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Securities Law Alert

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– Legal 500 2016

Ninth Circuit: Pharmaceutical Company's Decision to Discuss Certain Studies Supporting a Drug's Safety Necessitated Disclosure of Another Study Linking the Drug to Cancer

On October 26, 2016, the Ninth Circuit revived a securities fraud action alleging that Arena Pharmaceuticals had made material misrepresentations concerning the safety profile of and likelihood of FDA approval for lorcaserin, a weight-loss drug. *Schueneman v. Arena Pharmaceuticals,* 2016 WL 6246875 (9th Cir. 2016) (Bybee, J.) (*Arena II*). The Ninth Circuit determined that once the company chose to represent that animal studies supported the drug's safety, the company was then required to disclose the existence of a rat study linking the drug to cancer.

Background

In March 2009, Arena's CEO reported to investors that he was "confident" about the likelihood of FDA approval for lorcarserin based, among other things, on "all the animal studies that ha[d] been completed." In May 2009, Arena submitted an SEC filing representing that "the long-term safety and efficacy of lorcaserin had been demonstrated, in part, through . . . preclinical, animal studies." Neither disclosure mentioned a nonclinical study suggesting that lorcarserin caused cancer in rats (the "Rat Study").

On September 14, 2010, "the FDA disclosed the existence of the Rat Study and concerns about lorcaserin's possible carcinogenicity for the first time." Arena's stock price fell in value by 40% on the day of the FDA's announcement.

Plaintiffs subsequently brought the instant securities fraud action in the Southern District of California. The district court dismissed the complaint for failure to raise a strong inference of scienter. The court found the "more plausible inference" from plaintiffs' allegations was that "[d]efendants had a legitimate scientific opinion" that the Rat Study did not indicate that lorcaserin would cause cancer in humans. *Shueneman v. Arena Pharmaceuticals,* 2014 WL 12515272 (S.D. Cal. 2014). The court held defendants' "legitimate and unanticipated scientific disagreement with the FDA" regarding

the implications of the Rat Study did not "give rise to a strong inference of scienter." Plaintiffs appealed.

Arena Had a Duty to Disclose the Rat Study Because It Chose to Discuss Other Animal Studies

The Ninth Circuit found the question of Arena's obligation to disclose the Rat Study presented a "close case" under the federal securities laws. *Arena II*, 2016 WL 6246875. The court stated that "[d]efendants may not have had a duty to disclose the Rat Study had they not been representing that animal studies supported lorcaserin's safety and therefore its likelihood of being approved" by the FDA. However, the Ninth Circuit determined that "once they raised the animal studies, [d]efendants were obligated to disclose the Rat Study's existence to the market."

The court explained that under the Supreme Court's decision in *Matrixx Initiatives v. Siracusano,* 563 U.S. 27 (2011), "companies can control what they have to disclose under [the securities laws] by controlling what they say to the market" (quoting *Matrixx,* 563 U.S. 27). Once a company opts to "tout" positive information to the market, the company is then "bound to do so in a manner that wouldn't mislead investors" (quoting *Berson v. Applied Signal Tech.,* 527 F.3d 982 (9th Cir. 2008)). Specifically, the company must "disclos[e] adverse information that cuts against the positive information."

Here, the Ninth Circuit found that "once defendants chose to tout lorcaserin's likely approval by referencing allegedly positive animal and preclinical studies, they were bound to do so in a manner that wouldn't mislead investors as to potentially negative information within their possession." The court observed that "Arena was free to express confidence in FDA approval" and even "might have represented that [it] was working through some requests from the FDA and was confident the data would vindicate lorcaserin." What the company "could not do was express confidence by claiming that all of the data was running in lorcarserin's favor," because "[i]t was not."

The Ninth Circuit rejected defendants' claim that the allegations reflected merely "a good-faith scientific disagreement between the FDA and Arena about the meaning of the Rat Study." The court explained that "the simple fact that Arena had an explanation for its view of the data d[id] not mean investors would not want to know that Arena and the FDA were at odds" concerning the implications of the Rat Study. The court reasoned that "Arena could have remained silent about the dispute or it could have addressed its discussions with the FDA head-on[,] [b]ut it could not represent that there was no controversy here because all the data was favorable."

Plaintiffs Sufficiently Alleged Scienter

The Ninth Circuit found plaintiffs had "alleged scienter with sufficient particularity to survive a motion to dismiss." The court explained that plaintiffs' "theory of fraud [was] not that [d]efendants intentionally misled the market about the objective safety of lorcaserin" but rather, that "[d]efendants intentionally withheld information material to the market's assessment of whether and when the FDA would likely approve lorcaserin." Here, the court found "no question" that defendants allegedly "knew that the Rat Study existed" but made no mention of the study when representing that animal studies supported lorcaserin's safety.

