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# Securities Law Alert

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***– Benchmark Litigation***

## Supreme Court: Considers the Scope of Tipper/Tippee Liability Under the Securities Exchange Act of 1934

The Supreme Court heard oral arguments on October 5, 2016, in *Salman v. United States*, No. 15-628, a case in which the Court will consider a question at the center of many insider trading prosecutions: whether the personal benefit necessary to establish liability under *Dirks v. SEC*, 463 U.S. 646 (1983) requires proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137 (U.S. Oct. 5, 2015),[1] or only that the insider and the tippee shared a close family relationship, as the Ninth Circuit held *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 84 U.S.L.W. 3401 (U.S. Jan. 19, 2016) (No. 15-628).[2]

1. Please click here to read our prior discussion of the *Newman* decision.

2. Please click here to read our prior discussion of the *Salman* decision.

Although no federal statute or regulation expressly prohibits insider trading, courts have construed Section 10(b)—a "catch-all clause" in the Securities Exchange Act of 1934 (the "1934 Act")—to prohibit insider trading as a type of securities fraud. Today, under *Dirks*, determining whether trades executed by someone who has received material nonpublic information (a "tippee") qualifies as a type of fraud prohibited by the 1934 Act "depends in large part on the purpose of the [insider's] disclosure." 463 U.S. at 662. *Dirks* held that liability can only attach where the insider personally benefited directly or indirectly from the disclosure. *Id.* If the insider received no personal benefit from the disclosure, then there has been no breach of duty to stockholders, and no derivative breach can be attributed to tippees who trade on the information. *Id.* Thus, showing that the disclosing insider personally benefited from the tip is critical to establishing insider trading liability in this context.

## Oral Argument Highlights

The oral argument focused on each party's test for determining when a tipper received a "personal benefit" in exchange for material nonpublic information. Petitioner contended that the insider must receive a concrete benefit. In particular, the insider must receive either a pecuniary benefit, or something that may translate into a financial benefit (e.g., a reputational benefit with monetary value). Petitioner offered two primary defenses for this formulation. First, criminal statutes are generally construed narrowly, and the elements ought to clearly demarcate what is and is not illegal. According to Petitioner, a broader formulation would be ambiguous, and thus would subject market participants to unpredictable prosecutions. Second, it is well-accepted that not all trading on material nonpublic information is unlawful. Petitioner reasoned that if the satisfaction one experiences from sharing information and helping another were sufficient, then the "personal benefit" element would always be satisfied when information is intentionally shared. All information sharing would *ipso facto* be illegal. But Petitioner cautioned that his rule would not permit all information sharing among family members. For example, because family members are often financially inter-dependent, benefiting a family member could, in some instances, financially benefit the tipping insider.

The government took a different view, arguing that the 1934 Act broadly prohibits giving information to another—whether a relative, friend, or even a casual acquaintance—"for that person to be able to profit on it." Responding to questions from the bench, the government conceded that the tipping insider must know that the tippee will trade upon the information for criminal liability to attach. In support of its position, the government asserted that the obligation giving rise to the cause of action for insider trading tracks the common law duty of "loyalty," which is breached when one uses information for a personal reason. In addition, the government argued that a broad construction is necessary as a policy matter to prevent insiders from freely sharing information with friends and family, which could disrupt markets.

During oral argument, the Justices posed several hypotheticals to evaluate how the parties' competing frameworks would assign liability in different scenarios. For example, responding to Petitioner's contention that an insider must receive some tangible gain in order to satisfy the personal benefit requirement, Justice Kagan asked about an insider who planned to give a friend money, but decided to provide valuable nonpublic information instead. By contrast, in a hypothetical posed to the government, Chief Justice Roberts underscored that not all information sharing is done for personal gain: suppose an individual asks a friend to join him for a weekend retreat, and the friend declines, explaining that he has to work on an important transaction for Google. In Chief Justice Roberts' hypothetical, even if the tippee trades on the material nonpublic information, the insider did not offer the information as a gift or otherwise benefit from the disclosure. Throughout the oral argument, it was clear that the Justices were trying to reconcile two competing concerns. The Justices appeared to support the notion that an insider need not receive a tangible, immediate financial benefit in exchange for disclosing material nonpublic information. But certain Justices appeared wary of a test that could expose all sharing of material nonpublic information to potential liability. If the personal benefit element is to serve as a limiting principle, it must be given a more precise and workable definition.

