Simpson Thacher

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–The Legal 500 2017

Second Circuit: Affirms Denial of Leave to Amend a Securities Fraud Complaint, Finding Plaintiffs Alleged No Material Misrepresentations and Pled Only "Fraud by Hindsight"

On January 26, 2018, the Second Circuit affirmed denial of leave to amend a securities fraud complaint alleging misrepresentations concerning a consumer finance company's underwriting practices. *Waterford Twp. Police & Fire Ret. Sys. v. Reg'l Mgmt. Corp.*, 2018 WL 565780 (2d Cir. 2018) (*Waterford III*).[1] The Second Circuit found the proposed amended complaint alleged no material misrepresentations, and pled only "fraud by hindsight."

Plaintiffs' original complaint challenged the company's "characterizations of its underwriting practices as 'sound' or 'targeted,'" among other claims. *Waterford Twp. Police & Fire Ret. Sys. v. Reg'l Mgmt. Corp.*, 2016 WL 1261135 (S.D.N.Y. 2016) (*Waterford I*).[2] Plaintiffs "alleged that lower-level branch staff were skeptical of [the company]'s live check underwriting." However, the district court found plaintiffs pled no facts demonstrating that the company did not believe its statements of opinion concerning its underwriting practices at the time it made those statements, as required under the Supreme Court's decision in *Omnicare v. Laborers District Council*

1. Simpson Thacher represents Regional Management Corp. and certain of its current and former directors, officers and shareholders in this matter.

2. Please click here to read our prior discussion of the district court's decision.

Construction Industry Pension Fund, 135 S. Ct. 1318 (2015).[3] The court dismissed plaintiffs' complaint in its entirety.

The proposed amended complaint included new allegations from a supervisor who oversaw underwriting practices at a number of the company's branches. Because these new allegations did not address underwriting practices at the company's headquarters, which handled the live check loans at issue, the district court found plaintiffs' proposed allegations would be insufficient to survive a motion to dismiss. *Waterford Twp. Police & Fire Ret. Sys. v. Reg'l Mgmt. Corp.*, 2017 WL 395206 (S.D.N.Y. 2017) (*Waterford II*). The Second Circuit agreed, and found the facts pled were "just as consistent with the possibility that [the company] believed what it was saying about its underwriting practices (and that its beliefs were correct) as the opposite." *Waterford III*, 2018 WL 565780.

The proposed amended complaint also included allegations post-dating the class period that concerned the company's representations as to the adequacy of staffing in its loan servicing departments. The district court found these allegations were "a classic example of attempting to sustain a cause of action based on 'fraud by hindsight,' that is, alleging 'that defendants should have anticipated future events and made certain disclosures earlier than they actually did.'" *Waterford II*, 2017 WL 395206 (quoting *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000)).

The Second Circuit agreed that these proposed allegations were insufficient to suggest that the company did not believe its staffing was adequate at the time it made the statements at issue. The court further determined that plaintiffs did not point to "'any contemporaneous facts that would have rendered such a belief unfounded.'" *Waterford III*, 2018 WL 565780 (quoting *Waterford I,* 2016 WL 1261135). The Second Circuit observed that "[i]nvestors frequently clamor for cutting labor costs to pay out more in profits." The court emphasized that it "need[s] something more than hypotheticals to conclude that such a ho-hum feature of a capitalist enterprise was in fact a guise to defraud those it often benefits."

Fifth Circuit: (1) *Fifth Third* Applies to Claims of Excessive Riskiness, and (2) Failure to Disclose Inside Information or Investigate the Prudence of Investing in Company Stock Does Not Constitute a "Special Circumstance"

On February 6, 2018, the Fifth Circuit followed the Second Circuit in holding that the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014)[4] applies to ERISA claims alleging that company stock was excessively risky in addition to claims that the stock was overvalued. *Singh v. RadioShack Corp.*, 2018 WL 732913 (5th Cir. 2018) (per curiam). The Fifth Circuit further held that plaintiffs could not satisfy *Fifth Third*'s "special circumstances" exception for claims based on publicly available information by alleging that defendants failed to disclose inside information, or failed to monitor the continued prudence of investing in company stock. The court also ruled that plaintiffs did not satisfy *Fifth Third*'s "more harm than good" standard for claims based on inside information.