Northern District of California: Broad Statements Concerning the Success of Merger Integration Efforts Constitute Inactionable Puffery

On November 14, 2016, the Northern District of California held broad optimistic statements concerning the success of post-merger integration efforts are inactionable under the securities laws. *Fadia v. FireEye,* 2016 WL 6679806 (N.D. Cal. 2016) (Davila, J.). The court explained that "CEOs and executives of companies that merge with or acquire other companies often describe ongoing mergers as smooth, rapid, and successful," statements "which courts regularly deem corporate puffery" rather than actionable misrepresentations.

The court further held insider stock sales, standing alone, do not raise a strong inference of scienter. Finally, the court found plaintiffs may rely on the core operations theory for scienter purposes only if they provide "detailed and specific allegations about the management's exposure to factual information within the company."

Optimistic Generalized Statements Concerning the Progress of Merger Integration Efforts Are Not Actionable Misrepresentations

Plaintiffs alleged that FireEye, a cybersecurity company, "falsely represented" that its post-merger integration efforts with Mandiant Corporation were "progressing successfully." For example, FireEye stated that the combination was a "natural extension" of a strategic partnership" and that the companies' product synergies were "very strong." Plaintiffs claimed that the integration was in fact "going quite poorly."

The court held the statements at issue were not actionable misrepresentations but rather, "examples of corporate optimism" that fell into the category of inactionable puffery. The court explained that puffery "differs significantly" from a material misrepresentation because puffery is merely "an expression of opinion." The court noted that under Ninth Circuit precedent, "investors do not rely on puffery when making investment decisions" (citing *In re Cutera Sec. Litig.,* 610 F.3d 1103 (9th Cir. 2010)).

The court found that other courts have similarly rejected securities fraud claims based on optimistic statements concerning merger integration efforts. For example, in *In re Level 3 Comm. Sec. Litig.,* 667 F.3d 1331 (10th Cir. 2012), the Tenth Circuit found "broad claims by defendants regarding integration efforts" to be "non-actionable." The Tenth Circuit reasoned that "[t]hese are all the kind of rosy affirmations commonly heard from corporate managers . . . that are so vague, so lacking in specificity . . . that no reasonable investor could find them important."

Defendants' Stock Sales Did Not Raise a Strong Inference of Scienter

The court rejected plaintiffs' assertion that defendants' stock sales were "large and suspicious enough to support an inference of scienter." The court explained that "[u]nusual or suspicious stock sales by corporate insiders may serve as circumstantial evidence of the requisite scienter . . . only if the insider trading is dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." While the court recognized that stock sales can provide "viable circumstantial evidence of scienter," the court underscored that "stock sales alone cannot create a strong inference of scienter."

Here, plaintiffs alleged that three defendants sold stock amounting to 17.6%, 8.7%, and 15% of their respective total holdings. The court found these percentages insufficient to indicate scienter, noting that other "courts have held that higher percentages of stock sales failed to raise a strong inference of scienter." The court also observed that the Ninth Circuit had previously "caution[ed] against inferring scienter simply because the amount and percentages of the sales [were] large" (citing *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. American West Holding,* 320 F.3d 920 (9th Cir. 2003)).

In the case before it, the court found it significant that "[d]efendants sold their FireEye stock only during the secondary public offering, had no prior trading history, and retained a majority of their shares." The court noted that plaintiffs did not allege "accounting irregularities" or "dubious business practices" to support allegations of suspicious stock sales. Moreover, there were "no allegations of GAAP violations, and certainly no evidence that indicate[d] [d]efendants were informed to delay disclosures of their earnings reports."

Plaintiffs Failed to Raise a Strong Inference of Scienter Under the Core Operations Theory

Finally, the court held plaintiffs "fail[ed] to raise a strong inference of scienter under the core operations theory." The court explained that under this theory, "the role of corporate officers and their access to information may support a strong inference of scienter" only "if supported by detailed and specific allegations about the management's exposure to factual information within the company." The court noted that such "particularized allegations" can only be dispensed with in the "rare circumstances . . . where the nature of the relevant fact is of such prominence that it would be absurd to suggest that management did not have knowledge of it."