The Justices also appeared to grapple with a number of other issues. In *Dirks*, the Supreme Court expressly stated the "elements of fiduciary duty and exploitation of nonpublic information . . . exist when an insider makes a gift of confidential information to a trading relative or friend" because the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." 463 U.S. at 664. Although this clear pronouncement would appear to foreclose Petitioner's narrow framing, it was not central to the *Dirks* holding and thus could be considered non-binding dicta. Additionally, Justice Breyer engaged in a line of questioning aimed at resolving whether information-sharing with a relative ought to be treated differently. He posited that helping a relative may be analogous to helping one's self, thus creating a special rule inapplicable to a scenario where an insider assists a friend or casual acquaintance. Given the number of issues in play, and the varied questions from the Justices, whether a clear majority exists in support of a particular formulation remains uncertain.

# First Circuit: Affirms Dismissal of Securities Fraud Action Against Vertex Pharmaceuticals, Finding No Basis to Infer the Company Knowingly or Recklessly Published Erroneous Interim Clinical Study Results

On October 3, 2016, the First Circuit affirmed dismissal of a securities fraud action alleging that Vertex Pharmaceuticals and several of its executives "turned a blind eye" to "study results that seemed too good to be true" in order to reap "a windfall on the sale of their stock." *Local No. 8 IBEW Ret. Plan & Trust v. Vertex Pharmaceuticals*, 2016 WL 5682548 (1st Cir. 2016) (Kayatta, J.). The First Circuit found no allegations to support plaintiffs' contention that defendants knowingly or recklessly "announced interim results that overstated the improvement in lung function" of patients taking an experimental drug combination for the treatment of cystic fibrosis.

## Plaintiffs' Allegations Failed to Raise a Strong Inference of Scienter

The First Circuit noted that "Vertex's public description" of its interim clinical study results allegedly "contained an error that made unexpectedly good results look even better than they were." However, the court found the inference that Vertex knowingly or recklessly published the inaccurate study results was not "strong enough to equal the alternative inference that Vertex was negligent in viewing very good results as being even better than they in fact were."

### Interim Study Results Were Neither Implausible Nor Obviously Wrong

With respect to plaintiffs' contention that Vertex itself described the study results as "unexpected," the First Circuit explained that "many studies of new pharmaceutical products result in surprises, both good and bad." The court reasoned that "Vertex made the investment necessary to design and perform a study testing" the experimental drug combination because the company "must have thought that positive results were possible, even if not probable."

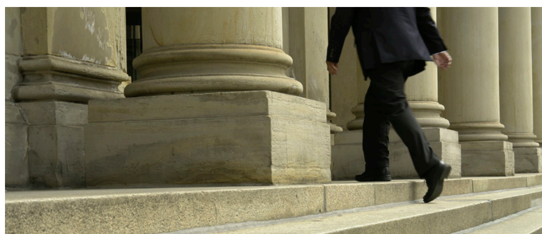
As to plaintiffs' claim that "it was obvious that there was something wrong with the [interim] results," the First Circuit found no allegations "that scientists in general, much less those at Vertex, regarded the interim results as implausible." The court also noted that plaintiffs did "not allege that anybody at Vertex responsible for receiving, reviewing, and reporting the results had actually spotted the error in the interpretation of the results before the discovery that led to" Vertex's announcement of corrected study results.

The First Circuit rejected plaintiffs' argument that it would be "'absurd' to suggest that [d]efendants were not aware of the suspect nature of the results" given the importance of the study to the company. The court stated that "the importance of a particular item can support an inference that the defendant is paying close attention to that item." However, the court explained that "[s]uch an inference . . . is only helpful in establishing scienter if that close attention would have revealed an incongruity so glaring as to make the need for further inquiry obvious." Here, the court found no allegation of "such an obvious incongruity" between the expected interim results and the reported interim results.

The First Circuit found similarly meritless plaintiffs' contention that defendants should have cross-checked the interim results against the raw data, which allegedly would have uncovered the error in question. The court found the complaint's allegations "insufficient to establish that the erroneously interpreted end results . . . were themselves so obviously suspect that [the court could] draw a strong inference that the defendants were reckless in failing to consult the raw data themselves for verification." The court further noted that plaintiffs pointed to no "legal requirement, or any undertaking by Vertex, that obligated the company to double-check the interim results before announcing them."

### Defendants Had No Financial Motive to Report Overstated Interim Results

The First Circuit also "considered" and rejected plaintiffs' theory that "defendants had a financial motive to 'turn[] a blind eye' to the erroneous interpretation of the interim results because of the stock price spike precipitated by the error." First, the court observed that Vertex's CEO did not sell any stock during the class period, and found the



CEO had "no motive to ignore an error that was obvious and that would therefore soon become known." The court explained that "[a]nnouncing good results on such a study would have been clearly better for Vertex than announcing great results only to reduce them to good by shortly thereafter confessing error, thereby harming the company's credibility and its reputation for competence."

