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Securities Law Alert

In This Edition:

May 2020

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– Chambers USA

Second Circuit: Investment Advisory Client Did Not Become a Member of a Section 13(d) "Group" With the Advisor Simply By Delegating Discretionary Investment Authority to the Advisor

On May 20, 2020, the Second Circuit held that a client of an investment advisor did not become "a member of a Section 13(d) group with his investment advisor and the advisor's other clients merely because he and the other clients had delegated discretionary investment authority to the advisor and the advisor had purchased for the client's account shares of the same issuer that was the subject of the advisor's Schedule 13D filing." *Rubenstein v. Int'l Value Advisers*, 2020 WL 2549507 (2d Cir. 2020) (Parker, C.J.). The court concluded that the client was therefore "not obligated to disgorge his short-swing profits" under Section 16(b) of the Exchange Act of 1934.

The Second Circuit explained that "Section 16(b) . . . imposes strict liability on certain insiders of an issuer, requiring them to disgorge to the issuer any profits they realize from short-swing trading in the issuer's securities."[1] "In addition to requiring individual statutory insiders to disgorge short-swing profits, the [Exchange] Act provides for 'group' liability" pursuant to Section 13(d). "A Section 13(d) group is formed '[w]hen two or more persons agree to act together for the purpose of acquiring,

1. Section 16(b) defines short-swing trading as "any purchase and sale, or any sale and purchase, of any equity of such issuer . . . within any period of less than six months . . . irrespective of any intention on the part [the insider]." 15 U.S.C. § 78p(b). Section 16(b) applies to "[e]very person who is directly or indirectly the beneficial owner of more than 10 percent of any of any class of any equity security" of the issuer. *Id.*

holding, voting or disposing of equity securities of an issuer.'" *Id.* (quoting 17 C.F.R. § 240.13d-5(b)(1)). "The group is then deemed to have acquired beneficial ownership of all equity securities of that issuer beneficially owned by any group members. If the group's collective holdings exceed 10% of any class of the issuer's outstanding equity securities, then each group member is subject to the short-swing profit rule."

In the case before the court, an investment advisor and two of its managing members had reported that "they beneficially owned, through their voting and investment power over their advisee-clients, more than 10% of [a company's] outstanding common stock" and "filed Schedule 13Ds with the SEC indicting that, in accumulating their position in [the company], they had formed a 'control purpose' with respect to [the company]." The plaintiff contended that "the filing of the Schedule 13D put an owner of [the company's] shares in a managed account . . . on notice of the [investment adviser] defendants' control purpose and that the owner thereby 'agreed' to become part of the group by failing to terminate the [investment adviser] defendants' control of the managed account."

The plaintiff "relie[d] principally on the theory that [the investment adviser's] clients became members of a group with their investment advisor and its other clients when they signed investment management agreements delegating discretionary trading authority to [the investment adviser]." The Second Circuit found the plaintiff's "theory . . . incompatible with the text of the [Exchange] Act and its implementing regulations." The court "straightforwardly conclude[d] that these provisions impose liability only when insiders enter an agreement . . . to trade the securities of *a particular issuer*." *Id.* (emphasis added). The court noted that "[n]either [the company in question] nor any other issuer was identified as one whose stock [the investment advisor] might purchase for [the client's] account." Moreover, "the investment management agreement did not address whether, or to what extent, the [investment adviser] defendants might purchase or sell the same securities for the other accounts they managed; nor did the investment management agreement touch on the subject of whether the [investment adviser] defendants might seek to influence or control an issuer whose shares might be in an account they managed." The court therefore determined that the plaintiff's contention that "the investment management agreement constituted an 'agreement' to trade in [the company's] securities" was "simply wrong."

The Second Circuit also deemed unpersuasive the plaintiff's policy argument that declining to impose Section 16(b) liability on an investment advisory client under these circumstances would "enable investment managers to evade Section 16(b) and to abuse inside information by trading in client funds rather than their own funds . . . and to earn profits from those trades." The court explained that "[b]ecause of the strict liability imposed by Section 16(b), the Supreme Court has cautioned against exceeding the 'narrowly drawn limits' on the class of corporate insiders who may be subject to the statute." The court found that it "may not expand the boundaries of the statute merely to address [the plaintiff's] concerns," particularly given that "[e]xempting certain client profits from Section 16(b) does not insulate investment advisors from liability under the more general anti-fraud provisions of the [Exchange] Act: Section 10(b) and Rule 10b-5."

