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Spotlight

US Supreme Court To Hear Whether Item 303 Omissions Are Actionable Under Section 10(b) of Exchange Act

Key Points

- The U.S. Supreme Court granted the petition for writ of *certiorari* in *Macquarie Infrastructure Corporation v. Moab Partners, L.P.* to decide whether the failure to make a disclosure pursuant to Item 303 of SEC Regulation S-K (*i.e.*, management discussion and analysis disclosures) can serve as the basis for a securities fraud claim under Section 10(b) of the Exchange Act, "even in the absence of an otherwise-misleading statement."
- Private securities plaintiffs have long brought Section 10(b) claims based on alleged Item 303 omissions. Circuit courts have been split on whether such omission-based claims are actionable.
- The Supreme Court is expected to resolve the circuit split, which may have important implications for companies facing securities fraud lawsuits based on alleged disclosure violations.

Introduction

The U.S. Supreme Court will likely decide before the end of its current term whether the failure to make a disclosure pursuant to Item 303 of Regulation S-K can serve as the basis for a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act). Section 10(b) and Rule 10b-5 make it unlawful for an issuer to "omit a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b). Item 303 of SEC Regulation S-K requires an issuer to disclose "any known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact" on the issuer's "financial condition or results of operations." 17 C.F.R. § 229.303(b)(2)(ii). Item 303 of Regulation S-K does not explicitly provide investors with a private right of action to sue for alleged disclosure violations, but private securities plaintiffs have long sought to assert Item 303 disclosure violations as a basis for a claim under Section 10(b).

The question of whether an alleged failure to comply with disclosure requirements in Item 303 can alone form the basis for an omissions case under Section 10(b) has worked into a circuit split. The Third Circuit has held that a violation of Item 303's reporting requirements

"does not automatically give rise to a material omission under Rule 10b-5," and that "[s]uch a duty to disclose must be separately shown." The Third Circuit reasoned that the materiality standards under Section 10(b) and Rule 10b-5 differ significantly from the materiality standards under Item 303 and, as such, Item 303's "disclosure obligations extend considerably beyond those required by Rule 10b-5." Relying on the Third Circuit's reasoning, the Ninth and Eleventh Circuits have also held that a violation of Item 303 does not necessarily give rise to Rule 10b-5 liability. The Second Circuit, however, departed from the majority view in its 2015 decision *Stratte-McClure v. Morgan Stanley*, holding that a failure to make a required Item 303 disclosure may be an actionable omission that can serve as the basis for a Section 10(b) claim. The Second Circuit recently reiterated its prior holding in *Macquarie Infrastructure Corporation v. Moab Partners, L.P.*, a case that has brought the circuit split before the Supreme Court.[1]

The Second Circuit's *Macquarie* Decision

The plaintiffs' claims in *Macquarie* centered around allegations that a public holding company made "material misrepresentations and omissions" to conceal potential exposures to its "most important operating division," International-Matex Tank Terminals-Bayone, Inc. (IMTT). IMTT was "one of the largest" bulk liquid storage businesses in the U.S., and its business primarily relied on revenue from the storage of No. 6 fuel oil. By the start of the class period, No 6. fuel oil faced a major industry ban caused by a pending regulation known as IMO 2020.

The plaintiffs alleged that the defendants omitted material information and made affirmative misstatements to conceal the extent of IMTT's exposure and anticipated resulting losses of revenue caused by IMO 2020. In particular, the plaintiffs alleged that the defendants had an obligation under Item 303 to "disclose that its profits, revenues, and dividends were at risk" during the period in which the demand for No. 6 fuel oil continued to decline. Instead, the plaintiffs alleged that the defendants not only failed to make Item 303 disclosures but also continued to assure investors, among other things, that Macquarie's business performance had been "boringly predictable." Ultimately, on a February 2018 earnings call, Macquarie's CEO announced that, in December 2017 and January 2018, many of IMTT's customers terminated their contracts for No. 6 fuel oil, calling the "sudden downturn a 'surprise.'" The same day, Macquarie's stock price dropped 41%.

The plaintiffs filed a consolidated class action complaint alleging violations of Section 10(b) of the Exchange Act and Sections 11 and 12(a)(2) of the Securities Act of 1933. In support of its claim under Section 10(b), the plaintiffs alleged in part that the defendants' failure "to comply with their Item 303 disclosure obligations" constituted an actionable omission of material information.

The Second Circuit vacated the dismissal of the plaintiffs' claims, holding that the plaintiffs adequately pled a "known trend or uncertainty" giving rise to a duty to disclose under Item 303. The Second Circuit held that the failure to make such a disclosure constituted an actionable omission that "can serve as the basis for ... a claim under Section 10(b) if the other elements have been sufficiently pleaded." The Second Circuit further held that the plaintiffs adequately pled that the omitted information was material under both the Item 303 and Section 10(b) materiality standards.