As to the allegation that five Vertex employees "sold almost $32 million worth of stock following release of the overstated interim results," the First Circuit stated that "insider trading in suspicious amounts or at suspicious times may be probative of scienter." In this case, however, the court observed that neither the current CEO nor the company's former CEO who now serves on the board of directors allegedly "engage[d] in any inconsistent trading behavior during the class period." The court found that in order "to regard the stock sales as either motive for the fraud or evidence of the defendants' knowledge that the interim study results had been misinterpreted," it would have to "hypothesize either that the error was obvious only to those defendants who made unprecedented sales, or that it was obvious to all, yet the company's current and former CEOs nevertheless went along with announcing obviously flawed results." The court explained that the complaint "offers no fact suggesting that the sellers knew more than the nonsellers."

The First Circuit found that there was "a simple alternative explanation" for the insiders' stock sales. Following announcement of the interim results, Vertex's stock price "suddenly jumped a large amount" following "a long period of steady or dropping stock prices." The court reasoned that "[s]uch an increase—no matter what its cause—creates a substantial incentive for holders to sell unless they believe the price will continue to rise and are willing to wait."

The court concluded that plaintiffs' allegations did "not paint the required strong inference of scienter," and affirmed dismissal of plaintiffs' complaint.

## Fifth Circuit: Supreme Court's *Fifth Third* Decision Mandates a "More Harm Than Good" Standard for ERISA Breach of Duty of Prudence Claims Based on Inside Information, Not a "More Good Than Harm" Standard

On September 26, 2016, the Fifth Circuit held the Southern District of Texas applied the wrong pleading standard in determining whether an amended ERISA complaint brought by the beneficiaries of BP's employee stock ownership plan passed muster under the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014).[3] *Whitley v. BP*, 2016 WL 5387678 (5th Cir. 2016) (Clement, J.). In *Whitley*, the Fifth Circuit stated that "[u]nder the Supreme Court's formulation," a plaintiff asserting an ERISA breach of the duty of prudence claim based on inside information "bears the significant burden of proposing an alternative course of action so clearly beneficial that a prudent fiduciary *could not conclude* that it would be more likely to harm the fund than to help it." The Fifth Circuit determined the district court had instead erroneously considered whether "no prudent fiduciary would have concluded that" the alternative actions "would do more good than harm."

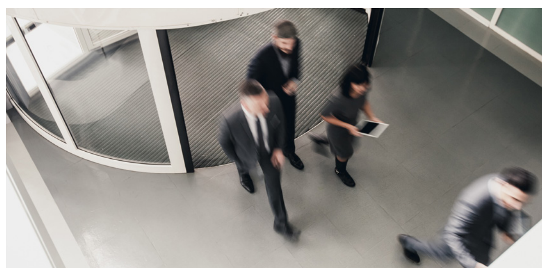
### The District Court Erred in Considering Whether No Prudent Fiduciary Would Have Concluded the Alternative Actions Would Have Done "More Good Than Harm"

The Fifth Circuit explained that in *Fifth Third*, the Supreme Court held that in order "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id.* (quoting *Fifth Third*, 134 S. Ct. 2459).

3. Please click here to read our prior discussion of the *Fifth Third* decision.

The Fifth Circuit also noted that in *Amgen v. Harris*, 136 S. Ct. 758 (2016),[4] the Supreme Court "confirmed" that plaintiffs asserting an ERISA breach of the duty of prudence claim based on inside information must "plausibly allege that *no* prudent fiduciary could have concluded that the proposed alternative action would do more harm than good."

In the case on appeal before the Fifth Circuit, however, the Southern District of Texas had evaluated plaintiffs' proposed amended complaint by considering whether "on the basis of the pleadings alone, . . . *no* prudent fiduciary would have concluded that [the alternatives] would do *more good than harm*." The Fifth Circuit determined that this formulation was "not equivalent" to the *Fifth Third* standard, and found the district court had "erred" by "alter[ing] the language of *Fifth Third* to reach its holding."



### Plaintiffs' Amended Allegations Did Not Meet the *Fifth Third* Standard

Turning to the allegations of plaintiffs' amended complaint, the Fifth Circuit explained that plaintiffs "theorize[d] that BP stock was overpriced because BP had a greater risk exposure to potential accidents than was known to the market." The Fifth Circuit found that it did "not seem reasonable to say that a prudent fiduciary at that time could not have concluded that (1) disclosure of such information to the public or (2) freezing trades of BP stock—both of which would likely lower the stock price—would do more harm than good." To the contrary, the Fifth Circuit determined that "a prudent fiduciary could very easily conclude that such actions *would* do more harm than good."

