar Payout

In re Bristol-Myers Squibb Co. CVR Sec. Litig.
(S.D.N.Y. Mar. 1, 2023)

What to know: The Southern District of New York dismissed a putative class action against a global biopharmaceutical company alleging it intentionally delayed FDA approval of three drugs to avoid a billion-dollar payout to CVR holders.

Judge Jesse M. Furman of the Southern District of New York dismissed a putative class action complaint brought by shareholders of global biopharmaceutical company Bristol-Myers Squibb Company (BMS) alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 11 and 12(a)(2) of the Securities Act. The plaintiffs alleged that, as part of a merger, the company issued CVRs — securities payable upon the occurrence of a specified future event — that were contingent upon approval of three drugs by the FDA. If the drugs were approved by the specified deadlines, BMS would have had to pay $6.4 billion to the CVR holders. The FDA did not approve the drugs until 36 days after the specified deadline, and thus the CVRs expired without payout. The plaintiffs alleged that the company intentionally delayed FDA approval to avoid the $6.4 billion payout and challenged various statements concerning the company's efforts to meet the deadlines, the likelihood that the deadline would be met and the value of the CVRs.

The court held that the plaintiffs' generalized motive allegations that the company wanted to avoid the $6.4 billion payout to CVR holders and the magnitude of that amount was insufficient to support a strong inference of scienter. The court also rejected the plaintiffs' argument that the CVR payout structure supported an inference of fraud because the plaintiffs failed to allege that the merger agreement containing the CVR payout structure was not negotiated at arms-length or was somehow fraudulently induced.

The company's alleged refusal to buy back CVRs on the open market when they were trading below the payout amount also did not support an inference of scienter because there were alternative explanations more cogent and compelling than an inference of culpability, including the company's determination that the risk of buying back the CVRs outweighed any potential benefits. The plaintiffs also failed to adequately allege that any individual defendant knew about alleged missteps causing the company to miss the FDA approval deadline.

The court also dismissed the Securities Act claims because the challenged statements were protected under the Private Securities Litigation Reform Act's (PSLRA's) safe harbor for forward-looking statements. Statements estimating the probability of achieving FDA approval and the CVR milestone were classic forward-looking statements about future events, and were identified and accompanied by exhaustive and substantive language of potential risks with meeting those achievements.

Biotechnology Company Secures Dismissal in Class Action Suit Over Insurance Claims

In re Eargo, Inc. Sec. Litig. (N.D. Cal. Feb. 14, 2023)

What to know: The Northern District of California dismissed federal securities claims brought against a hearing aid manufacturer, finding that the plaintiff investors did not plead any actionable misstatements or that the defendants acted with the requisite level of scienter.

Judge Charles R. Breyer of the Northern District of California dismissed federal securities claims brought against direct-to-consumer hearing aid manufacturer Eargo, alleging the company submitted fraudulent insurance claims and failed to disclose reimbursement eligibility information in its IPO documents.

Eargo considers itself a "disruptor" in the hearing aid industry because it sells company-manufactured hearing aids directly to customers. The company also offers customers the option to forgo a doctor's visit by completing one of its proprietary "do-it-yourself" hearing tests. In 2017, Eargo expanded its marketing efforts beyond over-the-counter sales to target customers who receive hearing aid benefits through an insurance plan affiliated with the Federal Employees Health Benefits Program (FEHBP). These efforts paid off: By the end of 2020, insured customers accounted for roughly 45% of Eargo's total customer base.

In 2021, Eargo's largest third-party insurance payor commenced an audit of claims submitted for reimbursement by the company in order to verify whether each claim had the requisite certification from a health care provider showing that the device was medically necessary. Shortly after, the Department of Justice commenced a separate audit that ended with Eargo agreeing to pay a $34 million civil penalty in exchange for settling alleged False Claims Act violations.

In 2022, the plaintiffs — Eargo shareholders — filed suit in the Northern District of California, claiming that the company violated Section 11 of the Securities Act and Section 10(b) of the Exchange Act by submitting fraudulent insurance claims and failing to disclose in its IPO documents that its hearing aids were ineligible for FEHBP reimbursement without medical certification.