Petitioners' and Respondents' Arguments

The petition urged the Supreme Court to resolve the split among the Courts of Appeals, arguing that the Second Circuit's approach to Item 303 has expanded the scope of the private right of action under Section 10(b), which "is not about the completeness of disclosures," but about prohibiting "deception." The petition warned that the Second Circuit's expansive approach would incentivize overdisclosure to the detriment of issuers and investors. In opposition, the Moab plaintiffs argued that "the Second Circuit's decision did not expand impermissibly the private right of action under § 10(b)" because "plaintiffs must prove both a violation of Item 303 and all the elements of § 10(b)."

Impact of the Supreme Court's Review

The Supreme Court is expected to resolve the circuit split on this issue and determine whether omissions under Item 303 — in the absence of an affirmative misleading statement — can provide the basis for Section 10(b) liability. A ruling affirming the Second Circuit's decision potentially could increase the number of securities fraud complaints across the nation alleging Item 303 omissions as a theory of liability under Section 10(b). If the Supreme Court finds that Item 303 omissions do not automatically give rise to Rule 10(b) liability, securities fraud plaintiffs likely would be reticent to assert lawsuits under the Item 303 theory of liability, but might attempt to allege that Item 303 omissions rendered other statements misleading when bringing claims under Section 10(b).

[1] This issue was before the Supreme Court in 2017 in *Leidos Inc. v. Indiana Public Retirement System*, No. 16-58, but the case settled before it could be decided.

Cannabis

SDNY Finds Cannabis Company 10b5-1 Plan Undercut Inference of Scienter

Kasilingam v. Tilray, Inc. (S.D.N.Y. Aug. 21, 2023)

What to know: The Southern District of New York reconsidered a previous decision and dismissed a securities fraud class action against a Canada-based cannabis company for lack of scienter, holding that a significant number of the stock trades made by one of the company's senior officers during the putative class period were made pursuant to a 10b5-1 plan, and there were no allegations that the plan was entered into in bad faith.

Judge Paul A. Crotty of the U.S. District Court for the Southern District of New York dismissed claims against a Canada-based cannabis and pharmaceutical distribution company for alleged violations of Sections 10(b) and 20(a) of the Exchange Act. In its previous decision, the court held that the plaintiffs had sufficiently pled scienter because the circumstances surrounding the company's former CEO's trades, including the timing and volume of shares traded, created a sufficient inference of motive and opportunity to commit fraud. The company had argued that a large percentage of the trades were made pursuant to a 10b5-1 plan, but the court determined that the mere presence of a 10b5-1 plan was not a complete defense to scienter, particularly because the plans were entered into during the class period.

Upon reconsideration, the court determined that it had committed a "clear error" of law in connection with its scienter analysis involving the 10b5-1 plan trades. The court explained that it had overlooked binding Second Circuit precedent holding that allegations that trades made under a 10b5-1 plan that were entered into during a putative class period alone are insufficient to support an inference of suspicious trades where there are no allegations that the plan was entered into in bad faith. *Ark. Pub. Emps. Ret. Sys. v. Bristol-Myers Squibb Co.*, 28 F.4th 343, 352 (2d Cir. 2022). The court therefore reasoned that, in light of *Bristol-Myers Squibb*, it had weighed the financial benefit the CEO received from the stock trades "too heavily in its analysis" and explained that evidence of the 10b5-1 plan provided "at least one cogent inference of a non-culpable explanation for [the] trades and [] financial benefit during the Class Period for at least 12 out of the 14 trades at issue (that is, those trades were innocently scheduled pursuant to 10b5-1 plans)."

The court further reasoned that such an inference was stronger than the one presented by the plaintiffs because there were no allegations that the plan was entered into in bad faith. In addition, the court determined that the remaining stock trades that were not made pursuant to the 10b5-1 plans were not adequately alleged to be suspicious because they accounted for only approximately 15% of the available shares, which were too small to create an inference of scienter.

In sum, the court stated that its previous analysis of the plaintiffs' allegations was "too lenient" because "[w]hile Plaintiffs' story [wa]s plausible," it did not rise to the level of at least as plausible as the competing inferences offered by the company, thus warranting dismissal on reconsideration.

Cryptocurrency

Ninth Circuit Reverses in Part Dismissal of Section 10(b) Claims Based on Alleged Failure To Disclose Impact of Cryptocurrency Mining on Revenues

E. Ohman J:or Fonder AB v. NVIDIA Corp. (9th Cir. Aug. 25, 2023)

What to know: The Ninth Circuit reversed in part the dismissal of claims brought under Sections 10(b) and 20(a) of the Exchange Act, holding that investors sufficiently alleged that the CEO of a producer of GPUs knowingly or recklessly understated the extent to which its revenues depended on cryptocurrency mining.