The Fifth Circuit deemed plaintiffs' amended complaint insufficient to meet the *Fifth Third* standard, and held "the district court [had] erred in granting [plaintiffs'] motion to amend."

4. Please click here to read our prior discussion of the *Amgen* decision.

## Southern District of New York: Dismisses Securities Fraud Action Against MDC Partners, Holding Plaintiffs' Disagreements with Defendants' Accounting Judgments and EBITDA Formulas Could Not Support a Claim

On September 30, 2016, the Southern District of New York dismissed with prejudice a securities fraud action against MDC Partners and certain of its officers and directors for failure to allege either material misstatements or scienter. *North Collier Fire Control and Rescue Dist. Firefighter Pension Plan v. MDC Partners*, 2016 WL 5794774 (S.D.N.Y. 2016) (Sullivan, J.).[5] The court held plaintiffs' goodwill-related allegations were insufficient to meet the standard for pleading a securities fraud claim based on a misstatement of opinion. As to plaintiffs' claim that defendants used a "misleading version of EBITDA," the court found that companies are free to calculate EBITDA as they deem appropriate, provided they disclose their methodology. With respect to plaintiffs' contention that the company failed to disclose the full amount of compensation paid to its CEO, the court found the allegedly underreported amount was neither quantitatively nor qualitatively material. Finally, the court held plaintiffs' allegations of insider stock sales did not support an inference of scienter "because the vast majority [of those] trades occurred a year or more before the alleged revelation of the fraud."

### Plaintiffs Failed to State a Securities Fraud Claim as to Alleged Goodwill-Related Misstatements

Plaintiffs contended that MDC Partners had "overstated its goodwill balance" in violation of Generally Accepted Accounting Principles ("GAAP") by failing to record a goodwill impairment for a poorly performing subsidiary that was ultimately merged into another one of the company's subsidiaries. The court held plaintiffs "failed to plead that [d]efendants made any false or misleading

5. Simpson Thacher represents MDC Partners and two of the individual defendants in this action.

statements in connection with MDC's goodwill reporting" for several reasons.

First, the court noted that "the law in the Second Circuit is clear that allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim." The court explained that "GAAP provisions are subject to interpretation and tolerate a range of reasonable treatments, leaving the choice among alternatives to management."

Second, the court observed that under "well-settled" Second Circuit law, "goodwill estimates are opinion statements because they depend on management's determination of the 'fair value' of the assets acquired and liabilities assumed, which are not matters of objective fact and will vary depending on the particular methodology and assumptions used." To plead a securities fraud claim based on an alleged misstatement of opinion, such as an estimate of goodwill, plaintiffs must allege that (1) "the speaker did not hold the belief she professed," (2) "the supporting fact[s] she supplied were untrue," or (3) "the stated opinion, although sincerely held and otherwise true as a matter of fact, omitted information whose omission made the stated opinion misleading to a reasonable investor."

Here, the court held the complaint did "not satisfy these pleading requirements." The court found plaintiffs "allege[d] nothing more than disagreement with MDC's accounting judgments, which cannot support a fraud claim."

## Plaintiffs Failed to State a Securities Fraud Claim Based on Allegedly "Nonstandard" Formulas for Calculating EBITDA

Plaintiffs further claimed defendants "misleadingly" used "the common term EBITDA" in MDC's public filings when in fact defendants calculated EBITDA based on formulas that allegedly did not comport with "the industry standard definition." The court held plaintiffs "failed to plead that [d]efendants made any false or misleading statements in connection with MDC's disclosures relating to EBITDA."

The court explained that MDC's Form 10-Qs did not "tout" or even use the phrase "industry standard" in describing the company's use of EBITDA as one factor in measuring its performance. Moreover, the court found that MDC's class period earnings releases "specifically explained how MDC had calculated the 'EBITDA' amounts reported in those releases." The court held that "[n]o reasonable investor would ignore these definitions, much less assume that the reported EBITDA [was] governed by" a generic industry standard definition.

The court also rejected plaintiffs' contention that "MDC misled investors by changing its 'nonstandard' calculation of EBITDA from quarter to quarter." The court held "this argument misses the mark" because "EBITDA is a non-GAAP metric for which there is no right formula." The court found "[t]he fact that a plaintiff may take issue with the way a company chooses to calculate these metrics is of no moment because it is not fraudulent for a reporting entity to calculate metrics that, like EBITDA, are not defined under GAAP." The court explained that "[u]nless [p]laintiffs can show that MDC somehow misled investors about how it actually calculated EBITDA, which they have not, there can be no claim for fraud."