Here, plaintiffs argued that scienter could be inferred from the fact that "[d]efendants were high level corporate officers [who] attended board meetings, had a 'hands-on' management style, and could access FireEye's reports, press releases, public filings, and other statements." The court deemed these allegations "informative" yet insufficient to establish a strong inference of scienter. The court found that "[a]t a minimum, [p]laintiffs needed to have provided information about precisely what was said by the parties in these meetings, which facts the [d]efendants were exposed to, and why this exposure support[ed] an inference of scienter." The court further held plaintiffs failed to "provide evidence that suggest[ed] the current circumstances [were] somehow rare, which justifies an inference of scienter without particularized allegations."

Delaware Chancery Court: Directors Did Not Act in Bad Faith in Approving a Controlling Stockholder's Takeover Offer Even Though a Higher Third-Party Offer Was on the Table

On October 10, 2016, the Delaware Chancery Court rejected allegations that the directors of Books-a-Million had acted in bad faith by approving a controlling stockholder's going-private offer instead of pursuing a higher third-party offer. *In re Books a Million,* 2016 WL 5874974 (Del. Ch. 2016) (Laster, V.C.). The court found that even when parties follow the Delaware Supreme Court's framework in *Kahn v. M&F Worldwide,* 88 A.3d 635 (Del. 2014) (*MFW*), plaintiffs can still challenge the transaction on bad faith grounds.[1] However, the court determined that approving a controlling stockholder's offer over a higher third-party offer is not sufficient, standing alone, to support an inference of bad faith because third-party offers incorporate a control premium and are therefore not "fairly comparable" to controlling stockholder offers.

Background

In January 2015, the Anderson Family, the controlling stockholder of Books-a-Million, proposed to acquire all outstanding shares of Books-a-Million that it did not already own at a premium over the trading price. The Anderson Family conditioned the proposal on compliance with the *MFW* framework, including approval by a special committee of independent directors and approval by a majority of the minority shareholders. A third party subsequently offered to purchase all shares of Books-a-Million, including the Anderson Family's shares, at a higher price than the Anderson Family's offer ("Party Y's offer"). The special committee did not pursue Party Y's offer, but instead decided to negotiate with the Anderson Family. The special committee ultimately approved the Anderson Family's offer, and a majority of the minority stockholders approved the transaction.

1. Please click here to read our prior discussion of the Delaware Supreme Court's decision in *MFW*.

Certain Books-a-Million stockholders subsequently brought the instant action claiming that the company's directors, together with the Anderson Family and several of the company's officers, breached their fiduciary duties in connection with the merger.

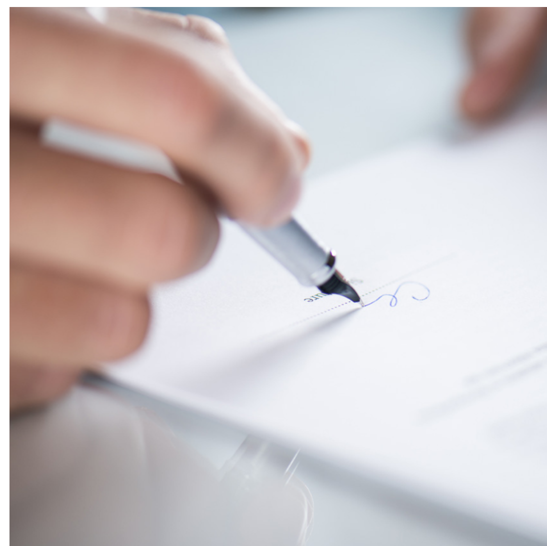
Plaintiffs Can Challenge Transactions Subject to the *MFW* Framework on Bad Faith Grounds

One of the requirements of the *MFW* framework is that the members of the special committee formed to review the transaction are independent and disinterested. Plaintiffs claimed that even though the members of the special committee formed to review the transaction "appeared to be independent," their purported independence and disinterestedness was "belied by their bad faith actions" in "recommending the Anderson Family's offer."

The Chancery Court observed that it was "not immediately clear how an argument regarding bad faith fits within the [*MFW*] framework." The court noted that in *MFW,* the Delaware Supreme Court "did not discuss whether a plaintiff could seek to call into question the independence of a director by contending that although appearing independent, the director did not in fact act independently for the benefit of the stockholders." However, the *Books-a-Million* court found the Chancery Court's opinion in the *MFW* case left open the possibility of such an argument.[2]

The *Books-a-Million* court determined that "the difficult route of pleading subjective bad faith is [a] theoretically viable means of attacking the [*MFW*] framework." The court reasoned that "[t]his makes sense, because pleading facts sufficient to support an inference of subjective bad faith is one of the traditional ways that a plaintiff can establish disloyalty sufficient to rebut the business judgment rule."