The Ninth Circuit reversed in part the dismissal of claims brought under Sections 10(b) and 20(a) of the Exchange Act alleged against multinational technology company NVIDIA Corp. The company produces graphics processing units (GPUs), hardware used in graphics rendering and, increasingly, cryptocurrency mining. NVIDIA's GeForce GPU is designed for videogaming, and revenues from sales of GeForce GPUs were reported in NVIDIA's gaming segment. In May 2017, NVIDIA introduced a GPU specifically designed for crypto mining. Revenues from the new Crypto GPU were reported in NVIDIA's original equipment manufacturer and intellectual property (OEM) segment. Although the GeForce GPU is designed for gaming, it also can be used for mining cryptocurrency.

From May 10, 2017, to November 14, 2018, NVIDIA reported increased revenues, which it attributed largely to sales of GPUs in its gaming segment. During this period, NVIDIA's CEO and CFO denied that a substantial part of its gaming segment revenues came from sales of the GeForce GPU to crypto miners. Rather, the executives maintained that the increases in gaming-segment revenues and overall revenues were primarily driven by sales of GeForce GPU products for gaming.

On November 15, 2018, NVIDIA announced that its overall revenue projections were declining. The CEO and CFO acknowledged the role of the declining cryptocurrency market in the decrease in revenues. As a result of this disclosure, NVIDIA's stock price fell by 28.5%. Shareholders filed suit, alleging that the CEO and CFO had made false or misleading statements regarding the degree to which NVIDIA's revenues came from sales of GeForce GPUs to crypto miners.

The district court dismissed the claims against all defendants, but the Ninth Circuit reversed with respect to the CEO's statements. The court reasoned that the plaintiffs adequately pled that the CEO was a "detail-oriented" manager who was "obsessed" with tracking sales data that would have shown that a large portion of GeForce GPU sales were being used for crypto mining. The CEO had also commented on crypto miners' preference for GeForce GPUs on at least two separate occasions. In contrast, the court affirmed the dismissal of the claims against NVIDIA's CFO, reasoning that the complaint alleged only that the CFO had access to sales data, and not that she actually knew GeForce sales were driven by crypto miners.

SDNY Dismisses Claims Alleging Cryptocurrency Exchange Investors and Developers Issued 'Scam Tokens'

Risley v. Universal Navigation Inc. (S.D.N.Y. Aug. 29, 2023)

What to know: In a case the court labeled as one of "first impression," the Southern District of New York dismissed claims alleging that investors in and developers of a decentralized digital asset trading platform violated the Exchange Act and Securities Act based on the sale of certain "scam tokens" by unknown third-party issuers.

Judge Katherine Polk Failla of the U.S. District Court for the Southern District of New York granted the defendants' motions to dismiss claims under Section 29(b) of the Exchange Act and Section 12(a)(1) of the Securities Act of 1933 (Securities Act). The plaintiffs, individual investors who allegedly purchased "scam tokens" from unknown third-party issuers on the Uniswap decentralized platform, claimed that the defendants violated federal securities laws by offering contracts for "scam tokens." With respect to the Section 29(b) claim for contract recession, the plaintiffs alleged that they contracted with the defendants because the platform required them to buy and sell the tokens using smart contracts allegedly drafted by the defendants, and the plaintiffs paid fees for each transaction they made through those smart contracts.

The court rejected the plaintiffs' theory of liability, reasoning that "it defies logic that a drafter of computer code underlying a particular software platform could be liable under Section 29(b) for a third-party's misuse of that platform." The court held that the protocols enabling the smart contracts were general, lawful contracts, and that the plaintiffs failed to plead a direct connection between the platform's protocol and the specific fraudulent "scam token" transactions at issue.

Concerning the alleged unlawful sale of securities, the court held that because the plaintiffs failed to plausibly allege that the defendants ever held title to the "scam tokens" at issue, or that the defendants had specifically promoted the "scam tokens" for their own financial gain, the plaintiffs failed to plead a Section 12(a)(1) violation. The court reasoned that just because the defendants may have drafted the smart contracts underlying the protocol where the tokens were traded does not mean that they took title in those tokens — thus, the defendants could not be considered statutory sellers under Section 12. The plaintiffs' allegations that the defendants solicited the tokens at issue in order to obtain a profit were conclusory and inadequately pled.

Data Security

Ninth Circuit Reverses in Part Dismissal of Securities Fraud Claims Arising From Data Breach of Major Social Media Platform

In re Facebook, Inc. Sec. Litig. (9th Cir. Oct. 18, 2023)

What to know: The Ninth Circuit reversed in part a lower court's dismissal of federal securities claims brought against a major social media platform, holding that shareholders plausibly alleged that its statements regarding the risk of third-party data breaches and user control over their data were misleading.