## Allegedly Underreported CEO Income Was Neither Qualitatively Nor Quantitatively Material

Plaintiffs claimed that "MDC failed to disclose the true amount of compensation paid" to its CEO, both by "underreporting [his] perquisites," such as the CEO's use of a corporate apartment, and by allegedly "improperly reimbursing" certain of his expenses. The court found the allegedly underreported income was neither quantitatively nor qualitatively material under the factors set forth in *Litwin v. Blackstone Group*, 634 F. 3d 706 (2d Cir. 2011).

The court explained that in *Litwin*, the Second Circuit "made clear that courts may evaluate materiality at the pleading stage," and courts that do so must consider both quantitative and qualitative factors. The court observed that the Second Circuit has held that "a five percent numerical threshold—i.e., at least a five percent difference between an inaccurate versus accurate financial disclosure—is a good starting place for assessing the materiality of the alleged misstatement." The court further stated that "useful 'qualitative factors' include (1) concealment of an unlawful transaction,

(2) significance of the misstatement in relation to the company's operations, and (3) management's expectation that the misstatement will result in a significant market reaction."

Applying this standard to plaintiffs' allegations concerning the CEO's perquisites, the court found the amount at issue was "well below the Second Circuit's 5% threshold." The court held this category of compensation "was not materially misstated" given "its minuscule impact on [the CEO's] overall compensation" and plaintiffs' "failure to identify any qualitative factors that would otherwise support materiality."

With respect to plaintiffs' allegations concerning expense reimbursements, the court found that if compared against the company's total expenses for the year, the allegedly underreported reimbursements "would amount to a paltry 0.18%—well below the Second Circuit's 5% threshold and clearly immaterial." The court observed that if the underreported income was measured against the CEO's compensation for the year, however, "the percentage lands above the threshold at 10.2%."

The court determined that even if the appropriate benchmark was the CEO's compensation for the year (rather than the company's total expenses), the court could not end its analysis without "also consider[ing] qualitative factors of materiality." The court found the amount of the allegedly underreported reimbursements would "hardly register[ ]" to a reasonable investor. The court deemed it "not substantially likely that a reasonable shareholder" would have considered this additional compensation "important" "in deciding whether to purchase MDC securities." The court concluded that the allegedly underreported reimbursements did not amount to a material misstatement.

## Allegations of Insider Stock Sales Failed to Raise a Strong Inference of Scienter

Finally, the court rejected plaintiffs' effort to plead scienter based on insider stock sales because most of the "trades occurred nearly a year or more before the end of the [c]lass [p]eriod." The court explained that it has "consistently held that stock sales occurring even a few months before the alleged revelation of the fraud do not raise a strong inference of scienter." In this case, "[b]ecause the vast majority of the [i]ndividual [d]efendants' trades occurred a year or more before the alleged revelation of the fraud," the court held the insider stock sales did "not support an inference of fraudulent motive."

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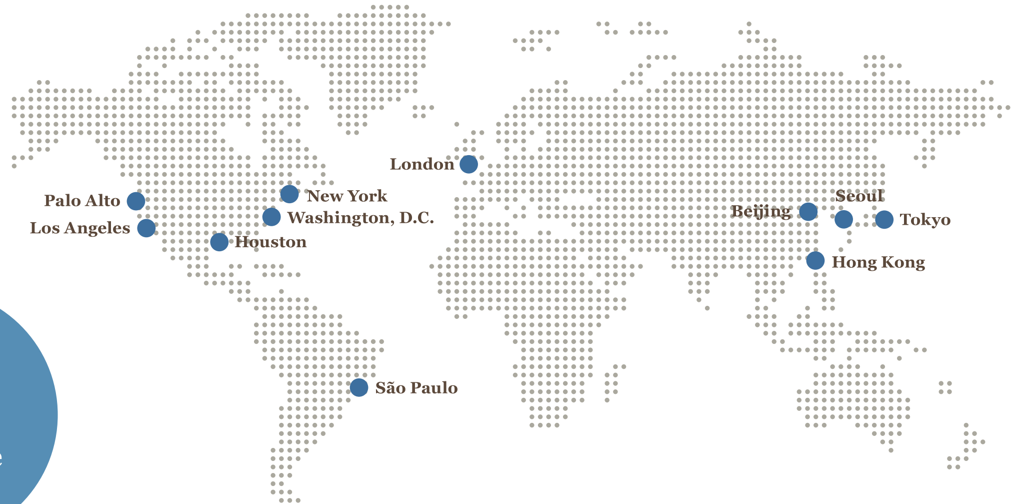

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