The court dismissed the plaintiffs' claims, finding they failed to allege with particularity facts demonstrating that the defendants believed FEHBP insurance companies would not reimburse their claims, given that insurers had reimbursed the company for three years prior to the 2021 audit. The court further found that the company's statements in its offering documents about its ability to obtain reimbursement from third-party insurers were inactionable, forward-looking projections. In reaching this conclusion, the court stressed that Eargo explicitly warned investors in its offering documents that insurance coverage and reimbursement were not guaranteed. The court also dismissed the complaint for failure to adequately plead scienter, finding that the plaintiffs did not allege any facts showing that the defendants knew their insurance reimbursement statements were false.

M&A

Court of Chancery Finds Officer Personally Liable for Conflicted Sales Process

In re Mindbody, Inc. S'holder Litig. (Del. Ch. Mar. 15, *revised* Mar. 21, 2023)

What to know: A Delaware court imposed liability on the target's CEO for sale process failures in connection with the sale of a technology company. The opinion also held the CEO liable for presenting misleading disclosures to company stockholders to get the acquisition approved, as well as the acquiror liable for aiding and abetting those misleading disclosures.

The Court of Chancery found that the CEO and director of Mindbody, Inc. (the Company), Richard Stollmeyer, was ready to sell the Company because, among other reasons, he desired liquidity and was ready to move on from the Company's recent struggles. The court determined that, after Stollmeyer received a "mind blowing" presentation about the amount of money portfolio company chief executives could make while working under the umbrella of the eventual buyer — Vista Equity Partners Management, LLC — he "effectively greased the wheels for Vista" to emerge as the acquiror from the board's sale process. The court catalogued several instances in which Stollmeyer gave the board no information, or only partial information, about his conversations with Vista. The court found that Stollmeyer tipped Vista about the board's upcoming formal sale process, and the Company's banker tipped Vista as to Stollmeyer's target deal price. With this information, the court determined that Vista "bragged" internally that it was '"able to conduct all of [its] outside-in work before the process launched"' and to '"move swiftly in the process to provide the Board with a highly certain offer within 3 days of receiving data room access."' In December 2018, the Company and Vista entered into a merger agreement, which the stockholders subsequently approved.

After the merger closed, the plaintiffs brought suit, arguing that Stollmeyer and the rest of the Company's board breached their fiduciary duties by tilting the sale process in Vista's favor and failing to disclose material information in the proxy statement. The plaintiffs also contended that Vista aided and abetted those breaches. All the defendants except for Stollmeyer and Vista had either settled before trial or been dismissed from the lawsuit.

Analyzing the plaintiffs' process-based claim for breach of fiduciary duty against Stollmeyer, the court found that Stollmeyer suffered a disabling conflict because of his desire for near-term liquidity, as well as the expectation that he would receive post-merger employment and significant equity-based incentives as a Vista portfolio company executive. The court similarly found the record "riddled with instances" where Stollmeyer tilted the sale process in Vista's favor, as well as multiple occasions where Stollmeyer had left the board "in the dark" about the extent of his personal interests or his interactions with Vista. As a result, Stollmeyer's conduct rendered the sale process outside the "range of reasonableness" required to satisfy "enhanced scrutiny" under Delaware law. In assessing damages, the court adopted the plaintiffs' "lost transaction" theory of damages, which evaluates the deal price that would have been reached without a fiduciary breach. Based on "internal Vista bets" about where the deal price would land, the court found that Vista would have paid $1 more than the deal price, per share. The court awarded $1 per share in damages, amounting to nearly $46 million (excluding the shares held by Stollmeyer).

Analyzing the plaintiffs' disclosure-based claim for breach of fiduciary duty against Stollmeyer, the court found that Stollmeyer knowingly withheld information from stockholders and created a false narrative about his interactions with Vista in the Company's proxy statement. The court also held Vista liable for aiding and abetting this breach of fiduciary duty because, under the merger agreement, Vista had a "contractual obligation … to correct any material omissions" in the proxy statement. Thus, the court determined Vista knowingly participated in the breach by not speaking up when contractually required to do so. The court awarded "nominal" damages because the plaintiffs made no attempt to prove the reliance and causation elements required for compensatory. The court examined prior case law on what constitutes nominal damages and used its discretion to award $1 per share in overlapping damages. The total $46 million damage award did not increase.

SEC

Northern District of Ohio Grants in Part, Denies in Part Officers' Motion to Dismiss Claims Arising From Product Performance Data Statements

Plagens v. Deckard (N.D. Ohio Mar. 30, 2023)

What to know: The Northern District of Ohio granted in part and denied in part a motion to dismiss securities fraud claims against a company's officers for statements allegedly touting misleading and inaccurate data regarding the efficacy of the company's products.