In addition, the Second Circuit rejected the plaintiff's contention that once the investment advisor "filed a Schedule 13D with the SEC disclosing its status" as an insider with respect to the company at issue, the investment advisor's clients "implicitly agreed to trade in the securities of [the company] as members of the insider group." The court reasoned that adopting the plaintiff's approach would require the court to "treat all investors as though they were conscious of the securities held by their advisors' other clients and would mandate that they tailor their investment decisions to those other clients' trades." The court held that "[s]uch requirements are impracticable ones that are not contemplated by the securities laws." The court emphasized that "Section 16(b) is not designed to threaten liability based on the trades of other investors to whom a defendant's only connection is sharing an investment advisor."

Eleventh Circuit: District Court Failed to Consider Whether Partial Corrective Disclosures Cumulatively Disclosed the Alleged Fraud

On May 4, 2020, the Eleventh Circuit reversed the dismissal of a securities fraud action alleging that a beverage company made misleading statements regarding two sales metrics that the company cited as measures of its growth and sales. [*Luczak v. National Beverage Corp.*, 2020 WL 2111947 (11th Cir. 2020) (per curiam)]. The Eleventh Circuit held that the district court erred in its loss causation analysis by "fail[ing] to analyze [the] complaint as alleging a series of partial disclosures" that, when taken together, revealed the alleged fraud.

The Eleventh Circuit explained that in order "[t]o show loss causation, a plaintiff must offer proof of a causal connection between the misrepresentation and the investment's subsequent decline in value." The court noted that while "loss causation can be difficult to prove in fraud-on-the market cases . . . a plaintiff can demonstrate loss causation circumstantially by: (1) identifying a 'corrective disclosure' (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud); (2) showing that the stock price dropped soon after the corrective disclosure; and (3) eliminating other possible explanations for this price drop."

The plaintiff alleged that the company made misrepresentations concerning two purportedly proprietary sales metrics—velocity per outlet ("VPO") and velocity per capita ("VPC")—in three press releases issued in 2017. According to the plaintiff, a March 23, 2018 letter from the SEC and a June 26, 2018 article in *The Wall Street Journal* were both partial corrective disclosures of the alleged fraud. The plaintiff alleged that "the March 23 letter was the first time the market learned that the company issued conflicting statements regarding its VPO and VPC metrics" and "was failing to cooperate with the SEC" in explaining these metrics. The plaintiff further alleged that "the June 26 article provided the market with a full realization that [d]efendants' claims about the VPO and VPC metrics were misleading."

The Eleventh Circuit held that the district court "erred in finding the March 23 letter could not serve as a corrective disclosure because it does not constitute either proof of fraud or proof of liability." The court explained that because the plaintiff "alleges the March 23 letter and the June 26 article cumulatively disclosed [the company's] allegedly fraudulent practices," the plaintiff did not "need to allege the March 23 letter alone shows proof of fraud."

The Eleventh Circuit held that "[t]he district court also erred in its separate analysis of both documents." The Eleventh Circuit determined that "it was improper for the court to reject [the plaintiff's] reading of the [March 23] letter and find that the SEC never accused [the company] of failing to cooperate." The Eleventh Circuit stated that "[w]hile a court is not bound to accept the truth of general allegations in a complaint where they are contradicted by specific factual details in attached exhibits, no contradiction exists here" between the plaintiff's allegations and the SEC's letter. The Eleventh Circuit further found the district court's characterization of the June 26 article as "a mere summary of the earlier correspondence between the [c]ompany and the SEC staff" was "not a fair reading of the article, nor of [the plaintiff's] allegations." The Eleventh Circuit noted that the article did not "specify that [the] information [in the article] was gleaned only from the March 23 letter, so the district court should not have drawn this conclusion."

The Eleventh Circuit concluded that the complaint adequately "alleges the defendants' fraudulent behavior leaked out through a series of partial disclosures, causing a drop in the stock price." Because the court found these allegations satisfied "the heightened pleading standards of Rule 9(b) and the [Private Securities Litigation Reform Act ("PSLRA")], the Eleventh Circuit found that it "need not resolve" the question of "whether the PSLRA's heightened pleading standards apply to allegations of loss causation."