The Ninth Circuit reversed in part the district court's dismissal of federal securities claims brought against Facebook (now Meta) alleging the company made false and misleading statements about its users' data. Prior to March 2018, Facebook and its executives publicly assured users that Facebook controlled its data and that third parties would not access the data without Facebook's consent. Facebook described third-party misuse of user data as a "purely hypothetical risk." Facebook gave these assurances even though it (i) maintained a system where "whitelisted" parties were exempt from its ban on third-party data access and collection, and (ii) had previously investigated Cambridge Analytica's access and use of Facebook users' data.

In March 2018, Facebook publicly announced that Cambridge Analytica had violated Facebook's policies by improperly harvesting and retaining personal data from millions of Facebook users. Facebook's stock dropped following the announcement. In the aftermath of the disclosure of the breach, Facebook assured users of their privacy and control over their personal data. However, on June 3, 2018, news outlets reported that Facebook had shared users' data with certain whitelisted parties. Facebook's stock price dropped again. Shareholders filed suit, alleging that Facebook made false or misleading statements regarding the risk of improper third-party access to Facebook users' data, as well as the control Facebook users have over their data.

The district court dismissed the shareholders' claims, but the Ninth Circuit reversed in part. The court held that the plaintiffs adequately pled falsity as to the statements regarding the risk of data misuse being only hypothetical. Applying its recent decision — *In re Alphabet* — the court reasoned that the plaintiffs' allegations supported the claim that Facebook was already aware of Cambridge Analytica's misconduct at the time it warned that risks "could" occur, when, in fact, those risks had already materialized. Specifically, the plaintiffs pleaded with particularity that Facebook learned about Cambridge Analytica's misuse of user data in 2015, which was well before Facebook characterized the risk of data breaches as hypothetical in its 2016 Form 10-K. Therefore, the public statements were misleading in light of the information Facebook knew when it filed the 10-K.

In addition, the court held that the shareholders adequately pled that Facebook's public statements regarding users' control over their data were misleading given that, at the time the statements were made, Facebook allowed whitelisted parties to access data against users' wishes.

IPOs

Northern District of Illinois Grants Motion To Dismiss Securities Action Over Alleged Misleading and Omitted Statements

Michalski v. Weber Inc. (N.D. Ill. Sept. 27, 2023)

What to know: The Northern District of Illinois granted in its entirety a barbeque grill manufacturer's motion to dismiss the plaintiffs' Securities Act violation claims against it. The plaintiffs alleged the company made misleading statements and omitted material information in its registration statement and prospectus when it went public in August 2021.

Judge Elaine E. Bucklo of the U.S. District Court for the Northern District of Illinois granted barbeque grill manufacturer Weber Inc.'s motion to dismiss plaintiffs' Securities Act violation claims against it. The plaintiffs, purchasers of shares in Weber's IPO, sued the company and its officers and underwriters on behalf of a putative class. The plaintiffs' action alleged that the defendants made misleading statements about the causes and durability of an upswing in Weber's sales, and omitted material information about the drivers and longevity of those sales.

Weber launched its initial public offering (IPO) in the summer of 2021 following a season of record-breaking sales during the COVID-19 pandemic. Weber's share price fell, and sales waned after analysts learned that the sales were due to a "pull-forward" phenomenon — existing customers made replacement purchases earlier than they would have were it not for the pandemic. The plaintiffs alleged that the defendants violated Section 11 of the Securities Act because the registration statement contained misleading statements. The plaintiffs also brought claims against certain defendants for violating Section 15 of the Securities Act because those defendants had the authority to control the contents of the registration statement and failed to ensure its accuracy.

The plaintiffs claimed that the defendants, through statements in Weber's registration statement, led investors to believe that the upswing in sales due to increased outdoor cooking would continue even after the pandemic subsided. The plaintiffs also alleged that the defendants possessed data showing that Weber's sales growth was not due to an increase in outdoor cooking that would continue, but was due to a temporary "pull-forward" phenomenon. By failing to disclose this data, and allegedly downplaying the importance of replacement sales to Weber's sales increase, the plaintiffs asserted that Weber's registration statement and prospectus were materially false or misleading. The defendants contended that the registration statement was not misleading because it included language noting that the company experienced higher demand during the pandemic, but that such growth "may not be sustainable and may not be repeated in future periods."

The plaintiffs also alleged that language in the registration statement disclosing certain risks was misleading because the defendants cautioned investors about the level of demand Weber experienced during COVID-19 without disclosing the "pull-forward" phenomenon. Weber argued that the plaintiffs failed to state a claim because the registration statement disclosed the very information the plaintiffs accused Weber of omitting.

The court held that Weber's registration statement, read as a whole, belied the plaintiffs' claim that Weber had made materially false or misleading statements. In granting Weber's motion to dismiss, the court noted that the registration statement acknowledged that the company had

experienced higher demand as customers sheltered in place, but that such growth might not be sustainable nor repeated in the future. The court also noted the registration statement cautioned that the pandemic could have the effect of heightening many of the risks described in the "risk factors" section of the prospectus.