Fifth Third's Standard Governs Public Information-Based Claims Alleging Excessive Risk

The Fifth Circuit rejected plaintiffs' contention that *Fifth Third* "addresses only allegations that public information showed

3. The *Omnicare* Court made it clear that "a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless [of] whether an investor can ultimately prove the belief wrong." 135 S. Ct. 1318. Please click here to read our prior discussion of the *Omnicare* decision.

4. In *Fifth Third*, the Court outlined the standards for pleading an ERISA breach of the duty of prudence claim against the fiduciary of an employee stock ownership plan. Please click here to read our prior discussion of the *Fifth Third* decision.

that a stock was overvalued, not claims that the stock was excessively risky." The court found "'illusory'" the "distinction between claims that stock is overvalued and claims that stock is excessively risky." *Singh,* 2018 WL 732913 (quoting *Rinehart v. Lehman Bros. Holdings*, 817 F.3d 56 (2d Cir. 2016)).[5] The Fifth Circuit reasoned that "[i]n an efficient market, market price accounts for risk." The court held that "although [*Fifth Third*] was primarily framed in terms of overvalued-stock allegations, it applies equally to [p]laintiffs' public-information claims premised on excessive risk." The Second, Sixth and D.C. Circuits have reached the same conclusion.[6]

Failure to Disclose Inside Information Does Not Constitute a "Special Circumstance"

In *Fifth Third*, the Court held that "allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." 134 S. Ct. 2459. The Fifth Circuit noted that "[t]he Supreme Court has not defined 'special circumstances,' but has said that such circumstances 'affect[ ] the reliability of the market price as an unbiased assessment of the security's value in light of all public information.'" *Singh*, 2018 WL 732913 (quoting *Fifth Third*, 134 S. Ct. 2459).

Plaintiffs contended that *Fifth Third*'s "special circumstances" requirement was met because defendants had "withheld material information from the market, skewing the stock price." The Fifth Circuit held that the failure to disclose inside information does not constitute a "special circumstance" because *Fifth Third* established a separate standard for analyzing insider-information claims.

5. Please click here to read our prior discussion of the Second Circuit's decision in *Rinehart*.

6. *See Rinehart*, 817 F.3d 56 ("*Fifth Third* foreclose[s] breach of prudence claims based on public information irrespective of whether such claims are characterized as based on alleged overvaluation or alleged riskiness of a stock."); *Pfeil v. State Street Bank and Trust Co.*, 806 F.3d 377 (6th Cir. 2015) ("the excessively risky character of investing ESOP funds in stock of a company experiencing serious threats to its business . . . is accounted for in the market price"); and *Coburn v. Evercore Trust Co.*, 844 F.3d 965 (D.C. Cir. 2016) ("arguing that a stock is too risky to hold at current market prices is part and parcel of the claim that that stock is overvalued" for *Fifth Third* purposes).

Failure to Investigate the Prudence of Continuing to Invest in Company Stock Is Not a "Special Circumstance"

The Fifth Circuit also rejected plaintiffs' contention that the "special circumstances" requirement was satisfied because the Plan fiduciaries allegedly "failed to investigate the continued prudence of investing Plan assets in [company] stock."

Because plaintiffs "did not plausibly allege that the purported lack of investigation had any effect on the reliability of the market price," the Fifth Circuit held that this failure to investigate "cannot be a special circumstance" within the meaning of *Fifth Third*.

Plaintiffs Did Not Satisfy *Fifth Third*'s "More Harm Than Good" Standard for Claims Based on Inside Information

"To state a duty of prudence claim based on nonpublic 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).