Southern District of New York: Mere Disagreement With a Company's Goodwill Calculation Does Not Give Rise to a Securities Fraud Claim

On May 7, 2020, the Southern District of New York dismissed a securities fraud action arising out of a company's multi-billion dollar goodwill impairment. [*In re General Electric Sec. Litig.*, 2020 WL 2306434 (S.D.N.Y. May 7, 2020) (Cote, J.)]. The court held that plaintiffs' "theory ultimately rests entirely on a disagreement about the exercise of judgment" in calculating goodwill.

The court began its analysis by noting that under the Second Circuit's decision in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011), "goodwill balances are opinion statements."[2] The court explained that because "[g]oodwill balances are accounting estimates produced through an exercise of judgment," there is "a wide range of goodwill values that could be compliant with GAAP." The court stated that in order to "plead that the defendants made misleading statements in their calculations of [the company's] goodwill, . . . plaintiffs must identify particular facts supporting an inference that [the company's] accounting fell outside of that permissible range."

Here, the "bulk" of the impairment "was attributed to goodwill that had been added to [the company's] balance sheet" from the acquisition of a manufacturing company. Plaintiffs alleged that the company "should have recognized" earlier than it did that the goodwill from the acquisition "was excessive and that the anticipated synergies would not be realized." The court found "plaintiffs' assertion of falsity rest[ed] on an accusation that [the company's] judgment or opinion about goodwill, which rested on other judgments—its projections of future cash flows and anticipated synergies—was misleading."

According to plaintiffs, the company "knew before it took the massive impairment about the very trends that it used to justify the impairment." But the court held that "a company's knowledge of unfavorable trends does not show that its goodwill balances were misleading as of the time they were stated," because "previously known trends may later reveal themselves to be of a different magnitude or importance than initially expected." The court found it significant that "the trends that plaintiffs rely on in alleging that [the company] should have more quickly written down its goodwill were all publicly disclosed to investors during the [c]lass [p]eriod." The court concluded that plaintiffs "failed to plead facts that would support a claim that the goodwill reported in the [c]lass [p]eriod . . . was a false or misleading statement of opinion."

Southern District of New York: Plaintiffs Must Allege That Failure to Disclose Form 483 Rendered Statements Actually Made Misleading

On April 28, 2020, the Southern District of New York considered a question of first impression in the Second Circuit: whether a Form 483 from the FDA, which documents FDA concerns with manufacturing processes, is immaterial as a matter of law. [*Schaeffer v. Nabriva Therapeutics*, No. 19-cv-4183 (VM), slip op. (S.D.N.Y. 2020) (Marrero, J.)]. The court determined that it could not "conclude that the Form 483 is so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of its importance." However, the court held that the failure to disclose a Form 483 will usually be insufficient, standing alone, to raise a strong inference of scienter. The court granted defendants' motion to

2. Please click here to read our discussion of the Second Circuit's decision in *Fait*.

dismiss because the plaintiff failed to allege facts demonstrating "that [d]efendants knew or recklessly disregarded that their statements were misleading in light of the Form 483."

The court explained that "a Form 483 is a form of interim feedback rather than a final FDA decision on" a new drug application ("NDA"). A Form 483 "lists 'significant conditions' that may indicate a drug is being prepared in ways that do not comply with FDA regulations." Once the FDA issues a Form 483, "the company is then responsible for taking corrective action to address any significant conditions identified."

In the case before the court, plaintiffs alleged that defendants violated Section 10(b) and Rule 10b-5 by making several statements regarding an NDA without mentioning the company's receipt of a Form 483. Plaintiffs alleged that the failure to disclose the Form 483 led investors to believe that the NDA would be approved within the year, "even though the Form 483 allegedly demonstrated that approval of the NDA would be delayed beyond that year."

The court held that the Form 483 was not *per se* immaterial. The court noted that other courts have "reached conclusions covering the entire spectrum on" the materiality of Form 483s. The court found that at the circuit level, "[t]he Eighth Circuit has provided the only clear guidance so far." The Eight Circuit has instructed that "the issuance of Form 483s may render a defendant's statement about its compliance with FDA regulations or [Current Good Manufacturing Practice regulations ("cGMP")] false, or at least misleading . . . depending on a number of factors, including the number, severity, and pervasiveness of objectionable conditions noted, as well as whether a company has failed to address or correct the deficiencies noted by the FDA." *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972 (8th Cir. 2012). The court found it significant that "[t]he First Circuit has suggested its agreement with the Eighth Circuit's conclusion." *Nabriva* slip. op. (citing *In re Genzyme Corp. Sec. Litig.*, 754 F.3d 31 (1st Cir. 2014)). The court further found that "[t]he large number of decisions denying motions to dismiss Section 10(b) claims involving Forms 483 bolsters the conclusion that Forms 483 may be material depending on the circumstances alleged."