Moreover, though the plaintiffs alleged that the registration statement gave the impression that replacement sales were relatively unimportant to Weber's business, the court found that Weber actually highlighted the importance of replacement sales by touting its repeat grill sales and large community of loyal Weber enthusiasts. The court conceded that, while investors might have been better informed about the impact of replacement sales on Weber's bottom line if the company had disclosed additional data, Section 11 did not require such granularity. The court therefore granted the defendants' motion to dismiss in its entirety.

Life Sciences and Health Care

Court of Chancery Dismisses Derivative Suit Criticizing Management of Company Business Risks

In re ProAssurance Corp. S'holder Derivative Litig. (Del. Ch. Oct. 2, 2023)

What to know: The Court of Chancery dismissed a stockholder derivative action asserting oversight and disclosure claims for failure to plead demand futility under Court of Chancery Rule 23.1. The stockholders pled no specific facts to infer the board's disloyalty in its management of business risks.

The Delaware Court of Chancery dismissed a stockholder derivative action against professional liability insurance provider ProAssurance Corp. asserting oversight and disclosure claims for failure to plead demand futility. After decades of underwriting policies for solo practitioners and smaller groups, amidst a competitive marketplace, ProAssurance decided to underwrite a large group account. An increase in claims from the large account impacted the company's loss reserves. The board and audit committee received regular updates about the loss reserves and potential claims from management and third-party experts. Management also regularly told the board that ProAssurance's loss reserves and claims paid remained reasonable and in line with historical averages, even though the number and severity of claims arising from the large account continued to increase. The company incurred large losses and was the subject of a federal securities lawsuit that it settled for $28 million.

Thereafter, two stockholders filed complaints in Delaware alleging that the ProAssurance board of directors breached their fiduciary duties of oversight — so-called *Caremark* duties — by failing to oversee the company's reserves for the large account and making false and misleading statements in public filings about ProAssurance's conservative underwriting and reserve practices. The court dismissed the claims for failing to plead "the sort of particularized allegations required to plead demand futility."

The court stated that the stockholders challenged a "commercial decision that went poorly — the stuff that business judgment is made of." The court recognized that insurance underwriting is "by its very nature, uncertain and risky," and that the board regularly received updates and properly delegated tasks to management while being guided by actuaries and auditors. The court found that "[t]he only so-called red flags were of business risks — not illegality. How (and whether) to respond was entirely within the directors' discretion."

The court also rejected the stockholders' disclosure claims for lack of any particularized allegations of scienter. The court held that signing public filings alone does not suggest "sufficient board involvement" in preparing disclosures. Further, while a third-party adviser took a "more pessimistic view" of the reserves required for the large account, the stockholders had not alleged facts that would permit the court to "take the inferential leap" that directors knew disclosures about ProAssurance's conservative reserve practices were false.

SDNY Dismisses Claims Against Migraine Therapy Developer for Failure To Plead Loss Causation

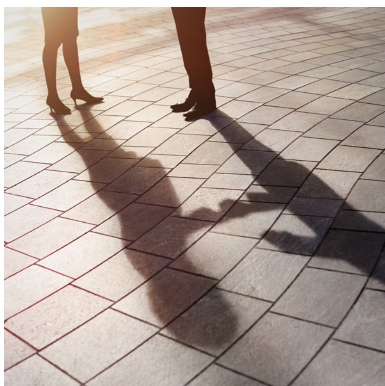
Gru v. Axsome Therapeutics, Inc. (S.D.N.Y. Sept. 25, 2023)

What to know: The Southern District of New York dismissed claims against a biopharmaceutical company alleging violations of Sections 10(b) and 20(a) of the Exchange Act, holding that statements concerning the timeline and prospect of FDA approval for a new migraine therapy were not knowingly false or misleading and did not support loss causation.

Judge Lorna G. Schofield of the U.S. District Court for the Southern District of New York dismissed claims for alleged violations of Sections 10(b) and 20(a) of the Exchange Act based on allegations that a biopharmaceutical company developing therapies for central nervous system disorders misled investors about the timeline and prospect of U.S. Food and Drug Administration (FDA) approval by failing to disclose alleged manufacturing difficulties. After initially announcing a target FDA submission date for the drug, the company announced that it would delay the submission date of its new drug application. At that time, the company stated that the delay was not related to manufacturing challenges. The company later publicly disclosed that manufacturing problems had delayed the FDA's review of its new drug application.

The court held that the plaintiff failed to adequately plead loss causation. Because the plaintiff sold all of his shares *before* the corrective disclosure of the alleged fraud was made — *i.e.*, when the negative news about the manufacturing problems was revealed — he had benefited from the inflated stock price and therefore could not sufficiently plead loss causation. The court also rejected the plaintiff's claim that an earlier partial corrective disclosure when he still held stock resulted in a stock price drop, finding that there was no corrective disclosure about manufacturing issues. The court also rejected the plaintiffs' materialization of the risk theory because the complaint failed to allege sufficient facts to support an inference that the manufacturing challenges were known to the defendants at the time they first announced a delay in the new drug application's submission.