Judge J. Philip Calabrese of the Northern District of Ohio granted in part and denied in part a motion to dismiss securities fraud claims against five Covia Holdings Corporation officers for statements allegedly touting misleading and inaccurate data. The plaintiff shareholder of Covia sued the officers under Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5 thereunder. The defendants moved to dismiss for failure to state a claim. The court granted the defendants' motion as to four of the five defendants, but denied the motion as to statements attributed to the company's former president and CEO.

The plaintiff alleged misrepresentations and omissions in three categories of statements: (i) comparing the performance of one of the company's products to a higher-performing and more expensive product on the market, (ii) testing performance results for another company product and (iii) the commercial prospects for products and the accompanying risk disclosures.

As to the first two statement categories, the plaintiff alleged the statements comparing the company's products to another product were false and misleading, and that the company reported inflated numbers from its field trials touting enhanced production using its product. In response, the defendants argued these statements were unactionable puffery and immaterial as a matter of law because they were vague and incapable of being proven or disproven.

The court disagreed with the defendants' characterization. As to the first category of statements, the court noted that the statements about the company's product referenced conductivity — a metric reasonably capable of being proven or disproven. Regarding the second category, the court held that the test results contained "objective, verifiable numbers" and found the plaintiff adequately alleged misleading statements.

As to the third category, the plaintiff alleged statements and risk disclosures about the commercial prospects of the company's products were false or misleading. The plaintiff argued the statements falsely represented that repeat customers adopted a product after testing and oversold the products' success. The plaintiff also alleged that the risk disclosures were misleading because the risks the company warned of had already occurred when the company made the disclosures. The defendants argued that the statements were not false or misleading because when the statements were made, the company was still working to commercialize the products, and the plaintiff could not base a securities fraud claim on statements disclosing the possibility of "the precise risk Plaintiff alleges form[ed] the basis for this lawsuit."

The court held that the plaintiff adequately alleged that statements about repeat customers were false and objectively verifiable because only one customer had adopted the product. However, as to the risk disclosures, the court found that, though vague, the disclosures sufficiently warned of the risk that occurred — the product failing — and the defendants' optimistic statements fell within the PSLRA's statutory safe harbor for forward-looking statements. The court further noted that the defendants were not obligated to disclose that the potential risk was "extremely likely to occur, or already had" occurred.

On scienter, the court found the plaintiff adequately alleged scienter only as to the former president and CEO through her statements about performance test results on earnings calls and SEC filings. Considering the control-person liability claims, the court could not find the underlying violation required for a Section 20(a) claim because the company was not a defendant in the case. The court declined to impute the former president's scienter to the non-defendant company to support a Section 20(a) claim against the former president.

SPACs

SDNY Dismisses Class Action Alleging Used Car Company Made Business Model Misstatements Before SPAC Merger

In re CarLotz, Inc. Sec. Litig. (S.D.N.Y. Mar. 31, 2023)

What to know: The Southern District of New York dismissed a putative class action against a used car marketplace and a SPAC entity alleging the car company made misstatements about its business model before going public through a SPAC merger.

Judge Ronnie Abrams of the Southern District of New York dismissed a putative class action against a consignment-to-retail used car marketplace and a SPAC entity for alleged violations of Sections 11 and 12(a)(2) of the Securities Act and Section 10(b) of the Exchange Act in connection with alleged misstatements about the car company's business model made before it went public through a SPAC merger. The plaintiffs alleged that the car company made misrepresentations regarding key aspects of the company's business model after the merger transaction was publicly announced.

The court dismissed the Section 10(b) claim for lack of standing because the plaintiffs did not buy or sell the securities about which the alleged misstatements were made. The court reasoned that because none of the named plaintiffs had purchased shares of the car company before the SPAC merger was completed, they did not have standing to challenge pre-SPAC merger misstatements that were made by the car company about itself. The court relied on the Second Circuit's decision in *Menora Mivtachim Industries Ltd. v. Frutarom Industries Ltd.*, which held 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 court further rejected the plaintiffs' argument that *Frutarom* creates a loophole for SPAC transactions, reasoning that the Second Circuit had rejected similar policy concerns, and a plaintiff has other available remedies to sue target companies for alleged misstatements.