At the same time, the court found that "[b]ecause a Form 483 is interim FDA feedback, there is no standalone duty to disclose its existence." The court held that defendants' failure to disclose the Form 483 would "be actionable only if disclosure was necessary to render the statements [at issue] not misleading." The court noted, for example, that "failing to disclose a recent Form 483 that lists numerous potential cGMP violations could potentially render misleading a company's statements that is presently in compliance with cGMP violations." The court found that two of the defendants' statements at issue "could mislead a reasonable investor" because of the failure to disclose the Form 483.

But the court held that the plaintiff's allegations were insufficient to raise a strong inference of scienter. The court noted that "knowledge of a Form 483 alone might be enough to render certain statements both misleading and made with scienter" if the "Form 483 . . . clearly contradicts the statement being made (for example, that the company is currently in substantial compliance with cGMP regulations)." But in "the majority of Form 483 cases," plaintiffs must "rely on additional factual matter to corroborate the allegedly serious nature of the omitted Form 483." The court explained that "[t]his is not an unduly high pleading requirement," as there are "a wide variety of ways that a plaintiff might adequately allege a defendant's failure to mention a Form 483 was reckless." The court noted, for example, that plaintiffs could point to "a pattern of FDA feedback reflecting the same unresolved concerns," or "statements by confidential former employees reflecting that the problems identified in the Forms 483 were pervasive enough that they could not be readily remedied." The court found the "[p]laintiff here pleads no such additional facts, instead relying on the conclusory allegation that the

Form 483's observations alone rendered [d]efendants' public statements knowingly or recklessly misleading."

Delaware Chancery Court: Directors Do Not Face a Substantial Likelihood of Liability for Failing to Disclose Information They Did Not Know

On April 28, 2020, the Delaware Chancery Court held that a majority of the directors who considered the demand (the "demand board") did not face a substantial likelihood of liability for allowing or failing to correct allegedly inaccurate management representations concerning the company's ability to meet its revenue guidance, because management had "regularly advis[ed]" the directors that the company "was on track to . . . hit its revenue guidance." *In re GoPro Stockholder Derivative Litigation*, 2020 WL 2036602 (Del. Ch. 2020) (Slights, V.C.). The court found that "[t]he Board was under no obligation to disclose what it did not know or did not believe to be true," nor was it "obliged to doubt the information it was receiving from [the company's] managers." The court therefore dismissed with prejudice plaintiffs' derivative action for failure to plead demand futility.

The court began its analysis by describing the complaint as "a model of . . . imprecision." Plaintiffs alleged, on the one hand, that the directors "caused [the company] publicly to issue false statements regarding the status of its new product releases and the corresponding projections of revenue." But plaintiffs also alleged, on the other hand, that the directors "failed to act when they consciously failed to monitor the information and reporting systems that could have prevented the same false statements." The court noted that "when the plaintiff struggles consistently to characterize the nature of the underlying wrongful conduct that gives rise to his claims, this imprecision signals that he may not have pled such conduct *with particularity*." *Id.* (emphasis in original).

As to the first theory of liability, the court recognized that "directors who knowingly make materially misleading statements to stockholders may be considered to be interested for the purposes of demand." But the court found plaintiffs failed to allege any particularized facts supporting the inference that the directors "contributed to and approved [the company's] revenue guidance while knowing it was impossible for the [c]ompany to achieve the projected results." The court underscored that "Board *acquiescence* cannot support an inference of *affirmative* Board-level misconduct." The court explained that "[e]ven if the Board were told by its management that the [c]ompany was not going to meet its revenue projections, and then did nothing as management publicly stood by its market guidance, that factual predicate would support a classic *Caremark* claim for failing to respond to red flags, not a claim against the Board for causing the [c]ompany to make false disclosures."

The court also found it significant that plaintiffs failed to "offer a conceivable explanation of *why* a majority of the Demand Board would cause the [c]ompany to release false statements to the market knowing full well" that the market would learn the truth "within a matter of weeks." Given the lack of "a legally cognizable explanation for why the [d]emand [b]oard would lie so openly, especially when they were virtually certain to be caught in the lie," the court determined that it was "unreasonable to infer bad faith malfeasance."