M&A



Court of Chancery Holds '*Con Ed* Provision' Unenforceable by Target Company and Stockholders

Crispo v. Musk (Del. Ch. Oct. 31, 2023)

What to know: The Court of Chancery held that one iteration of a so-called "*Con Ed* provision" was unenforceable by the target company as drafted because the target had no right or expectation to receive the premium, and was unenforceable by the stockholder-plaintiff because stockholders never had standing to assert the provision.

The Delaware Court of Chancery denied a plaintiff's fee petition in a case related to a then-potential acquirer and a social media company's merger agreement. The plaintiff was a stockholder of the social media company who had previously sued the acquirer seeking specific performance of the merger agreement and damages, including damages under the "Lost-Premium Provision" of the merger agreement. This provision stated that, in the event of a breach of the merger agreement, "the buyers will be liable for 'the benefits of the transactions contemplated by this Agreement lost by the Company's stockholders ... taking into consideration all relevant matters, including lost stockholder premium[.]'" The court previously dismissed the plaintiff's claims in large part, but left open the question of whether the merger agreement permitted stockholders to seek "lost stockholder premium" damages as a third-party beneficiary.

The court denied the plaintiff's fee petition because his remaining claim also would not survive a motion to dismiss. In analyzing the Lost-Premium Provision, the court recounted the history of *Consolidated Edison, Inc. v. Northeast Utilities (Con Ed)*, in which the Second Circuit held that, based on a provision in the merger agreement between Consolidated Edison and Northeast Utilities providing for no third-party beneficiaries, Northeast's stockholders lacked standing to sue Consolidated Edison for breach of the merger agreement. The Court of Chancery noted that this decision "came as a surprise to M&A practitioners 'who believed that a merger premium (or some amount of shareholders damages) would be recoverable against a buyer such as Con Ed who wrongly terminates or breaches a merger agreement.'" The Court of Chancery examined the three types of provisions that had been created in the wake of the *Con Ed* decision to address the issue, ultimately focusing on the iteration that defined damages resulting from breach in terms of lost premia, which was the case here. The court stated that "[c]ommentators describing the damages-definition approach agree that it was not intended to grant stockholders third-party beneficiary status."

Examining the Lost-Premium Provision, the court found that the provision could not define the social media company's damages in the event of a breach because the company never would have received the merger consideration — only the company's stockholders received the consideration. Thus, unless the company's stockholders were given third-party beneficiary status to enforce the Lost-Premium Provision, the provision itself would be unenforceable. Applying settled Delaware law, the court found that "one reasonable interpretation" of the merger agreement did not grant third-party beneficiary status to the company's stockholders to enforce the Lost-Premium Provision. The court concluded by acknowledging "another possible construction," which would have granted the company's stockholders standing to enforce the Lost-Premium Provision "in exceptionally narrow circumstances," but it was clear that these circumstances would not arise if the company was pursuing specific performance against the acquirer. Because the company was pursuing specific performance of the merger

agreement against the acquirer and the merger ultimately closed, the plaintiff's right to enforce the Lost-Premium Provision never vested, and thus he never had an actionable claim. As a result, the plaintiff never had standing to enforce the Lost-Premium Provision under either construction of the merger agreement, and the claim would have been dismissed.

SDNY Denies in Part, Grants in Part Class Action Complaint Alleging Entrepreneur Concealed Acquisition of Major Social Media Platform

Okla. Firefighters Pension and Ret. Sys. v. Musk
(S.D.N.Y. Sept. 29, 2023)

What to know: The Southern District of New York denied in part and granted in part a putative class action complaint against an entrepreneur for allegedly waiting too long to disclose that he had invested in a social media company he later purchased.

Judge Andrew L. Carter of the U.S. District Court for the Southern District of New York denied in part and granted in part a motion to dismiss a putative class action against an entrepreneur alleging he violated Sections 10(b) and 20(a) of the Exchange Act. The plaintiff claimed the entrepreneur concealed his acquisition of more than 5% of stock of a social media company when he allegedly failed to file a Schedule 13 with the SEC within ten days of passing the 5% ownership threshold pursuant to Section 13(d) of the Exchange Act and 17 C.F.R. § 240.13d-1(a). The plaintiff alleged that the entrepreneur's misconduct deprived investors who sold the company's securities of material information about the securities' value.