The court also determined that the plaintiffs failed to allege standing in connection with their Section 11 claims. The plaintiffs unsuccessfully alleged that they purchased shares traceable to the registration statement for the merger transaction between the car company and the SPAC. Generalized allegations that the plaintiff purchased securities during the class period were insufficient. In addition, because the plaintiffs purchased shares in the SPAC prior to the challenged offering, those shares could not have been traceable to the challenged registration statement. The court further rejected the plaintiffs' argument that the merger "functionally transformed" the plaintiffs' SPAC shares into the merged car company's shares that were issued pursuant to the challenged registration statement as foreclosed by Second Circuit authority, limiting Section 11 claims to those challenging the same registration statements under which the securities were issued.

Technology

Ninth Circuit Revives Securities Fraud Claims Against Information Technology Company Due to Statute of Limitations Interpretation

York Cnty. v. HP, Inc. (9th Cir. Apr. 11, 2023)

What to know: The Ninth Circuit revived securities fraud claims against a multinational information technology company, holding that the statute of limitations commences only when plaintiffs discover, or should have discovered, facts that would allow them to plead their claims with "sufficient detail and particularity" to survive a motion to dismiss.

The Ninth Circuit reversed the dismissal of securities fraud claims under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder against HP, Inc. (HP). The lower court had held that the suit was time-barred under the two-year statute of limitations in 28 U.S.C. § 1658(b)(1).

In November 2015, the Hewlett-Packard Company (HPC) split into two entities: HP and Hewlett Packard Enterprise. HP kept HPC's consumer electronics and printing business, while Hewlett Packard Enterprise retained HPC's corporate technology infrastructure and services business. HP's main source of profits was its printing supplies business — the company sold printers at a loss and then recovered those earnings by selling printing supplies like toner and ink cartridges.

Between 2015 and 2016, HP allegedly sold printing supplies through a "push model" that incentivized two "[t]ier[s]" of distributors to purchase HP supplies from each other before ultimately selling them to end users. HP allegedly tracked its inventory using a metric called Weeks of Supply (WOS), which measured how many weeks' worth of products the company could supply if sales remained consistent. WOS was allegedly calculated using only one distributor tier, which meant that supplies could be shifted to another tier or sold to an unassigned territory to keep WOS within the mandated sales targets. HP purportedly did not disclose these practices to investors — instead, it simply reported whether the company was within or above the company-wide sales target.

In September 2020, the SEC released an order detailing these sales practices and disclosing its settlement with HP, in which the company agreed to pay a $6 million fine. A few weeks later, the plaintiffs sued HP for securities fraud. The district court dismissed the investors' claims as time-barred because the alleged misrepresentations occurred four years before the suit was filed in 2020, two years beyond the statute of limitations for securities fraud claims set forth in 28 U.S.C. § 1658(b)(1).

On appeal, the Ninth Circuit reversed, holding that the Exchange Act's statute of limitations commences only once a plaintiff discovers, or should discover, facts that would allow them to plead their securities fraud claim in "sufficient detail and particularity" to survive a motion to dismiss. Relying upon the Supreme Court's reasoning in *Merck & Co., Inc. v. Reynolds*, the panel reasoned that the plaintiffs would not have been able to uncover the facts they needed to plead to survive a motion to dismiss based on the defendant's allegedly fraudulent statements alone. Rather, the plaintiffs needed the information contained in the SEC's September 2020 order to sufficiently plead their claims. Thus, the statute of limitations began to run only after the SEC published its order, not when the defendants made the purportedly fraudulent statements in 2016.

Other Notable Cases

Third Circuit Holds PSLRA Requires Sanctions for Rule 11 Violations

Scott v. Vantage Corp. (3d Cir. Apr. 5, 2023)

What to know: The Third Circuit imposed sanctions against investors who filed "factually unsupported" securities fraud claims against a trading firm and its executives, vacating a lower court order that found Rule 11 violations, but declined to impose any sanctions for those violations.

The Third Circuit vacated a lower court order declining to impose sanctions against investor plaintiffs who committed minor Rule 11 violations, ruling that the plaintiffs must face sanctions according to PSLRA guidance.