As to the second theory of liability (the *Caremark* claim), the court found plaintiffs' core allegation was that "a majority of the Demand Board *knew* there was no way [the company] would meet its revenue guidance and yet it failed to cause that guidance to be corrected or to prevent management from continuing to report that the guidance was unattainable." The court rejected plaintiffs' argument that the directors were required to access the company's internal data and "extrapolate on [their] own that the [c]ompany" would have challenges meeting its revenue guidance. The court explained that "the duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise." The court also found no basis for inferring that "the Board *knew* the [c]ompany would miss its guidance or consciously disregarded risk." The court emphasized that "[p]laintiffs cannot equate a bad outcome with bad faith."

New York Supreme Court: No Duty to Update Business Issues That Were Not Discussed in the Registration Statement

On May 6, 2020, a New York state court dismissed a securities fraud action alleging claims under Sections 11 and 12(a)(2) of the Securities Act of 1933. [*Hoffman v. AT&T*, 2020 WL 2236189 (N.Y. Sup. Ct. 2020) (Ostrager, J.)]. The court held that defendants had no duty to update the Registration Statement to address declines in subscriptions for one of the company's business services, because the Registration Statement made no specific representations concerning that business service.

The court stated that "[g]enerally, Section 11 liability is judged from the effective date of the Registration Statement." However, the court noted that "Item 512(a) of Regulation S-K requires an issuer to file a post-effective amendment in specified circumstances," including when "'facts or events arising after the effective date of the registration statement . . . represent a fundamental change in the information set forth in the registration statement." *Id.* (quoting 17 C.F.R. § 229.512(a)(1)(ii)).

In the case before it, the court found that "no duty to issue a post-effective amendment was triggered." First, the court explained that "the text of the Registration Statement itself does not contain any reference to" the relevant business service. Rather, "[t]he only references to [the business service] that were part of the Registration Statement were a few references to a 'strong' launch contained in [two SEC filings] that were incorporated by reference." The court agreed with defendants that "there can be no duty to update information that was not contained in the Registration Statement in the first place."

Second, the court held that "even if there was a duty to make a post-effective amendment about a topic that was not explicitly set forth in the Registration Statement, the changes plaintiff alleges to [the business service] do not represent a 'fundamental change' within the meaning of the Securities Act." The court noted that "[t]he SEC has provided examples of 'fundamental changes' that trigger a duty to issue a post-effective amendment." These include "major changes in the issuer's operations, such as significant acquisitions or dispositions, and any change in the business or operations of the registrant that would necessitate a restatement of the financial statements." The court explained that the changes to the subscribership of the business service at issue did "not constitute a fundamental change" under the guidance provided by the SEC, as subscribers to that service "represented less than 1%" of subscribers to the company's subscription-based services, which, in turn, represented "only one part of [the company's] overall business."

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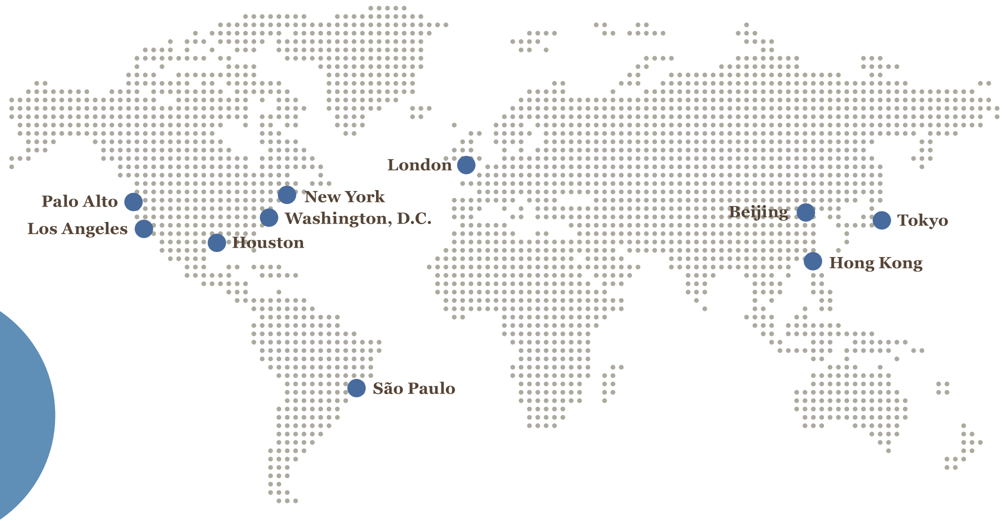

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