2. The Chancery Court in *MFW* stated that there was "no basis to infer" that the special committee "did not attempt in good faith to obtain the most favorable price they could secure for the minority or believe they had done so." *In re MFW S'holdrs. Litig.*, 67 A.3d 496 (Del. Ch. 2013).



Special Committee's Failure to Pursue a Higher Third-Party Offer Did Not Support an Inference of Bad Faith

Plaintiffs contended that the independent directors' "failure to pursue Party Y's offer support[ed] an inference that the independent directors disloyally favored the interests of the Anderson Family" over those of the minority stockholders.

In considering plaintiffs' bad faith claims, the Chancery Court relied on its prior decision in *Mendel v. Carroll,* 651 A.3d 297 (Del. Ch. 1994), which involved an analogous fact pattern. The *Mendel* court explained that "it is widely understood that buyers of corporate control will be required to pay a premium above the market price for the company's traded securities." The court found that the third-party offer at issue was "an offer, in effect, to the controlling shareholder to purchase corporate control, and to all public shareholders, to purchase the remaining part of the company's shares, all at a single price." The third party's offer "distributed the control premium evenly over all the shares." The *Mendel* court determined that the third-party offer on the table was "not fairly comparable to the per-share price proposed" by the controlling stockholder because the controlling stockholder was "not buying corporate control."

The *Mendel* court also outlined the scope of directors' duties when weighing a controlling stockholder's offer against a third-party

offer. The court stated that the board must "respect the rights" of the controlling stockholders, including the right not to sell their shares, while at the same time ensuring that any transaction "would be accomplished only on terms that were fair to the public stockholders." The court explained that directors may "take extraordinary steps to protect the minority from plain overreaching" by the majority stockholder, but they may not "deploy corporate power *against* the majority stockholder[], in the absence of a threatened serious breach of fiduciary duty by the controlling stock[holder]."

Applying the reasoning set forth in *Mendel,* the *Books-a-Million* court stated that it could "reasonably infer that Party Y's offer was higher because Party Y was seeking to acquire control and that the Anderson Family's offer was lower because it took into account the family's existing control over the [c]ompany." *Books-a-Million,* 2016 WL 5874974. Although the court noted that that it was "not possible to infer the exact amount of the premium or discount" of control, the court determined that the Anderson Family's "bargained-for consideration" fell "within a rational range of discounts and premiums." The court reasoned that the "difference" between the two offers was "not so facially large as to suggest that the [special committee] was attempting to facilitate a sweetheart deal for the Anderson Family."

The court also observed that the Anderson Family's insistence on "[a]ppraisal [rights] act[ed] as a further check on expropriation by the Anderson Family," because a court would "exclude any minority discount" when appraising the shares. In addition, the court found it significant that the Anderson Family's offer represented a sizable premium over the trading price. The court reasoned that the special committee "rationally could [have] believe[d] that stockholders might prefer liquidity at a premium to market."

The court concluded that plaintiffs' allegations did "not support a reasonable inference that the [special committee had] acted in bad faith" in approving the Anderson Family's offer.

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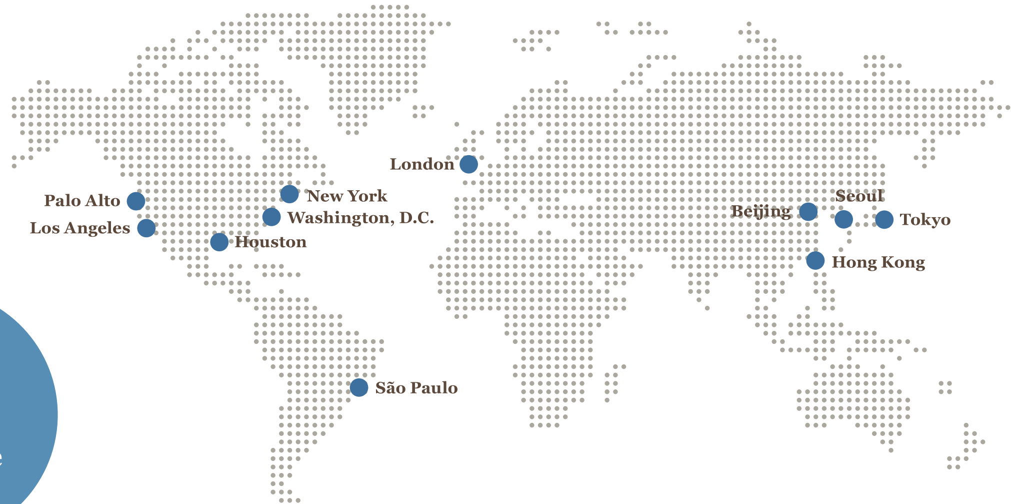

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