In 2016, Vantage raised approximately $8 million from 16 investors during its stock offering. Plaintiffs Tara Scott and Wilson Carter purchased a combined $5 million of Vantage stock, roughly 60% of the total amount raised in 2016. Upon purchasing the stock, the plaintiffs experienced buyers' remorse: They became concerned about Vantage's financial condition and felt that the company's executives had not provided them with enough information about the status of their investments. They tried to recoup their funds but discovered that they lacked the right of rescission under the terms of Vantage's stock agreements.

Lacking the contractual right to rescind their investment, the plaintiffs attempted to claw back their funds through litigation. In April 2017, Scott and Carter sued Vantage and its executives for securities fraud in the District of Delaware, alleging the company violated federal securities laws by selling unregistered and nonexempt securities to purportedly unsophisticated and unaccredited investors without sufficient disclosures, and by making material misrepresentations in connection with the issuance of a security. Within months of filing the lawsuit, one of the plaintiffs noted in an email to his counsel that their "strategy was to file [] complaints to force a settlement."

The defendants moved for summary judgment and sanctions under Rule 11. After the district court granted summary judgment for the defendants, it also found that the plaintiffs were guilty of violating Rule 11(b)(1) by filing a complaint for an improper purpose — to "force a settlement" with the defendants. The district court declined to impose sanctions, however, because it believed that the Rule 11 violations were not "substantial" enough to warrant sanctions under the PSLRA.

On appeal, the Third Circuit agreed that the Rule 11 violations were de minimis, but nevertheless vacated the lower court's ruling, holding that under the PSLRA, courts must impose sanctions when they find Rule 11 violations in securities fraud cases. The panel remanded the case to the district court to determine which sanctions to impose.

SDNY Dismisses Class Action Alleging Fitness Company, Certain Officers Made Demand Sustainability Misstatements During COVID-19

Robeco Cap. Growth Funds SICAV v. Peloton Interactive, Inc. (S.D.N.Y. Mar. 30, 2023)

What to know: The Southern District of New York dismissed a putative class action against a prominent fitness company and certain of its officers alleging the company intentionally misled investors about the sustainability of demand for its fitness products during the COVID-19 pandemic.

Judge Andrew L. Carter, Jr. of the Southern District of New York dismissed a putative class action against a prominent fitness 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 intentionally misled investors about the sustainability of demand for its fitness products during the COVID-19 pandemic.

The court determined that the plaintiffs failed to adequately allege an actionable misstatement, rejecting the plaintiffs' argument that the alleged statements were not forward looking or covered by the PSLRA's statutory safe harbor. The court held that the company's projection statements regarding the future demand for its products were forward looking and accompanied by meaningful cautionary language. For example, the company prefaced the forward-looking statements with the warning that "[a]ctual results may differ materially from those contained in or implied by these forward-looking statements due to risks and uncertainties associated with our business." The court further reasoned that such statements were accompanied by disclosures of specific risks made in the company's public filings.

The court also rejected the plaintiffs' argument that the alleged statements were not puffery and "were made specifically to alleviate investor concerns" about the company's rising inventory levels. The court held that statements such as "we think the future of fitness is in the home," "we think 2022 is going to be a fantastic year" and "[we] feel like [at home fitness] is a trend that's here to stay" are statements that are "textbook cases" of corporate optimism.

Northern District of Illinois Dismisses Derivative Action Against Bank, Current and Former Directors and Officers With Prejudice

In re Fifth Third Bancorp Derivative Litig. (N.D. Ill. Mar. 8, 2023)

What to know: The Northern District of Illinois dismissed a derivative action against a large bank and 15 of its current and former directors and two former officers with prejudice, finding the plaintiffs failed to show that demand would have been futile.

Judge Sara L. Ellis of the Northern District of Illinois dismissed a derivative action with prejudice brought by Fifth Third shareholders against Fifth Third, 15 of its current and former directors, and two former officers in the wake of the Consumer Financial Protection Bureau's (CFPB's) filing of an enforcement action against Fifth Third in 2020. After the court dismissed the plaintiffs' first complaint, the plaintiffs filed an amended complaint alleging that the director and officer defendants breached their fiduciary duties to Fifth Third, were unjustly enriched, wasted corporate assets, and committed violations of Sections 10(b) and 14(a) of the Exchange Act in connection with the sales practices alleged in the CFPB's 2020 enforcement action.

The court dismissed the amended complaint — this time with prejudice — holding that the plaintiffs failed to allege that making a demand on the directors would have been futile because the plaintiffs failed to plead either (i) that a majority of the director defendants lacked independence, or (ii) that the director defendants faced a substantial likelihood of personal liability on any of the asserted claims.