In the case before it, the Fifth Circuit found that a prudent fiduciary could conclude that freezing investments in company stock "would signal to the market 'that insider fiduciaries viewed the employer's stock as a bad investment,' causing the Fund's existing holdings of [company] stock to decline in value." *Id.* (quoting *Fifth Third*, 134 S. Ct. 2459).

The Fifth Circuit also found that "a prudent fiduciary could readily conclude that 'publicly disclosing negative information would do

more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund.'" *Id.* (quoting *Fifth Third*, 134 S. Ct. 2459).

Ninth Circuit: Disclosure of the Alleged Fraud Is Not a Prerequisite for Loss Causation

On January 31, 2018, the Ninth Circuit held that "a general proximate cause test . . . is the proper test" for loss causation under Section 10(b) and Rule 10b-5 and that disclosure of the fraud is not a prerequisite for loss causation. *Mineworkers' Pension Scheme v. First Solar*, 2018 WL 626948 (9th Cir. 2018) (per curiam).

The Ninth Circuit found the district court had appropriately applied the general proximate cause test in holding that "[a] plaintiff can satisfy loss causation by showing that the defendant misrepresented or omitted the *very facts* that were a substantial factor in causing the plaintiff's economic loss." *Id.*

The district court read the Ninth Circuit's earlier decisions as divided on the appropriate test for loss causation. In the district court's view, one line of prior Ninth Circuit opinions held that "[s]ecurities fraud plaintiffs can recover only if the market learns of the defendants' fraudulent practices. It is not enough that plaintiffs are injured by the consequences of those practices." *Smilovits v. First Solar*, 119 F. Supp. 3d 978 (D. Ariz. 2015).[7] The district court found that another group of Ninth Circuit rulings held that "drawing a causal connection between the *facts* misrepresented and the plaintiff's loss will satisfy loss causation. A plaintiff need not show that the fraudulent practices themselves were revealed."[8]

The district court followed the latter approach, but certified the following question for interlocutory appeal:

> [W]hat is the correct test for loss causation in the Ninth Circuit? Can a plaintiff prove loss causation by showing that the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market, or must the market actually learn that the defendant engaged in fraud and react to the fraud itself?

Id. (internal citations omitted).

On appeal, the Ninth Circuit explained that the Exchange Act, as modified by the Private Securities Litigation Reform Act, "defines 'loss causation' as the plaintiff's 'burden of proving that the act or omission of the defendant alleged to violate [Section 10(b)] caused the loss for which the plaintiff seeks to recover damages.'" *Mineworkers' Pension Scheme*, 2018 WL 626948 (quoting 15 U.S.C. § 78u-4(b)(4)). The court found "[t]his inquiry requires no more than the familiar test for proximate cause."

The Ninth Circuit stated that in order "[t]o prove loss causation, plaintiffs need only show a causal connection between the fraud and the loss, by tracing the loss back to the very facts about which the defendant lied." *Id.* (internal citations omitted). The court emphasized that "'[d]isclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss.'" *Id.* (quoting *Nuveen Mun. High Income Opportunity Fund v. City of Alameda*, 730 F.3d 1111 (9th Cir. 2013)).

The Ninth Circuit noted that its recent decision in *Lloyd v. CVB Financial Corporation*, 811 F.3d 1200 (9th Cir. 2016)[9]—issued after the district court's order—"clarifie[d] the applicable rule." The *Lloyd* court observed that "loss causation is a context-dependent inquiry, as there are an infinite variety of ways for a tort to cause a loss." 811 F.3d 1200 (internal citations omitted). The *Lloyd* court stated that "[b]ecause loss causation is simply a

7. The district court found the following Ninth Circuit rulings took this approach: *Oregon Public Employees' Retirement Fund v. Apollo Group*, 774 F.3d 598 (9th Cir. 2014); *Loos v. Immersion Corporation*, 762 F.3d 880 (9th Cir. 2014); *In re Oracle Corp. Securities Litigation*, 627 F.3d 376 (9th Cir. 2010); and *Metzler Investment GMBH v. Corinthian Colleges*, 540 F.3d 1049 (9th Cir. 2008).