In declining to dismiss the plaintiff's Section 10(b) claim, the court held as a threshold matter that material omissions and misstatements on a Schedule 13D Form in alleged violation of Section 13(d) may be actionable under Section 10(b), and Rule 10b-5 thereunder, even though they may also be actionable under Section 18(a). The court further determined that the plaintiff had adequately pled scienter, both as to the entrepreneur's failure to disclose his more than 5% ownership stake in the company, as well as to his failure to disclose his activist interest in it. The court credited the plaintiff's allegations that the entrepreneur knew of his duty to disclose given his sworn deposition testimony in an unrelated SEC enforcement action, and that he knew his ownership had crossed the 5% threshold because he held several nonpublic meetings where he specifically discussed his stake. The court also credited the plaintiff's circumstantial evidence that the entrepreneur embarked on a campaign to join the company's board of directors while amassing more than a 5% ownership stake, and that he was invited to join the board the day before he filed the Schedule 13G Form.

In dismissing the plaintiff's Section 20A claim for insider trading, the court found that the plaintiff failed to plead that the entrepreneur was a "temporary insider." For example, the plaintiff had not alleged that the entrepreneur entered into a confidentiality agreement, made material decisions for the company or misappropriated material nonpublic information that had been entrusted to him in confidence, thereby breaching a fiduciary duty to shareholders and its board to gain a personal profit.

Other Notable Cases

Ninth Circuit Holds Originally Named Plaintiff Lacks Standing To Appeal Dismissed Consolidated Securities Complaint

Habelt v. iRhythm Tech., Inc. (9th Cir. Oct. 11, 2023)

What to know: The Ninth Circuit held that a plaintiff who filed a securities fraud class action but was not named lead plaintiff under the PSLRA could not subsequently appeal the dismissal of the lawsuit.

The Ninth Circuit held that plaintiff Mark Habelt could not appeal the dismissal of a lawsuit he brought against iRhythm on behalf of himself and other iRhythm shareholders. Pursuant to the PSLRA lead plaintiff process, multiple iRhythm shareholders filed motions to be named lead plaintiff, and the district court ultimately appointed Public Employees' Retirement System of Mississippi (PERSM). The caption of the case, however, continued to list Mr. Habelt as the plaintiff. After multiple rounds of briefing, the district court dismissed PERSM's second amended complaint without leave to amend. PERSM did not appeal the dismissal — instead, Mr. Habelt filed a notice of appeal.

The appeal presented two threshold questions:

- First, was Mr. Habelt a party and thus allowed to appeal the dismissal?
- Second, if Mr. Habelt was not a party, was he nonetheless allowed to appeal the judgment as a nonparty?

As to the first question, the panel held that filing the original complaint did not confer upon Mr. Habelt the party status required to appeal the adverse judgment. Although Mr. Habelt's name continued to appear on the case caption, the body of the operative complaint did not mention Mr. Habelt, his alleged losses or his individual claims against iRhythm, nor did Mr. Habelt's status as a member of the *putative* class affect the analysis. On this point, however, the court explained that a member of a *certified* class action can appeal a dismissal of a securities fraud lawsuit.

As to the second question, the court held that there were no exceptional circumstances that gave Mr. Habelt the ability to appeal the dismissal of the lawsuit as a nonparty. A nonparty may appeal an adverse judgment only if they (i) significantly participated in the district court proceedings, and (ii) it would be just for the court to hear the case on appeal. In this case, the panel held, filing the original complaint was not "significant involvement." The court reasoned that Mr. Habelt did not move to be appointed the lead plaintiff, challenge PERSM's appointment as lead plaintiff or otherwise participate in the lawsuit after PERSM was appointed. Finally, it was not unfair to refuse to hear the appeal because Mr. Habelt was not "haled [] into the proceeding against his will" and then denied the right to appeal.

Sixth Circuit Affirms Dismissal of 10b-5 Claim Against Residential and Commercial Services Company

Teamsters Local 237 Welfare Fund v. ServiceMaster Glob. Holdings, Inc. (6th Cir. Sept. 28, 2023)

What to know: The Sixth Circuit affirmed a district court decision to dismiss a union health care fund's putative class action against a residential and commercial services company. The plaintiff alleged that the company violated Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, when it made statements relating to its exposure to liability for certain termite infestations.

The Sixth Circuit affirmed the dismissal of a class action against residential and commercial services company ServiceMaster Global Holdings, Inc. alleging the company violated Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. In the district court, the plaintiff argued that ServiceMaster misrepresented its subsidiary's potential liability under termite service contracts in its quarterly financial statements, resulting in lawsuits, extensive damages and a government investigation. Additionally, the plaintiff argued that the company's executives misrepresented the success of its customer retention policy on earnings calls, as these executives allegedly knew they were trying to shed at-risk customers to reduce future liability.

ServiceMaster argued that its statements were true at the time they were made and that it revised its liability estimates as the information developed. The district court sided with ServiceMaster, granting its motion to dismiss, in part, on the basis that statements the company made about transforming its subsidiary's customer retention and growth models were unactionable as generalized statements of optimism. However, the district court found that two statements or omissions could be actionable under Rule 10b-5: (i) ServiceMaster's failure to disclose its increasing termite liability, and (ii) its CEO's explanation that price increases were the result of favorable market conditions and not ServiceMaster's effort to shed customers. Despite this, the district court found that the plaintiff had failed to plead a strong case of scienter as required by the Private Securities Litigation Reform Act (PSLRA) because the plaintiff's allegations were consistent with the plausible, nonculpable inference that ServiceMaster developed a strategy it believed was reasonable under the circumstances and disclosed the problem with reasonable promptness.