In making the first determination, the court noted that the plaintiffs' allegations solely "rest[ed] on the same allegations the Court [had] previously rejected as insufficient." In making the second determination, the court found that, with respect to the plaintiffs' failure of oversight claim, "the amended complaint undermines the contention that the Director Defendants ignored the increased focus on regulation of sales practices ... [rather, the] amended complaint [ ] suggest[s] that Fifth Third and the Board responded to reports of wrongdoing, complied with the CFPB's investigative demands, refined their compliance procedures, and oversaw steps management took to address areas of concern."

This conclusion also doomed the plaintiffs' claim that the director defendants made false and misleading statements in violation of Section 14(a), or did so with scienter in violation of Section 10(b). The plaintiffs alleged that Fifth Third's proxy statements violated Section 14(a) by failing to disclose that (i) Fifth Third's oversight programs were insufficient and the company's success was based on false cross-sell numbers, (ii) the company's code of conduct was not being followed or enforced and (iii) the price of Fifth Third's stock was artificially inflated in the executives' pay-for-performance compensation statement.

The court held that the statements about Fifth Third's oversight programs were too general to be actionable, and that there is no duty to disclose uncharged, unadjudicated allegations such as the CFPB investigation of Fifth Third. The court reiterated that Fifth Third's executive compensation statements were not misleading, and that the adoption of a code of conduct does not imply that all directors and officers are in compliance with that code.

The court also held that the plaintiffs failed to show that the director defendants made allegedly misleading statements about risk management and compliance, executive compensation and ethics training with scienter because the allegations "d[id] not support Plaintiffs' conclusion of persistent account problems or a culture of abusive sales practices." Further, the court stated that knowledge of a government investigation cannot, without more evidence, support an inference of scienter, as "making such an inference on its own amounts to improperly inferring fraud by hindsight."

Court of Chancery Extends *Caremark* Duty of Oversight to Corporate Officers

In re McDonald's Corp. S'holder Derivative Litig.
(Del. Ch. Jan. 26, 2023 & Mar. 1, 2023)

What to know: A Delaware vice chancellor found as a matter of first impression that corporate officers owe a duty of oversight, akin to the oversight duties owed by corporate directors, under *Caremark*. However, the court later dismissed all claims against the defendants for failure to state a claim.

The Court of Chancery dismissed all claims brought against director defendants in a case acknowledging that while officers owe a duty of oversight, context-driven applications matter and may differ in various situations.

The plaintiffs, stockholders of McDonald's Corporation (the Company), alleged that the former chief people officer (CPO) of the Company breached his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct, and also by engaging in his own sexual misconduct. The plaintiffs claimed that the officer had a duty of oversight and breached that duty by consciously ignoring red flags of misconduct.

The court rejected the officer's defense that oversight duties are limited only to a board of directors. The court opined that corporate officers also owe a duty of oversight and have an obligation to make a good faith effort to put in place reasonable information systems in order for officers to obtain the information necessary to do their job and report to the CEO and board. The court also determined that officers cannot consciously ignore red flags indicating that a corporation is going to suffer harm. These obligations mirror the two prongs of the traditional *Caremark* standard for corporate directors' duty of oversight.

The court explained that although the duty of oversight applies equally to officers, its context-driven application will differ. Some officers, like the CEO, have a company-wide remit; others with particular areas of responsibility will have their duty limited to that area except for particularly egregious red flags, even if such flags fall outside the officer's domain.

The court highlighted that such claims remain derivative, so the board controls the claims unless a stockholder can plead demand futility or show wrongful refusal. As with traditional *Caremark* duties of directors, the court also explained that establishing a breach of the officer's duty of oversight requires pleading and later proving disloyal conduct that takes the form of bad faith.

In the same opinion that recognized corporate officers' duty of oversight, the court held that the plaintiffs had stated a claim that the defendant officer acted in bad faith by consciously ignoring red flags of sexual harassment that caused the Company harm. However, one month later, the court dismissed all claims against the director defendants for failure to state a claim. The court found that the directors, when confronted with issues of sexual harassment and misconduct at the Company, acted and engaged with the problems by working with management on a response. This meant that the directors could have considered a demand from the stockholders to take action against the former CPO. As a result, the plaintiffs had no standing to assert claims against the officer, and the court dismissed those claims as well.

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