8. The district court cited to the following decisions: *Nuveen Municipal High Income Opportunity Fund v. City of Alameda*, 730 F.3d 111 (9th Cir. 2013); *Berson v. Applied Signal Technology*, 527 F.3d 982 (9th Cir. 2008); and *In re Daou Systems*, 411 F.3d 1006 (9th Cir. 2005).

9. Please click here to read our prior discussion of the *Lloyd* decision.

variant of proximate cause, the ultimate issue is whether the defendant's misstatement, as opposed to some other fact, foreseeably caused the plaintiff's loss."

In *Mineworkers' Pension Scheme*, the Ninth Circuit explained that "[r]evelation of fraud in the marketplace is simply one of the 'infinite variety' of causation theories a plaintiff might allege to satisfy proximate cause."[10] 2018 WL 626948. The court noted that if "a stock price drop comes immediately *after* the revelation of fraud," this "can help to rule out alternative causes." However, the Ninth Circuit emphasized that "[a] plaintiff may also prove loss causation by showing that the stock price fell upon the revelation of an earnings miss, even if the market was unaware at the time that fraud had concealed the miss."

New York Supreme Court: Rejects Disclosure-Only Settlement That Provided "Worthless" Supplemental Disclosures, and Holds That Supplemental Disclosures Must "Aid a Reasonable Shareholder in Deciding Whether to Vote for the Merger"

On February 8, 2018, the New York Supreme Court refused to approve a disclosure-only settlement based on its determination that the supplemental disclosures were "worthless." *City Trading Fund v. Nye*, 2018 WL 792283 (N.Y. Sup. Ct. 2018) (Kornreich, J.) (*City Trading Fund III*). The court held that a disclosure-only settlement should not be approved unless the supplemental disclosures "aid a reasonable shareholder in deciding whether to vote for the merger."

The court had previously declined to approve the settlement at issue because the supplemental disclosures were "utterly immaterial." *City Trading Fund v. Nye*, 46 Misc.3d 1206(A) (N.Y. Sup. Ct. 2015) (Kornreich, J). On appeal, the First Department observed that the additional disclosures were "arguably beneficial," and reversed and remanded. *City Trading Fund v. Nye*, 144 A.D.3d 595 (1st Dept. 2016) (*City Trading Fund II*). The First Department found the trial court's determination was "premature" because the court had not conducted a fairness hearing before issuing its decision.

Following its ruling in *City Trading Fund II*, the First Department adopted a multi-factor test for evaluating disclosure-only settlements in *Gordon v. Verizon Communications*, 148 A.D.3d 146 (1st Dept. 2017). The *Gordon* court instructed that courts must consider the factors set forth in *Matter of Colt Industries Shareholder Litigation*, 155 A.D.2d 154 (1st Dept. 1990) for reviewing nonmonetary settlements of class action suits,[11] as well as "two additional criteria: whether the proposed settlement is in the best interests of the putative settlement class as a whole, and whether the settlement is in the best interest of the corporation." The *Gordon* court indicated that the factor concerning the best interests of the class "is satisfied where the supplemental disclosures provide 'some benefit to the shareholders.'" *City Trading Fund III*, 2018 WL 792283 (quoting *Gordon*, 148 A.D.3d 146).

The *City Trading Fund III* court recognized that "approval under *Gordon* requires a lesser showing than" that required under the Delaware Chancery Court's decision in *In re Trulia Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).[12] The *Trulia* court stated that a disclosure-only settlement "was likely to be met with continued disfavor unless the

10. The Ninth Circuit indicated that there was no conflict in its prior rulings on loss causation. The court stated that its "approval of one theory should not imply [its] rejection of others." *Mineworkers' Pension Scheme*, 2018 WL 626948.