On appeal, the question before the Sixth Circuit was whether the district court correctly determined that the plaintiff had failed to allege a strong inference of scienter regarding these statements concerning liability and customer retention. Considering the allegations holistically, the court held that the district court had not erred in dismissing the complaint for failure to sufficiently plead scienter. The court based this determination on the fact that the nonculpable explanation cited by the district court was more plausible than the fraudulent intent alleged by the plaintiff. In so holding, the court stated that neither pending litigation against a company nor a government investigation alone were sufficient to give rise to a strong inference of scienter without showing that the disclosures about the defendant's liability were inadequate at the time they were made. Furthermore, finding that the plaintiff did not allege specific facts or circumstances suggesting how the defendants' knowledge of certain facts demonstrated scienter, the court also rejected the notion that the plaintiff could establish a strong inference of scienter simply by pointing to a senior executive's intimate knowledge of a company's business plans.

Eleventh Circuit Affirms Dismissal of Securities Fraud Claims Against Parent Company Based on Alleged Fraudulent Sales Scheme of Foreign Subsidiary

In re Tupperware Brands Corp. Sec. Litig. (11th Cir. Aug. 8, 2023)

What to know: The Eleventh Circuit affirmed the dismissal of a complaint alleging that a fraudulent sales scheme at the foreign subsidiary of a major household products company violated federal securities laws, holding that shareholders failed to connect the lower-level corporate officials' knowledge and involvement in the fraud with any alleged false or misleading statements by the parent company.

The Eleventh Circuit affirmed the dismissal of a complaint alleging that a fraudulent sales scheme at Fuller Cosmetics, the foreign subsidiary of major household products company Tupperware, violated federal securities laws. Fuller employed a direct-to-consumer sales approach that utilized independent salespersons. The plaintiff shareholders alleged that Fuller took advantage of this sales model by sending products to the salespersons in excess of what they ordered in a scheme to inflate Fuller's accounts receivable. When the excess products were eventually returned by the salespersons, Fuller's management allegedly overrode the system that automatically replenished the company's stock when products shipped. When the scheme

was uncovered, Tupperware's stock price fell 35%. The plaintiff shareholders filed suit, alleging that Tupperware's quarterly and annual financial statements, as well as the related press releases and earnings calls that touted increases in Fuller's sales, were false and misleading because those increased sales were based on Fuller's scheme.

The district court dismissed the complaint, and the Eleventh Circuit affirmed. The panel held that the complaint failed to adequately allege scienter because the plaintiffs failed to plead that the individuals who made the allegedly misleading statements — Tupperware's CEOs and CFOs — were aware of the fraud or reckless in failing to discover it. Rather, only lower-level officials associated with Fuller were involved with and aware of the fraudulent scheme. The court rejected the plaintiffs' argument that if any corporate official's fraudulent act is a proximate cause of a materially false or misleading statement, then that corporate official's scienter should be imputed to the corporation. The court clarified that the corporate official making the statement must have known it was false, or been reckless as to whether it was in fact true.

District of Massachusetts Dismisses Claims Against 3D-Printing Company and Officers Alleging Misleading Compliance Statements

Luongo v. Desktop Metal, Inc. (D. Mass. Sept. 20, 2023)

What to know: The District of Massachusetts dismissed putative securities fraud claims against a 3D-printing company and three of its officers, holding that the plaintiffs' general allegations were insufficient to support a claim under the PSLRA.

Judge Indira Talwani of the U.S. District Court for the District of Massachusetts dismissed a putative class action against a 3D-printing 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 defendants made misleading statements regarding its compliance with FDA manufacturing regulations and the quality of one of its products.

The court rejected the plaintiffs' argument that the alleged statements were materially misleading. It found the plaintiffs' allegations that (i) the defendants conveyed to investors that they had conducted due diligence sufficient to identify issues surrounding the manufacturing of the product and product compliance practices and procedures, (ii) that those procedures were "deficient" and (iii) the deficiencies presented a "material risk to the commercialization" of the product to be "general allegations" insufficient to support a claim under the PSLRA. The court reasoned that nothing in the defendants' statements could be read to suggest anything about its due diligence procedures, and even if it could, the plaintiffs were unable to allege that the defendants' due diligence procedures were inadequate at the time.

The court also found that none of the "deficiencies" that the plaintiffs alleged had yet to materialize at the time the challenged statements were made. For example, the court reasoned that the issues with the product's manufacturing and quality were not present when the statements were made by the defendants. Therefore, the plaintiffs did not sufficiently allege that any of the statements during that time period "could be possibly fraudulent or misleading."

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