11. The *Colt* factors are: "the likelihood of success, the extent of support from the parties, the judgment of counsel, the presence of bargaining in good faith, and the nature of the issues of law and fact." 155 A.D.2d 154.

12. Please click here to read our prior discussion of the Delaware Chancery Court's decision in *Trulia*.

supplemental disclosures address a plainly material misrepresentation or omission." 129 A.3d 884. The *Trulia* court emphasized "that it should not be a close call that the supplemental information is material as that term is defined under Delaware law."

The *City Trading Fund III* court then considered what the *Gordon* court meant when it stated that the supplemental disclosures must provide "some benefit" to the shareholders.[13] The *City Trading Fund III* court concluded that "while the plaintiff need not (as under *Trulia*) rule out all doubts as to the materiality of the supplemental disclosures, the court must be able to plausibly conclude that the supplemental disclosures would, in fact, aid a reasonable shareholder in deciding whether to vote for the merger." The court reasoned that "[i]f the supplemental disclosures would not do so, then there is no basis to conclude that such disclosures were of *any* benefit to the shareholders."

Turning to the disclosure-only settlement before it, the court found "the supplemental disclosures were not at all helpful to the shareholders." The court explained that the disclosures were "of the 'tell me more' sort that countless courts have recognized are of little to no value, and which certainly do not substantially alter the total mix of available information." For example, the court noted that the disclosures included "independent, third-party projections" which "are not considered material" as a general rule.

The *City Trading Fund III* court found it significant that "shareholders that own shares worth hundreds of thousands of dollars more than [plaintiff's] nominal holding of ten shares [had] objected" to the settlement. The court concluded that the corporation and its shareholders would be "net losers" under the terms of the agreement, and therefore denied approval of the settlement.

13. The court noted that it did not read *Gordon*, which post-dated the First Department's decision in *City Trading Fund II*, "to permit approval if plaintiff merely makes a showing that the supplemental disclosures are 'arguably beneficial.'" *City Trading Fund III*, 2018 WL 792283.

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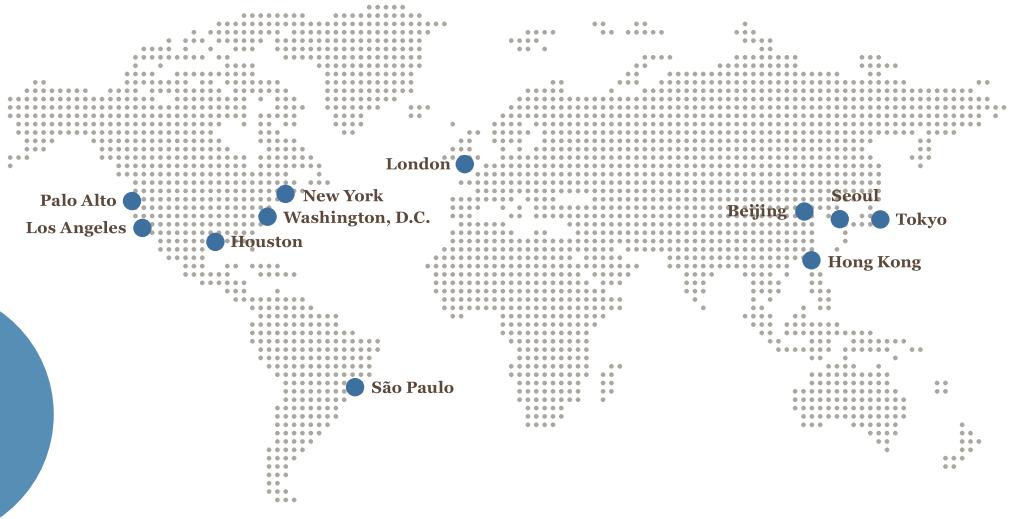

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